The Biden Administration's "Green Book"

A New Framework for Taxing the Accumulation of Wealth?

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The Biden administration released its 2022 fiscal budget on May 28, calling for over $6 trillion of federal spending for the upcoming fiscal year, a 25% increase over the 2021 budgeted amount of $4.8 trillion. If fully enacted, the 2022 budget represents the largest annual expenditure ever proposed by the U.S. government. Even factoring in the significant tax increases currently under consideration, the proposed spending is anticipated to create a $3.3 trillion fiscal deficit in the upcoming year. And it means that for the first time since World War II, the U.S. government would derive more of its annual funding from borrowing than from tax revenue. The budget release was accompanied by the 114-page "Green Book" which outlines in broad strokes the Treasury's revenue raising and tax proposals for the 2022 fiscal year.

Many, but not all, of these tax proposals were already part of the twin American Jobs and American Families Plans ... the two omnibus Democratic packages currently being debated on Capitol Hill. In the aggregate, these bills together raise the specter of almost $4 trillion of additional tax revenue to be collected over the next decade. But even with these proposed tax increases, the Biden administration is currently projecting annual budget deficits exceeding $1 trillion each and every year over that same decade.

Although one can certainly argue the merits of the various spending and revenue proposals, no one can dispute the fact that that the sheer scale of the numbers is unprecedented. Yes ... somewhere along the way billions became trillions. And the nation is now left with a very fundamental question: *Can the U.S. government ever again be expected to fund itself solely through tax revenue?*

The Political Landscape

Even if a significant portion of the proposed spending increases do not ultimately become law, it seems clear that going forward tax revenue will have to increase substantially in order to keep future budget deficits from spiraling out of control. At this juncture, however, there is no consensus among lawmakers with respect to specifics, and the situation remains fluid. But the fundamental question does not appear to be will there be tax increases, but rather when will they arrive and what might they look like.

The Democrats appear to be proceeding along two parallel rails. On the one hand, they continue to voice a desire for bipartisanship, reaching across the aisle in an attempt to reach consensus on spending with their Republican colleagues. And a bipartisan working group of Senators has, in fact, recently agreed on approximately $1 trillion of "hard" infrastructure spending, supposedly achieved without raising taxes and evidently supported by the White House. On the other hand, Democratic leaders in both chambers of Congress remain vocal in their desire to link passage of this bill with another, with 51 votes in the Senate using Reconciliation, seeking up to an additional $6 trillion of "human infrastructure" spending as originally put forth by Senate Budget Committee Chairman Bernie Sanders (D-VT).

Republicans have remained hopeful that a few moderate Democratic Senators, most notably Joe Manchin (D-WV) and Kyrsten Sinema (D-AZ), would continue to resist any over the top spending bills beyond hard infrastructure. But recently Senator Manchin appeared to voice his tentative support for a pared down Reconciliation bill, which could authorize up to an additional $2 trillion of social and "green" appropriations. So although the outcome of all of this political jockeying remains unclear ... the federal spending spree does not yet appear to be over.

With respect to how to pay for all of this, some observers argue that overall momentum behind tax increases has actually slowed of late, pointing to the lack of legislative progress as well as to the levelling off of certain economic indicators. But President Biden and the Democratic majority have steadfastly maintained that taxes must rise significantly going forward [although sparing those with adjusted gross taxable income (AGI) under $400,000]. Specific tax increases have been floated for many months now ... predating even last fall's presidential campaign. Some proposals have survived while others have fallen by the wayside. But those that appear in the recently released Green Book are those that have presumably "made the cut" and thus represent the current thinking in the White House. And although the Green Book does not represent what will ultimately become law, it does act as a legislative roadmap to the Democratic majorities in both congressional chambers.

What Did *Not* Appear in the Green Book

What did not appear in the Green Book is significant in its own right, and we begin our analysis with a few notable absentees. We caution the reader, however, that failing to be listed does not necessarily mean that the administration has dropped the proposal. It may simply mean that the particular reform is still under review, or is not deemed a sufficient priority at this time. In any event, what follows below are certain tax proposals which were being actively debated within the Biden administration leading up to the release of the 2022 Budget and Green Book, but were not present on the day of their release.

<u>Certain estate and gift tax provisions</u>

The estate and gift tax exemption currently stands at an inflation adjusted $23.4 million at the death of a joint tax filer, with the tax rate capped at 40%. Leading up to the budget release, the Biden administration had vocally targeted potentially lowering that exemption to the Obama era level of $7 million, and in addition implementing a more progressive rate structure above 40%. Neither of these provisions appear in the Green Book. Perhaps coupling one or both of these measures, along with proposals to tax unrealized capital gains at death, may simply have been viewed as a bridge too far for lawmakers. In any event, we strongly suspect that a significant reduction in the estate and gift tax exemption and/or an increase in the attendant rate remains very much a live issue.

<u>Reinstatement of the SALT deduction</u>

Prospects for full or partial reinstatement of the federal deduction for state and local taxes appeared strong earlier in the year, with the leaders of both congressional chambers, Chuck Schumer and Nancy Pelosi, strongly in favor. Yet, the provision became somewhat of a political football as full reinstatement was projected to cost over $80 billion over 10 years and, in addition, was viewed as benefitting high income taxpayers and thus anathema to the Democrats' stated goal of making the tax code more progressive. Democratic support has waned, and if reinstatement were to survive, it would probably be limited to those taxpayers under the ubiquitous $400,000 AGI threshold that we see in many other tax proposals.

We might add, however, that it was interesting to watch Senate Majority Leader Chuck Schumer (D-NY) and Speaker of the House Nancy Pelosi (D-CA) argue in favor of a tax deduction benefiting the "wealthy," while, on the left, Senate Budget Committee Chairman Bernie Sanders (D-VT) and Senator Elizabeth Warren (D-MA) argued in favor of preserving a controversial Trump era tax reform.

<u>Repeal of the 20% deduction from pass-through entity income</u>

Well over 90% of businesses in the U.S. are structured as pass-through entities (partnerships, LLCs, subchapter S corporations, etc.), and almost all are small businesses. The Qualified Business Income (QBI) deduction, enacted as part of the Trump era 2017 Tax Cuts and Jobs Act (TCJA), allows the owners of certain of these entities a 20% reduction in their tax liability on allocations of their pass-through income. Last fall, the Biden campaign discussed curtailing or eliminating this benefit as a means to further equalize taxation of business owners and their workers, as well as to make the tax code more progressive. As of this writing, however, the QBI deduction appears to be off the radar screen. No doubt this stems at least in part from a reluctance to increase taxes on small business owners across the country still straining under the weight of the pandemic.

<u>Other missing tax reforms</u>

Also absent from the Green Book were various other previously discussed reforms such as curtailing Opportunity Zone program benefits, capping the benefit of the 401(k) tax deduction, assessing payroll taxes on incomes above the current $142,800 cap, and even implementation of some form of federal wealth tax. All of these reforms had previously been discussed as part of a broad push to make the tax code more progressive and thereby reduce historic levels of economic inequality existing across the nation. But at this juncture it appears increasingly unlikely that any of these proposals will ultimately find their way into legislation.

As previously mentioned, much of what *did* make it into the Green Book appears in the tandem legislative packages of the American Jobs Plan (which originally included infrastructure spending as well) and the American Families Plan. The former contains tax increases predominately targeting domestic and international businesses, while the latter focuses on increasing tax revenue from individual taxpayers. Underpinning the entire set of revenue proposals are the tandem concepts of making the tax code more progressive (the concept of high income taxpayers paying their "fair share"), along with the desire to increase social spending and reduce the economic inequality burgeoning across the nation.

Taxation of Capital Gains/Wealth Accumulation in General

There are over 50 specific tax-related proposals spread between the Green Book and the various legislative packages referenced above, and for months readers have been inundated with lists, analysis, and commentary from all corners of the political and financial press. But what has seemingly been missing is an in depth look at the set of proposals which we believe could radically alter the entire tax planning landscape. We are referring to the many aspects of proposed capital gain tax reform, which when coupled with certain related proposals in the Green Book, could profoundly affect the taxation of the accumulation of wealth in this country going forward. And the reader should keep in mind that our discussion addresses *income* taxes only, as opposed to potential reform of our unified gift and estate tax system which may also be on the horizon.

Senate Finance Committee Chairman Ron Wyden (D-OR), Chairman of the House Ways and Means Committee, Richard Neal (D-MA), and President Biden himself have been vocal in their collective belief that the current framework for the taxation of asset appreciation is flawed on two counts. First, since the capital gain rate is substantially lower than the rate paid by ordinary wage earners, it benefits the investment class over the working class and thereby exacerbates economic inequality. And second, that the tax on capital gains is essentially a voluntary tax, paid when a taxpayer has either the need or simply the desire to sell a capital asset. One can argue the merits of each of these points, but to understand them helps to explain the thinking behind and the resulting shape of the current legislative proposals.

With respect to benefiting the investment class over workers, the current proposals address the issue head on by equalizing the current capital gains tax rate of 23.8% (20% + 3.8% Net Investment Income Tax), with the rate on ordinary earned income, currently a maximum of 37%, but proposed to increase to 39.6%. And what is often left out of the discussion but as currently proposed, the rate increase would also apply to qualified dividend income which is currently also taxed at the preferential 20% + 3.8% rate.

Currently, the odds appear to strongly favor some increase in the capital gain and/or dividend rate structure in excess of certain dollar thresholds. This would dovetail with the Democrats' stated goal of making the tax code more progressive, although the nature and extent of any increase remains unclear. It may very well be that the rate(s) are increased but to some lesser degree, as rates of 25% or 28% have been discussed.

Turning to the notion that the current tax framework of capital gains taxes is voluntary, the perception in certain circles on Capitol Hill, along with the media, appears to be that the wealthy have long avoided selling appreciated assets (stock, real estate, art, etc.) in order to forestall or eliminate the payment of the capital gain taxes. Instead of selling assets and triggering the resulting tax liability, they could continually borrow against the appreciation, and at extremely attractive interest rates courtesy of the Federal Reserve. If held until death, the assets then receive a step-up in income tax basis equal to fair market value, eliminating the inherent capital gain liability altogether. The assets then pass through the estate to the next generation where the process renews and repeats. This long-term wealth preservation approach has been aptly referred to as the "buy, borrow, and bequeath" strategy.

Various approaches to taxing asset appreciation prior to its actual sale (referred to as a "realization event") have been proffered over the years. One approach is some form of annual taxation of unrealized asset appreciation as it occurs. Another is some form of wealth tax. Both approaches have received increased attention of late, spurred in large part by the disproportionate increases in the net worth of many in the billionaire class during the pandemic ... along with recently leaked Treasury data that reveal some in this class have paid little or no income tax in recent years.

However, formidable logistical issues present themselves in subjecting unrealized gains and/or post income tax wealth to taxation. These issues include but are not limited to valuation of illiquid assets, as well as difficulty of enforcement. And from an empirical standpoint, such tax frameworks have been attempted in Europe and elsewhere with decidedly less than stellar results.

Yet, many on Capitol Hill maintain their belief that in spite of the significant logistical hurdles, the taxation of unrealized gains and/or accumulated but yet untaxed wealth should be re-examined. Tacitly acknowledging the difficulties but then sidestepping them, the Green Book lays out a new approach to the same end. Instead of taxing ongoing asset appreciation as it occurs or implementing some form of wealth tax after the fact, why not simply tax assets and/or capital whenever it moves? Its beauty lies in its simplicity.

The Specifics

The new framework for taxing capital gains outlined in the Green Book essentially bifurcates all transfers into two buckets ... lifetime transfers and transfers at death. Almost all lifetime transfers of assets, with a few exceptions, would constitute taxable dispositions. Previously untaxed appreciation remaining in assets at death would be subject to income tax at the estate level. There is seemingly no escape ... almost all asset appreciation would become taxable when assets are either sold, transferred, or ultimately at death.

With respect to lifetime dispositions, the subject Green Book proposals would impose a capital gain tax on appreciation inherent in:

- Gifts to non-charitable recipients.
- In-kind transfers of property into non-grantor trusts, partnerships, or other non-corporate entities.
- In the case of grantor trusts, in-kind distributions of property to beneficiaries, the trust toggling to non-grantor status, or the death of the grantor.
- Assets transferred into split interest trusts, to the extent of the non-charitable component.
- All assets currently in partnerships or non-grantor trusts that have resided therein for a period of 90 years, measured back from 1940, meaning inherent gain in assets currently in these entities could be taxable as early as 2030.

Certain exemptions would apply but they are limited in scope. They include gifts to charitable recipients and spouses, distributions from a grantor trust to discharge an obligation of the grantor, certain transfers of family owned farms or businesses, transfers of personal and/or household items, and exemptions below certain dollar thresholds.

At death, appreciation left in estate assets would be subject to capital gain taxation, thus eliminating the step-up in income tax basis for assets passing through the estate. Similar exemptions would apply as enumerated above for lifetime transfers, and income taxes imposed at death would constitute a deduction for estate tax purposes. Under this new framework, death therefore becomes the final taxable disposition of all appreciated assets.

Conclusion

Treating most lifetime asset transfers as dispositions would severely reduce the effectiveness of many of the most common estate planning techniques in use today, including dynasty trusts, intentionally defective trusts, family limited partnerships, etc. And taxing appreciation left in the estate at death reduces the incentive to hold assets for an eventual step-up in income tax basis, which would in theory increase the frequency of lifetime asset sales and thereby accelerate overall tax revenue derived from capital. This is no doubt viewed as a win-win by the Biden administration and the proponents of taxing wealth in general.

In the final analysis, treating lifetime asset transfers as taxable dispositions, coupled with taxing appreciation in assets that remain at death, effectively neuters the previously discussed “buy, borrow, and bequeath” strategy. And although some or all of these proposals may or may not ultimately become law, they do provide insight into the current thinking of the Biden administration. Taken together, these proposals represent a potentially new framework for taxing capital gains and the accumulation of wealth in the U.S.

Taxpayers and their financial advisors should take note.

Contact Us

As always, for further guidance and assistance, please reach out to your PKF O'Connor Davies engagement team members, or to Thomas J. Riggs at triggs@pkfod.com. We are here to help you.

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