Insights: President Biden's 2023 "Green Book" Proposal

The Specter of Possible Tax Increases Continues

March 30, 2022

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On March 28, 2022, the U.S. Treasury Department released its 2023 "Green Book," known as the General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals (click to download). Contained within it are various proposed tax increases on high-net-worth individuals and businesses which include, but are not limited to, the following:

Corporate and Business Taxation

- Increase the tax rate for C corporations from 21% to 28%.

  Effective for taxable years beginning after 12/31/2022.

- Reduce the ability of family members to use a partnership to shift the tax basis of partnership assets among themselves under IRC § 754.

  Effective for partnership taxable years beginning after 12/31/2022.

Individual Income Taxation

- Increase the top marginal income tax rate to 39.6% on taxable income over $450,000 (married filing jointly), $400,000 (unmarried individuals), $425,000 (head of household), and $225,000 (married filing separately).

  Effective for taxable years beginning after 12/31/2022.

- Tax long-term capital gains and qualified dividends as ordinary income to the extent that taxable income exceeds $1 million (married filing jointly) or $500,000 (married filing separately), the rate for which would be increased from 23.8% (20% capital gain rate plus 3.8% NIIT) to 40.8% under current law (37% top rate plus 3.8% NIIT) and 43.4% under the Green Book (39.6% proposed top rate plus 3.8% NIIT).

  Effective for gains realized and dividends received on or after the date of enactment.

- Tax unrealized capital gains in appreciated assets transferred by gift during life or held at death.[i]

  Effective for property transferred by gift, or property owned by individuals dying, after 12/31/2022.

- Tax unrealized capital gains in appreciated assets transferred into, or distributed in kind from, an irrevocable trust, partnership, or other non-corporate entity if such transfers have the effect of a gift to the recipient.

  Effective for property transferred after 12/31/2022.

- Tax unrealized capital gains in appreciated assets held by an irrevocable trust, partnership or other non-corporate entity if such property has not been recognized for tax purposes within the prior 90 years.

  Effective for property not subject to a recognition event since 12/31/1939 – the first possible recognition event would be deemed to occur on 12/31/2030.

- Impose a 20% minimum tax rate on total income, generally inclusive of unrealized capital gains, for taxpayers with wealth exceeding $100 million.[ii]

  Effective for taxable years after 12/31/2022.

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Estate and Gift Taxation

- Require the remainder interest in a Grantor Retained Annuity Trust (GRAT) at inception to have a minimum value equal to the greater of 25% of the value of assets transferred into the GRAT or $500,000 (but not more than the value of such assets), require the term of a GRAT to be a minimum term of 10 years and maximum of the annuitant's life expectancy plus 10 years, and require recognition of gain or loss in GRAT assets acquired by the grantor in an exchange.

  Effective for trusts created on or after the date enactment.

- Treat the sale of an asset between an irrevocable grantor trust and its deemed owner (grantor or any other person) as regarded for income tax purposes resulting in the seller recognizing gain on any appreciation in the transferred asset and the buyer taking a basis in the asset equal to its value (includes the satisfaction of an obligation, such as an annuity payment or note repayment, with appreciated property).[iii]

  Effective for such transactions occurring on or after the date of enactment.

- Treat the payment of income tax on the income of an irrevocable grantor trust as a gift by its deemed owner unless such person is reimbursed by the trust during that same year.[iv]

  Effective for all trusts created on or after the date of enactment.

- Require consistent valuation of promissory notes treated as bearing sufficient interest (to avoid below-market status) by limiting the discount rate subsequently used to value the note for gift and estate tax purposes to the greater of the actual interest rate of the note or the applicable federal rate (AFR) based on the remaining term of the note.[v]

  Effective for valuations as of a valuation date on or after the date of enactment.

- Limit the applicability of the generation-skipping transfer (GST) tax exemption to direct skips and taxable distributions from a GST trust to beneficiaries who are no more than two generations below the transferor (grandchildren) and any younger generation beneficiaries who were alive at the creation of the trust, as well as taxable terminations of a GST trust occurring while any of these persons are beneficiaries of the trust.[vi]

  Effective for all trusts subject to the GST tax on or after the date of enactment regardless of the trust's GST inclusion ratio on the date of enactment.

What the Green Book Refers to as Closing "Loopholes"

- Tax carried profits interests as ordinary income (subject to self-employment taxes as well) regardless of the character of the income at the partnership level if the partner holding the interest and providing services to the partnership has taxable income over $400,000.[vii]

  Effective for taxable years beginning after 12/31/2022.

- Limit the deferral of gain in section 1031 like-kind exchanges of real property to an aggregate amount of $500,000 for each taxpayer ($1 million married individuals filing a jointly) per year.

  Effective for exchanges completed in taxable years beginning after 12/31/2022.

- Limit a partner's deduction in certain syndicated conservation easement transactions by providing that a direct or indirect contribution by a partnership is not treated as a qualified conservation contribution if the amount of such contribution exceeds 2.5 times the sum of each partners' basis in the partnership.[viii]

  Effective for contributions made in taxable years ending after 12/23/2016, or, in the case of contributions to preserve a certified historic structure, for contributions made in taxable years beginning after 12/31/2018.

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- Limit use of donor-advised funds (DAF) to avoid private foundation (PF) payout requirement by clarifying that a distribution from the latter to the former is not a qualifying distribution unless the DAF funds are expended as a qualifying distribution the following taxable year and the PF maintains adequate records or other evidence to that effect.

  Effective after the date of enactment.

- Expand pro-rata interest expense deduction disallowance for interest allocable to unborrowed cash values of business-owned life insurance by repealing the exception under IRC § 264(f)(4) for policies covering employees, officers or directors (the exception for a policy covering a 20% owner of a business would remain).

  Effective for policies issued after 12/31/2021 (material changes in existing policies treated as a new policy issue date).

Exclusions, exceptions, limitations, or other considerations may apply to the above tax policy proposals. Please refer to the Green Book for complete details and seek advice from a tax and legal professional.

Key Takeaways

Although influential, the Green Book is only a statement of the President's principles regarding the budget and overall revenue priorities. Historically, very little from the President's Green Book actually becomes law. Congress must first determine tax policy and any resulting legislation must pass both Chambers before making its way to Presidential approval. Reportedly, many of these proposed tax increases do not have any Republican support nor unanimous Democrat support in Congress.

While it may remain unlikely that these tax policy proposals become law, this Green Book reinforces the ongoing focus on, and risk related to, tax increases on wealthy individuals and businesses. Such taxpayers should consider capitalizing immediately on any applicable tax planning opportunities that have been targeted for elimination by recent proposals. A properly structured and administered cash value life insurance could be a valuable tool to consider in response to many of the proposed individual tax increases due to the policy's underlying tax-deferred build-up of cash value, tax-free accessibility of cash value, and tax-free death benefit protection.[ix]

Taxpayers should first seek advice and guidance from an independent tax and legal professional regarding their specific circumstances.

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[i] Under this proposal, $5 million per-donor lifetime exclusion (indexed for inflation after 2022) from recognition of unrealized gains on property transferred by gift or at death would apply to the extent that cumulative total transfers exceed the basic exclusion amount for gift and estate tax purposes. Any unused portion of this lifetime exclusion would be portable to a surviving spouse. 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. Transfers to a spouse of the transferor or a charity would carry over the basis to the recipient and not result in gain recognition at the time of transfer thereto. Transfers to a split interest trust, such as a Charitable Remainder Trust (CRT), would be subject to this recognition rule with an exclusion for the charity's share of the gain based on the charity's share of the transfer as determined for gift or estate tax purposes. This rule would not apply to transfers of tangible personal property (excluding collectibles). The $250,000 per-person ($500,000 for married couple) exclusion for gain on a personal residence under current law would apply in addition to the above $5,000,000 exclusion. Exclusion for gain on certain small business stock under current law would additionally apply. A deferral election would be available for certain family-owned and -operated businesses where gain recognition could be deferred until the business is sold or ceases to be family-owned and -operated. A 15-year fixed-rate payment plan for tax on appreciated assets transferred at death, other than liquid publicly traded assets or businesses for which the deferral election is made, would be available.

[ii] Under this proposal, additional details include, but are not limited to, the following: A taxpayer's minimum tax liability would equal the minimum tax rate (20%) times the sum of taxable income and unrealized gains (including on ordinary assets) of the taxpayer, less the sum of the taxpayer's unrefunded, uncredited prepayments and regular tax. 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 impose for those years in five equal, annual installments. Payments of the minimum tax would be treated as a prepayment credited against subsequent taxes on realized capital gains to avoid double taxation thereon. Refunds would be provided to the extent that net uncredited prepayments exceed the long-term capital gains rate (inclusive of surtaxes) times the taxpayer's unrealized gains – refunded by first offsetting any remaining minimum tax installment payments. Minimum tax liability would be reduced to the extent that the sum of minimum tax liability and uncredited prepayments exceeds two times the minimum tax rate times the amount by which the taxpayer's wealth exceeds $100 million. As a result, the minimum tax would be fully phased in for all taxpayers with wealth greater than $200 million. For single decedents, net uncredited prepayments in excess of tax liability from gains at death would be refunded to the decedent's estate and would be included in the decedent's gross estate for Federal estate tax purposes. For married decedents, net uncredited prepayments that are unused would be transferred to the spouse. Taxpayers with wealth over the threshold would be required to fulfill annual reporting requirements to the IRS regarding the value and basis of certain assets they own.

[iii] Securitized transactions would not be subject to this proposal.

[iv] Under this proposal, the gift would be deemed to occur on 12/31 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. The amount of the gift would be the unreimbursed amount of the income tax paid.

[v] Under this proposal, the Secretary would be granted regulatory authority to establish exceptions to account for any difference between the AFR at the issuance of the note and actual interest rate of the note. In addition, the term of the note would be treated as being short term regardless of the due date, or term loans would be valued as demand loans in which the lender can require immediate payment in full, if there is a reasonable likelihood that the note will be satisfied sooner than the specified payment date and in other situations as determined by the Secretary.

[vi] The result of this proposal 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 who was alive at the creation of the trust. Specifically, this limit on the duration of the GST exemption would be achieved at the appropriate time by increasing the inclusion ratio of the trust to one, thereby rendering no part of the trust exempt from GST tax.

[vii] To prevent income derived from labor services from avoiding characterization as ordinary income, this proposal assumes that the gain recognized on the sale of a partnership interest that compensated a partner in the form of a carried profits interest would generally be taxed as ordinary income, not as capital gain, if the partner is above the income threshold. The Administration seeks to work with Congress to develop mechanisms to assure the proper amount of income recharacterization where the business has goodwill or other assets unrelated to the services provided by a partner holding a carried profits interest.

[viii] This proposed disallowance would not apply if a three-year holding period requirement is satisfied and would also not apply to certain partnerships and other pass-through entities substantially all of the interests in which are held by family members.

[ix] Tax-free accessibility of cash value refers to avoidance of income taxation of policy withdrawals and loans if the policy remains in force until the insured's death and never becomes a Modified Endowment Contract (MEC). Tax-free death benefit protection refers to the general rule that death benefit proceeds are not includible in the beneficiaries gross income (assuming the policy was never transferred for valuable consideration to an impermissible transferee) as well as the ability to own the policy in a properly structured irrevocable trust where the proceeds avoid inclusion in the insured's gross estate for estate tax purposes (assuming there are no incidents of ownership over the policy held by the insured at the time of his or her death or within three years thereof). See IRC §§ 72, 7702, 7702A, 101, 2042, 2035. Note, it is not clear whether the proposed 20% minimum tax for centimillionaires and billionaires would include life insurance cash value as an "ordinary asset" in the calculation of minimum taxable income.