"Billionaire Tax" Faces Uncertain Prospects

March 29, 2022

The Treasury Department released its [General Explanations of the Administration's Fiscal Year 2023 Revenue Proposals] (the "Greenbook") on March 28. The principal proposals potentially affecting high net worth individuals are summarized below. A discussion of the legislative prospects follows.

THE REVENUE PROPOSALS

The press has focused on the so-called "Billionaire Minimum Income Tax," a proposal designed to "ensure that the very wealthiest Americans pay a tax rate of at least 20% on their full income, ***including unrealized appreciation***." (*Emphasis added*). In addition, the Administration has renewed proposals to strengthen the taxation of high-income taxpayers, reform the taxation of capital income, and tax carried (profits) interests as ordinary income. It also has made significant new proposals to modify the estate, gift, and generation-skipping transfer tax regime.

The "Billionaire Minimum Income Tax"

This new proposal, effective for taxable years beginning after December 31, 2022, would impose a minimum tax of 20% on total income, **generally inclusive of unrealized capital gains**, for all taxpayers with net wealth in excess of $100 million.

In general, the minimum tax liability would be 20% multiplied by the sum of the taxpayer's taxable income and unrealized gains, reduced by payments of regular tax. A payment of the minimum tax would be treated as a prepayment of capital gains tax relating to future sales of capital assets.

Taxpayers could elect to pay the first year of minimum tax liability in nine equal annual installments. Subsequent minimum tax liabilities could be paid in five installments.

The suggested technical rules implementing this proposal are extremely complex, and the proposal will face Constitutional challenges.

Taxation of High-Income Taxpayers

Effective for taxable years beginning after December 31, 2022, the top marginal rate would increase to 39.6% for taxable income above $450,00 for married individuals filing jointly, $400,000 for unmarried individuals (other than surviving spouses), $425,000 for a head of household, and $225,000 for married individuals filing separately. The income thresholds would be indexed for inflation.

Taxation of Capital Income

Long-term capital gains and qualified dividends would be taxed at the highest marginal income tax rate to the extent the taxpayer's taxable income exceeds $1 million.[*] The proposal would be effective for gain recognized and dividends received on or after the date of enactment.

Carried Interests

Effective for taxable years beginning after December 31, 2022, the proposal would generally tax as ordinary income a partner's share of "investment services partnership income" (ISPI) in an investment partnership, if the partner's income from all sources exceeds $400,000. An ISPI is a profits interest in an investment partnership held by a person who provides services to the partnership. An investment partnership is a defined term. Rules are provided to separate the return on a partner's capital investment from the return on services.

Transfer Tax Modifications

<u>Capital Gains Tax on Gift and Estate Transfers of Appreciated Property</u>

The donor or estate of a deceased owner of an appreciated asset would realize and recognize a capital gain at the time of the gift or estate transfer, with specified reporting rules.

The property would be valued at its gift or estate tax value with several special rules. A transfer of a partial interest generally would be valued at its proportional (undiscounted) share of the fair market value of the entire interest, with a special rule for transfers of business interests. Gift or estate transfers of appreciated assets into a trust, other than a trust that is revocable and deemed to be wholly owned by the donor, would be recognition events, as would be distributions of appreciated assets from a trust to beneficiaries. The deemed owner of such 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 U.S. spouse.

Unrealized appreciation in the assets of such a revocable trust would be taxable at the grantor's death or when the trust becomes irrevocable.

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[*] The 3.8% net investment income tax also would apply.

Gift or estate transfers to charity and surviving spouses would not be realization events. Carryover basis would apply.

Gift or estate transfers of tangible personal property (other than collectibles) would be excluded from the deemed realization rules. The $250,000 exclusion for capital gain on the sale of a principal residence would apply and be portable to the decedent's spouse. The current law exclusion for capital gain on the sale of qualified small business stock would continue to apply.

In a significant expansion from the Administration's FY 2022 proposal, the current proposal allows a portable $5 million per-donor exclusion from gain recognition for property transferred by gift 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. The proposal would allow any remaining portion of the $5 million exclusion that was not used during life to be used at death. The recipient of such property would receive a basis equal to the property's fair market value at the time of the gift or the decedent's death.

For owners of certain farms and closely held businesses, a special election would be available to defer tax until the business is sold or ceases to be family owned and operated. Owners of illiquid assets could elect a 15-year fixed rate payment plan.

In addition to unspecified additional proposals to implement this regime, explicit regulatory authority is provided to draft regulations or guidance relating to rules and safe harbors for determining basis when complete records are not available.

The Treasury also proposes a periodic tax on unrealized appreciation in property held in trust that has not been the subject of a recognition event within the prior 90 years.

The proposed changes would apply to gifts made after December 31, 2022, and to the estates of decedents dying after December 31, 2022.

GRATS

The remainder interest in a GRAT would have to have a minimum value of the greater of 25% of the value of the assets transferred to the trust or $500,000. There could be no decrease in the amount of the annuity over the term of the GRAT. The exchange of an asset held in a GRAT would result in a recognition event to the grantor. A newly formed GRAT must have a minimum term of ten years and a maximum term of the life expectancy of the annuitant plus ten years. The proposal would be effective for GRATs created on or after the date of enactment.

Sales to Grantor Trusts

Sales to grantor trusts that are not fully revocable by the deemed owner would be recognition events. The unreimbursed portion of the income tax paid by the deemed owner would be a gift in the year paid. The proposal would be effective for transactions occurring on or after the date of enactment.

Generation-Skipping Transfer Tax Exemption

In order to assure the periodic taxation of property in long-term trusts, the GST tax 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 of the foregoing is a beneficiary of the trust. The proposal would apply on or after the date of enactment to all trusts subject to the GST tax.

THE LEGISLATIVE PROSPECTS

Predicting the content of prospective tax legislation is at best a tricky process. It is especially so this year.

First is the economic context. The President's Budget, of which the tax proposals are a part, is an opening bid in addressing the economic situation the country faces. Over ten years, the Treasury estimates that the tax proposals will raise $2,513 billion, of which roughly $775 billion is attributable to the proposals discussed above. The extent to which tax increases of that magnitude will be acceptable is an open question. Suffice it to say that this would represent the largest tax increase in history.

Second is the legislative procedural path to enactment. Constitutionally, tax legislation must begin in the House of Representatives. The House has passed its version of the President's "Build Back Better" agenda. That legislation does not contain any of the President's current tax proposals, although it does contain a surcharge on high-income individuals, estates, and trusts.

The House-passed bill can be the vehicle for the Senate to move the tax legislation. That bill is being considered under the special "reconciliation" process that eliminates normal Senate procedural requirements and enables legislation to be passed with a majority vote. Assuming all Democrats vote for it, the Vice President can break the tie. Hence the importance of satisfying Senators Manchin and Sinema.

If the Senate passes a bill, it will go to "conference" with the House and the differences between the two bills will be resolved.

Finally, procedural hurdles aside, one must confront the content of the legislation. Apart from the extraordinarily complex, constitutionally suspect Billionaire Minimum Income Tax, the bulk of the President's tax proposals were in last year's budget and garnered no legislative support.

It is fair to ask whether it will be any different this year. While lip service is paid to the notion that the tax system should be used to address wealth and income inequality, Congress has shown scant appetite to confront the issue. Moreover, an election year is not typically when bold moves would be made.

All of this would indicate that enactment of these proposals is a long shot. But stranger things have happened. We will monitor progress and keep you informed as the debate proceeds.

If you have questions, or would like additional information, please contact a member of our Estate Planning Team.