PALLAS
CAPITAL ADVISORS

It's Greenbook Time

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Decent-Sized Proposals

At the end of last month, the Biden administration released its General Explanations of the Administration's Fiscal Year 2023 Revenue Proposals, (the 2023 *Greenbook*). In the *Greenbook*, nearly 50 proposals total 114 pages and represent the first comprehensive tax revenue-raising proposals from the administration since *Build Back Better* failed to advance in Congress late last year.

Greenbook proposals are interesting because they describe in detail the administration's current thinking about increasing tax revenue, and, if history is any indication, will foreshadow what the Biden administration will advance publicly.

In this month's newsletter we will cover **just a few** of the nearly 50 proposals that, if enacted into law, would impact millions of taxpayers in terms of income and estate taxation. To reduce the potential for error in interpretation, in many cases we will simply report what the Greenbook says and avoid commentary. Of course, we encourage the reader to get a more comprehensive overview by clicking the link to the Greenbook above.

Issues Addressed in the Proposals that Affect Affluent Taxpayers:

- **Prevent basis shifting by related parties through Partnerships**

  - A partnership is permitted to make a section 754 election to adjust the basis of its property when it makes certain distributions of money or property to a partner. For example, if a partnership distributes property to a partner and the partnership has a section 754 election in effect, the partnership may increase ("step-up") the basis of its non-distributed property.
  - The proposal would reduce the ability of related parties to use a partnership to shift partnership basis among themselves. In the case of a distribution of partnership property that results in a step-up of the basis of the partnership's non-distributed property, the proposal would apply a matching rule that would prohibit any partner in the distributing partnership that is related to the distributee-partner from benefitting from the partnership's basis step-up until the distributee-partner disposes of the distributed property in a fully taxable transaction.

- **Increase the top marginal income tax rate**

  - For taxable years beginning after December 31, 2017, and before January 1, 2026, the top marginal tax rate is 37%. For taxable years beginning after December 31, 2025, the top marginal tax rate for individual income tax is 39.6%.
  - The proposal would increase the current 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, $400,000 for unmarried individuals (other than surviving spouses), $425,000 for head of household filers, and $225,000 for married individuals filing a separate return.

- **Reform the taxation of capital income**

  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% generally being the highest rate (40.8% including the net investment income tax).
  - The proposal would only apply to the extent that the taxpayer's taxable income exceeds $1 million ($500,000 for married filing separately), indexed for inflation after 2023.

<u>Treat transfers of appreciated property by gift or on death as "realization events"</u>

- O Under the proposal, the donor or deceased owner of an appreciated asset would realize a capital gain at the time of the transfer (either during lifetime or at death). 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 decedent on the Federal gift or estate tax return or on a separate capital gains return.
- O Transfers of property into, and distributions in kind from a trust, other than a grantor trust that is deemed to be wholly-owned and **<u>revocable by the donor</u>**, 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.
- O Gain on unrealized appreciation also would be recognized by a trust, partnership, or other noncorporate 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.
- O Under the proposals 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 trust (such as Charitable Remainder Trust - CRT) 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 as determined for gift or estate tax purposes.
  - 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.
  - The exclusion under current law for capital gain on certain small business stock would also apply (Section 1202 – qualified small business stock – QSBS).
  - A key change from the prior attempt to enact deemed realization events as a trigger for tax is that now 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.
  - The $5 million exclusion would be portable to the decedent's surviving spouse under the same rules that apply to portability for estate and gift tax purposes (resulting in a married couple having an aggregate $10 million exclusion) and would be indexed for inflation after 2022.

- O The proposal also includes deferral options:

  - 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.

► **Impose a minimum income tax on taxpayers with assets greater than $100 million (so-called "Billionaires'" Income Tax)**

- O The proposal would impose a minimum tax of 20% on total income, **<u>generally inclusive of unrealized capital gains</u>**, for all taxpayers with wealth of an amount greater than $100 million. (Clearly the "Billionaires" nomenclature is designed to curry favor with voters).

- O The amount of minimum tax paid as a result of the unrealized gain could be used as a credit on a future disposition of that asset. There are provisions phasing in the tax for those over $100 million but under $200 million.
- O The proposal requires those with wealth over the threshold to file annual returns reporting by asset class the total basis and estimated value as of Dec. 31. The proposal also includes methodology for valuing non-tradable assets, and suggests the IRS may offer avenues for taxpayers to challenge a valuation.
- O Under this proposal, taxpayers could choose to pay the first year of minimum tax liability in nine equal, annual installments. For subsequent years, taxpayers could choose to pay the minimum tax imposed for those years (not including installment payments due in that year) in five equal, annual installments.

▶ Modify income, estate, and gift tax rules for certain grantor trusts

The insurance industry lobbied hard against last fall's *House Ways and Means Committee* proposal to cause additional gifts to an irrevocable grantor trust to result in that trust's property being included in the grantor's taxable estate. Such rules would have been highly problematic for the common-place irrevocable life insurance trust- where annual gifts are usually necessary to fund the insurance premiums.

With the latest (arguably more limited) proposals concerning grantor trusts, the concerns of the life insurance industry are significantly decreased or eliminated. Thus, the lobbying power of that industry should be somewhat weakened.

- O The proposals would substantially limit the tax benefits of grantor-retained annuity trusts (GRATs) by calling for changes previously proposed by the Obama administration. 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 25% of the value of the assets transferred to the GRAT or $500,000 (but not more than the value of the assets transferred).
    - Would prohibit any decrease in the annuity during the GRAT term and would prohibit the grantor from acquiring an exchange an asset held in the trust without recognizing gain or loss for income tax purposes.
    - 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.

- O For trusts that are not fully revocable by the deemed owner, the proposal would treat the transfer of an asset **<u>for consideration</u>** between a grantor trust and its deemed owner or any other person as one that is regarded for income tax purposes, which would result in the seller recognizing gain on any appreciation in the transferred asset and the basis of the transferred asset in the hands of the buyer being the value of the asset at the time of the transfer. This would limit the effectiveness of the popular sale to an intentionally defective grantor trust (IDGT) strategy.
- O The proposal also would provide that the payment of the income tax on the income of a grantor trust is a gift.

▶ Require consistent valuation of promissory notes

- O The proposals would eliminate the ability to value intra-family loans and/or sales that were made in exchange for a promissory note at FMV for gift tax purposes (to avoid the transfer being treated as a gift) and then later discount the value of the note for estate tax purposes. Under current law this promissory note "arbitrage" can result in significant additional value transferred to the next generation.

▶ "Improve" tax administration for trusts and estates

- O The proposals would require all trusts with an estimated value over $300,000 at the end of a taxable year or $10,000 of income to report information about its grantor, trustees, and "general information with regard to the nature and estimated total value of the trust's assets as the Secretary might prescribe." Although it is difficult to imagine how the IRS would police such a rule, if enacted, this requirement would provide the IRS with very helpful information in order to identify trusts it wants to audit.

- A repeat proposal relates to IRC Section 6324, which provides a special estate tax lien to secure the payment of unpaid estate and gift taxes. Unless the tax liability is paid, the lien remains for 10 years. The problem, from the IRS's standpoint, is that if there is a deferral of estate taxes in excess of 10 years, for example, when an IRC Section 6166 election for a closely held business is made, then the lien expires before full payment is made. The 2023 Greenbook adds a proposal to have the lien continue during any deferral or installment payment period.
- Surprisingly, a proposal that is more favorable for the taxpayer is also included. For estate tax purposes, the FMV of property is generally determined at the property's highest and best use. There's an optional valuation election that can be made under IRC Section 2032A for when qualified real property or personal property can have its value reduced to reflect its actual use. This election applies only to property used for farming or in a trade or business where the property comprised a substantial part of the estate and the reduction in value was capped at $1.23 million for decedents dying in 2022. The proposal would increase this cap to $11.7 million effective for those dying on or after the election date.

Limit duration of generation-skipping transfer (GST) tax exemption

- Under the proposals, the GST tax-exempt status would apply only to "beneficiaries no more than two generations below the transferor, and to younger generation beneficiaries who were alive at the creation of the trust…"
- This means only transfers to the taxpayer's children, grandchildren, and those great-grandchildren (or younger) who were alive when the trust was created will be able to be GST Tax-exempt. For purposes of this proposal, pre-enactment trusts will be treated as having been created on the enactment date in identifying what beneficiaries are alive.

Tax carried (profits) interests as ordinary income

- Under current law, carried interests that investment professionals may earn on certain investment partnerships are taxed at more favorable capital gains rates.
- 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.
- If the top income tax bracket is increased to 39.6%, and self-employment tax is also due, this could represent an almost doubling of tax costs for these investment professionals.

Limit deferral of gain from like-kind exchanges of real property

- The proposal would limit the deferral of gain up to an aggregate amount of $500,000 for each taxpayer ($1 million in the case of married individuals filing a joint return) each year for real property exchanges that are like-kind (Section 1031 exchanges). Any gains from like-kind exchanges in excess of $500,000 (or $1 million in the case of married individuals filing a joint return) a year would be recognized by the taxpayer in the year the taxpayer transfers the real property subject to the exchange.

Limit use of donor advised funds (DAFs) to avoid private foundation payout requirement

- The proposal would clarify that a distribution by a private foundation to a DAF is not a qualifying distribution unless (a) the DAF funds are expended as a qualifying distribution by the end of the following taxable year and (b) the private foundation maintains adequate records or other evidence showing that the DAF has made a qualifying distribution within the required time frame.

Conclusion

It remains to be seen how much, if any, of the proposals become reality. Recently, some speakers at the nation's largest estate planning conference speculated that it was unlikely for any of this to get enacted. However, we've learned that it is a fool's errand to try to accurately predict law changes at a time when most of the country is dealing with record high inflation, a war in Ukraine, and the prolonged impact of Covid-19.

That said, it appears the administration is responding to some of the criticism of the *Build Back Better* agenda, with a repackaging that includes specific details to let the proposals find a more favorable reception -- well, at least with 50% of Congress.

Since the significant increase in the Federal Estate Tax exemption level that occurred under the 2017 *Tax Cuts and Jobs Act*, the high-net-worth taxpayer's focus has shifted from planning for transfer taxes to managing and planning for income taxes. Now with even higher income and capital gains taxes looming on the horizon, along with the specter of increased visibility of trust assets by the IRS, individuals need to give even more thoughtful consideration to how they preserve and transfer their wealth.

Charlie Evangelakos, James Landry, and Christie Fitzgerald recording a podcast about the Greenbook in our new recording studio.

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