CHIEF INVESTMENT OFFICE

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Income and Transfer Tax Proposals in Administration's Fiscal Year 2023 Budget

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INTRODUCTION

On March 28, 2022, the Biden Administration released its fiscal 2023 Budget. On that same date, the Treasury Department released its General Explanations of the Administration's Fiscal Year 2023 Revenue Proposals (known as the Greenbook), which includes a more detailed discussion of the various tax proposals in the President's Budget. Included among the Budget's dozens of proposed tax changes are modifications to correct perceived loopholes, adjustment to rates and even some unconventional changes such as imposing a tax on unrealized appreciation. In aggregate, the tax proposals would generate an additional $2.5 trillion of revenue over the 10-year budget window. These proposals are in addition to the nearly $1.6 trillion in new taxes proposed in the House's Build Back Better Act.

These are only proposals, some of which are new and many of which have been proposed before and rejected by the Democrat-controlled House of Representatives. Given the very slim margins of Democratic control of Congress, it is by no means a certainty that these proposals will become law. Nevertheless, the proposals provide insight into the President's plan for tax reform. It is also possible that one or more of these proposals could be incorporated into future compromise legislation. This Tax Alert summarizes certain of these proposals relating to income and transfer tax and discusses some of the proposals in more detail.

Below is a summary of some of the proposed tax changes included in the President's Budget:

Individual Income Tax

- Re-impose top 39.6% income tax rate on taxable income over $450,000 for married couples and $400,000 for single taxpayers. Effective for tax years beginning on or after January 1, 2023. Revenue estimate $187 billion.
- Eliminate preferential capital gains and dividend tax rates for those with taxable income exceeding $1 million (married couples and single taxpayers) and only to extent income exceeds such threshold. The $1 million threshold would be indexed for inflation after 2023. Effective for gain recognized and dividends received after date of enactment. Revenue estimate $174 billion.
- Impose a new minimum income tax on high net worth taxpayers equal to 20% of total income, which would include unrealized gains. Revenue estimate $361 billion.

Estate, Gift and GST Tax

- Transfers of appreciated property by gift or upon death (and in some cases, to and from partnerships and trusts) treated as an income tax realization event. Revenue estimate included in the $174 billion above.
- Increase special use valuation deduction for certain real estate. No specific revenue estimate.
- Modify tax rules for grantor trusts. Revenue estimate $41.5 billion.
- Curtail rules for Grantor Retained Annuity Trusts. Revenue estimate included above.
- Consistent valuation rules for certain assets. Revenue estimate $6.3 billion.
- Limit duration of generation-skipping transfer tax exempt trust to no more than two generations below the taxpayers. No revenue estimate.
- Impose a new requirement for reporting estimated total value of trust assets. No revenue estimate.

Corporate and Other

- Increase top corporate income tax rate to 28%. Effective for tax years beginning on or after January 1, 2023 (but could apply on a pro-rata basis for tax years straddling 2022 and 2023). Revenue estimate $1.3 trillion.
- Impose a tax on the unrealized appreciation of property held by a trust, partnership or other non-corporate entity if such property has been held for over 90 years (and not subject to a gains tax during that period). Ninety years would be measured from December 31, 1939, so the first recognition event would be deemed to occur on December 31, 2030.
- Modify rules for deferral of gain from like-kind exchanges. Revenue estimate $19.5 billion.
- Tax carried (profits) interests as ordinary income. Revenue estimate $6.6 billion.
- Require full recapture of depreciation deductions as ordinary income for certain depreciable real property. Revenue estimate $6.3 billion.
- Limit use of Donor Advised Funds to avoid private foundation payout rules. Revenue estimate $64 million.
- Modernize taxation of digital assets. Revenue estimate $11 billion.

SELECTED PROVISIONS OF THE PRESIDENT'S BUDGET BILLIONAIRE'S TAX

New Minimum Income Tax of 20%. Current tax law imposes a tax on only recognized gains, with very limited exceptions. Generally the appreciation of assets without a corresponding sale of the underlying assets does not trigger an income tax event. The Biden Administration, in an effort to "reduce economic disparities among Americans and raise needed revenue," seeks a dramatic change to long-standing rules by imposing a tax on unrealized gains for a limited group of taxpayers. This proposal is targeted to raise an estimated $361 billion in new revenue from only 0.01% of households.

In our view, it is highly unlikely such a proposal would become law. Several recent attempts to impose a wealth tax or tax on unrealized appreciation have been met with concerns over constitutional issues and unnecessary complexity, let alone lack of support. The current proposal, while not specifically a wealth tax, will likely confront many of the same issues and concerns. It is interesting to note that President Biden did not support a wealth tax during the primary elections but is now supporting it by means of a somewhat similar "unrealized appreciation" tax. Moreover, Senator Joe Manchin appears

BUILD BACK BETTER

What does the President's budget mean for the status of the Build Back Better Act? The President's budget does not directly reference the House's Build Back Better Act which stalled in Congress in late December 2021, but many of the current spending priorities are similar in nature. Because discussions with the Congress continue, the President's Budget "includes a deficit neutral reserve fund to account for future legislation, preserving the revenue from proposed tax and prescription drug reforms for the investments needed to bring down costs for American families and expand our productive capacity." In other words, the President does not want to publicly interfere with the sensitive negotiations taking place over a skinny version of the House's Build Back Better Act. Rather, the President merely mentions that his approach is "working collaboratively with the Congress to shape this legislation; and fully paying for the long-term costs of all new investments and reducing the deficit."

However, a "skinny" version of Build Back Better, by some other name, may not be dead. It appears that Senator Manchin remains open to a smaller and tailored version of BBB, which could focus on climate change, domestic energy production, drug price negotiation, tax increases in the range of $1.2 trillion and deficit reduction.

not to support the proposal, stating that you cannot be taxed "on things you don't have." Although this proposal likely goes nowhere, we would expect Democrats to campaign on higher taxes for billionaires this fall and would expect continued future proposals for such a tax from various Democrats.

The "Billionaire Tax" proposal would impose a new annual minimum tax equal to 20% of total income, only for taxpayers with net wealth (assets less liabilities) exceeding $100 million. "Total income" would be the sum of taxable income and unrealized gain on capital assets and ordinary assets. To arrive at the minimum tax, the product of 20% of total income would be reduced by the current year's regular tax and by prior minimum tax payments.

The minimum tax could be paid all at once or at the election of the taxpayer in five equal annual installments (or nine equal annual installments with respect to the first year of the minimum tax liability).

The minimum tax would apply to taxpayers with net wealth of $100 million, but would not fully phase in until net wealth exceeded $200 million.

Valuation of Assets—Taxpayers with wealth greater than $100 million would be required to report to the IRS on an annual basis, separately by asset class, the total basis and total December 31 estimated value of their assets in each specified asset class, along with the total amount of their liabilities.

Tradeable assets (i.e., publicly traded stock) would be valued using end-of-year market prices. Non-tradeable assets would be valued using the greater of the original or adjusted cost basis, the last valuation event from investment, borrowing, or financial statements, or other methods approved by Treasury (annual market valuations would not be required). Valuations of non-tradeable assets would not be required annually: instead their values would be increased by a conservative floating annual return (the five-year Treasury rate plus two percentage points) in between valuations.

If a taxpayer is considered as "illiquid" the taxpayer could elect to include only unrealized gain in tradeable assets in the calculation of their minimum tax liability. A taxpayer making such election would then be subject to a deferral charge on the realization of gains from non-tradeable assets. As proposed, the deferral charge would not exceed 10% of unrealized gains. A taxpayer would be treated as "illiquid" if their tradeable assets make up less than 20% of the taxpayer's wealth.

Effective date: The new minimum tax is proposed to be effective for taxable years beginning on or after January 1, 2023.

INDIVIDUAL TAX REFORM

Increase the top marginal income tax rate for high earners. The proposal would increase the top marginal tax rate to 39.6%. The top marginal tax rate would apply to taxable income over $450,000 for married individuals filing a joint return, and $400,000 for unmarried individuals (other than surviving spouses). These thresholds are lower than the current levels at which taxpayers pay the top income tax rate. After 2023, the thresholds would be indexed for inflation. The proposal would be effective for taxable years beginning after December 31, 2022.

Tax capital income for high-income earners at ordinary rates. Long-term capital gains and qualified dividends of taxpayers with taxable income of more than $1 million would be taxed at ordinary rates, with 37% being the highest rate for 2022 (40.8% including the net investment income tax) and 39.6% being proposed for 2023. The proposal would only apply to the extent that the taxpayer's taxable income exceeds $1 million ($500,000 for married filing separately). The threshold would be indexed for inflation after 2023. The proposal would be effective for gain required to be recognized and for dividends received on or after the date of enactment.

ESTATE, GIFT AND GST REFORM

Transfers of appreciated property by gift or on death as realization events. Under the proposal, the donor or deceased owner of an appreciated asset would realize a capital gain at the time of a transfer. The amount of the gain realized would be the excess of the asset's fair market value on the date of the gift or on decedent's date of death over the decedent's basis in that asset. That gain would be taxable income to the donor or decedent. Capital losses and carry-forwards from transfers at death would be allowed against capital gains and up to $3,000 of ordinary income on the decedent's final income tax return, and the tax imposed on gains deemed realized at death would be deductible on the estate tax return of the decedent's estate (if any).

A transfer would be defined under the gift and estate tax provisions and would be valued at the value used for gift or estate tax purposes. However, for purposes of the imposition of this capital gains tax, the following would apply: first, a transferred partial interest generally would be valued at its proportional share of the fair market value of the entire property, provided that this rule would not apply to an interest in a trade or business to the extent its assets are actively used in the conduct of that trade or business, and second, transfers of property into and distributions in kind from a trust, other than a grantor trust that is deemed to be wholly owned and revocable by the donor, would be recognition events, as would transfers of property to, and by, a partnership or other non-corporate entity, if the transfers have the effect of a gift to the transferee.

The deemed owner of a revocable grantor trust would recognize gain on the unrealized appreciation in any asset distributed from the trust to any person other than the deemed owner or the U.S. spouse of the deemed owner, not including distributions made in discharge of an obligation of the deemed owner. All of the unrealized appreciation on assets of such a revocable grantor trust would be realized at the deemed owner's death or at any other time when the trust becomes irrevocable.

Certain exclusions would apply. Transfers to a U.S. spouse or to charity would carry over the basis of the donor or decedent.

Capital gain would not be realized until the surviving spouse disposes of the asset or dies, and appreciated property transferred to charity would be exempt from capital gains tax. The transfer of appreciated assets to a split-interest (charitable) trust would be subject to this capital gains tax, with an exclusion from that tax allowed for the charity's share of the gain based on the charity's share of the value transferred.

The proposal would exclude from recognition any gain on all tangible personal property such as household furnishings and personal effects (excluding collectibles). The $250,000 per-person exclusion under current law for capital gain on a principal residence would apply to all residences and would be portable to the decedent's surviving spouse, making the exclusion effectively $500,000 per couple. Finally, the exclusion under current law for capital gain on certain small business stock would also apply.

In addition to the above exclusions, the proposal would allow a $5 million per-donor exclusion from recognition of other unrealized capital gains on property transferred by gift during life. This exclusion would apply only to unrealized appreciation on gifts to the extent that the donor's cumulative total of lifetime gifts exceeds the basic exclusion amount in effect at the time of the gift. In addition, the proposal would allow any remaining portion of the $5 million exclusion that has not been used during life as an exclusion from recognition of other unrealized capital gains on property transferred by reason of death. This exclusion would be portable to the decedent's surviving spouse under the same rules that apply to portability for estate and gift tax purposes and would be indexed for inflation after 2022. The recipient's basis in property, whether received by gift or by reason of the decedent's death, would be the property's fair market value at the time of the gift or the decedent's death.

In some instances, a taxpayer can elect to defer the gain. Taxpayers could elect not to recognize unrealized appreciation of certain family-owned and -operated businesses until the interest in the business is sold or the business ceases to be family-owned and operated. Furthermore, the proposal would allow a 15-year fixed-rate payment plan for the tax on appreciated assets transferred at death, other than liquid assets such as publicly traded financial assets and other than businesses for which the deferral election is made.

The proposal would be effective for gains on property transferred by gift, and on property owned at death by decedents dying, after December 31, 2022, and on certain property owned by trusts, partnerships, and other non-corporate entities on January 1, 2023.

Grantor Retained Annuity Trusts (GRATs). The proposal would require that the remainder interest in a GRAT at the time the interest is created have a minimum value for gift tax purposes equal to the greater of (i) 25% of the value of the assets transferred to the GRAT or (ii) $500,000 (but not more than the value of the assets transferred).

In addition, the proposal would prohibit any decrease in the annuity during the GRAT term and would prohibit the grantor from acquiring in an exchange an asset held in the GRAT without recognizing gain or loss for income tax purposes. Finally, the proposal would require that a GRAT have a minimum term of ten years and a maximum term of the life expectancy of the annuitant plus ten years. These provisions would significantly diminish the appeal of GRATs as an estate planning tool. This proposed change would apply to all GRATs created on or after the date of enactment.

Other Trusts. For trusts that are not fully revocable by the deemed owner, the proposal would treat the transfer of an asset for consideration between a grantor trust and its deemed owner or any other person as a gain recognition event for income tax purposes, which would result in the seller recognizing gain on any appreciation in the transferred asset. The basis of the transferred asset in the hands of the buyer would then become the value of the asset at the time of the transfer. Such transfers would include sales as well as the satisfaction of an obligation (such as an annuity or unitrust payment) with appreciated property.

This proposal would apply to all transactions between a grantor trust and its deemed owner occurring on or after the date of enactment. It is expected that the legislative language providing for such an immediate effective date would appropriately detail the particular types of transactions to which the new rule does not apply.

Income Tax Paid on Grantor Trusts. The proposal also would provide that the payment of the income tax by the grantor on the income of a grantor trust is a gift. That gift occurs on December 31 of the year in which the income tax is paid (or, if earlier, immediately before the owner's death, or on the owner's renunciation of any reimbursement right for that year) unless the deemed owner is reimbursed by the trust during that same year. The amount of the gift is the unreimbursed amount of the income tax paid.

This proposal would apply to all trusts created on or after the date of enactment.

Limit duration of generation-skipping transfer tax exemptions. The proposal would provide that the GST exemption would apply only to: (a) direct skips and taxable distributions to beneficiaries no more than two generations below the transferor, and to younger generation beneficiaries who were alive at the creation of the trust; and (b) taxable terminations occurring while any person described in (a) is a beneficiary of the trust. Certain rules regarding taxation of multiple skips would not apply for these purposes. In addition, solely for purposes of determining the duration of the exemption, a pre-enactment trust would be deemed to have been created on the date of enactment. The result of these proposals is that the benefit of the GST exemption that shields property from the GST tax would not last as long as the trust. Instead, it would shield the trust assets from GST tax only as long as the life of any trust beneficiary who either is no younger than the transferor's grandchild or is a member of a younger generation but was alive at the later of the enactment date of this proposal or the creation of the trust.

The proposal would apply on and after the date of enactment to all trusts subject to the generation-skipping transfer tax, regardless of the trust's inclusion ratio on the date of enactment.

Mandatory Reporting of Trust Assets. The IRS has no statistical data on the magnitude of wealth held by domestic trusts. The Administration believes that the lack of this data hampers efforts to design tax policies intended to increase the equity and progressivity of the tax system. Therefore, the Administration proposes a requirement that certain trusts report to the IRS on an annual basis. The report would include the name, address, and tax identification number of each trustee and grantor of the trust, and general information with regard to the nature and estimated total value (or range of value) of the trust's assets. Reporting would only apply to a trust whose estimated total value on the last day of the taxable year exceeds $300,000 or whose gross income for the taxable year exceeds $10,000. The proposal would apply for taxable years ending after the date of enactment.

BUSINESS TAX REFORM

Raise the corporate income tax rate to 28%. The proposal would increase the tax rate for C corporations from 21% to 28%. The proposal would be effective for taxable years beginning after December 31, 2022. For taxable years beginning before January 1, 2023, and ending after December 31, 2022, the corporate income tax rate would be equal to 21% plus 7% times the portion of the taxable year that occurs in 2023.

Tax carried (profits) interests as ordinary income. The proposal would generally tax as ordinary income a partner's share of income on an "investment services partnership interest" (ISPI) in an investment partnership, regardless of the character of the income at the partnership level, if the partner's taxable income (from all sources) exceeds $400,000. Accordingly, such income would not be eligible for the reduced rates that apply to long-term capital gains.

In addition, the proposal would require partners in such investment partnerships to pay self-employment taxes on ISPI income if the partner's taxable income (from all sources) exceeds $400,000. In order to prevent income derived from labor services from avoiding taxation at ordinary income rates, this proposal assumes that the gain recognized on the sale of an ISPI would generally be taxed as ordinary income, not as capital gain, if the partner is above the income threshold.

The proposal goes on to explain several defined terms such as "ISPI," an "investment partnership," a "qualified capital interest," "invested capital," among other terms. The proposal is not intended to adversely affect qualification of a real estate investment trust owning a profits interest in a real estate partnership.

The proposal would be effective for taxable years beginning after December 31, 2022.

Gain on certain unrealized appreciation. The proposal would trigger gain on unrealized appreciation for a trust, partnership, or other non-corporate entity that is the owner of property if that property has not been the subject of a recognition event within the prior 90 years. This provision would apply to property not subject to a recognition event since December 31, 1939, so that the first recognition event would be deemed to occur on December 31, 2030.

Recapture of depreciation deduction as ordinary income for certain depreciable real estate. Generally the sale of real estate used in a trade or business results in a capital gain taxed at preferential tax rates. A portion of that gain, however, could be depreciation recapture and taxed at 25%. Under the proposals, long-term gain attributable to depreciation recapture would be treated as ordinary income to the extent of the cumulative depreciation deductions taken after the effective date of the provision. Depreciation deductions taken prior to the effective date would continue to be subject to current rules and recaptured as ordinary income only to the extent such depreciation exceeds the cumulative allowances determined under the straight-line method. Any unrecaptured gain on section 1250 property would continue to be taxed to non-corporate taxpayers at a maximum 25% rate. The proposal would not apply to non-corporate taxpayers with adjusted taxable income below $400,000 ($200,000 for married individuals filing separate returns). The proposal would be effective for depreciation deductions taken on section 1250 property in taxable years beginning after December 31, 2022, and sales, exchanges, involuntary conversions, or other dispositions of section 1250 property completed in taxable years beginning after December 31, 2022.

CONCLUSION

For now these are only budget proposals, not even legislative proposals. Given the difficulty of passing the Build Back Better Act, it is unlikely that the President's tax proposals will find their way into proposed legislation. Due to the possibility of a Republican-controlled House in the next session of Congress, these tax proposals may be nothing more than campaign talking points.

— National Wealth Strategies, Chief Investment Office