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More on Administration's Proposal for Taxing Unrealized Gains and Related Matters

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The American Institute of Certified Public Accountants (the AICPA) has written a letter dated August 24, 2021 to the Chairmen and Ranking Members of the Senate Finance Committee and the House Ways and Means Committee concerning statements made in the Green Book (see 2021-2, p. 16) concerning the Administration's Proposals regarding capital gains on unrealized appreciation. See Tax Analyst Doc. No. 2021-33138.

The primary concern of the AICPA is with valuation and the following language in the Green Book:

A transfer would be defined under the gift and estate tax provisions and would be valued using the methodologies used for gift or estate tax purposes. However, for purposes of the imposition of this tax on appreciated assets, the following would apply. First, a transferred partial interest would be its proportional share of the fair market value of the entire property.

After quoting this provision with an emphasis on the last sentence, the letter says:

The "proportionate share of the fair market value of the entire property" requirement has, in the opinion of the AICPA, a fatal flaw assumption that the partial owner has adequate insights or access to information that would allow for a determination of FMV of the entire property. This determination is often not possible. For example, a minority interest holder in a private or public company may not have the ability or legal right to obtain the information necessary to value the entire company. And without some recourse, taxpayers will not be able to provide the Treasury or Internal Revenue Service (IRS) any reasonable and supportable value of the partial interest. The AICPA recommends that this criterion be removed or, if not removed, revised to provide law that takes into account the limitations faced by many owners of partial interests.

The letter discusses "fair market value" (FMV), its definition and concerns about the "proportionate share" requirement as follows:

In addition to the concerns raised about limited access to information, the "proportionate share of the fair market value of the entire property" requirement will result in valuations that fail to take into account the unique legal, economic, and business characteristics of transfers of partial interests in closely-held entities. In short, values developed under this requirement will not be representative of FMV. The proposed language will result in at least two separate valuation paradigms: tax valuations (which include various different valuation paradigms) and fair market value valuations.

The letter states that the failure to consider unique characteristics of a partial ownership interest will result in valuations that do not reflect "market-basis values" and gives the following example:

A simple example to illustrate this inconsistency (and the discounts discussed below): Taxpayer A owns a 40% partial interest in a company, 100% of which is valued at $3.75 million. On the same day, Taxpayer A transfers half of the 40% interest (20% of the whole) to a charity and gifts the other half to a grandchild. Each half is identical in every way. The value of the interest transferred to charity, determined under Reg. §20.2031-1(b) and Rev. Rul. 59-60 and taking into account discounts for lack of marketability and control is determined to be $500,000 (a total discount of33.3%). The value of the interest transferred to the grandchild, valued using the Administration's proposed proportionate value rule, is $750,000 because it is a 20% interest of a company valued at $3.75 million and no discounts are allowed. The result is a $250,000 valuation difference for identical interests in the company.

The letter discusses the well-known discounts for a lack of (i) control and (ii) marketability, believes that they would be inconsistent with the proportionate share approach and recommends that Congress consider these discounts and incorporate the concepts mentioned in Rev. Rul. 93-12, 1993-1 C.B. 202, when computing taxes on appreciated assets transferred by gift or through an estate.

Later, on another point, the letter expresses concern that taxation of unrealized appreciation by gift or at death would be a third tax on the same income and provides the following illustration:

Business Income	$100.00	$100.00	
Corporate income tax at the proposed 28% rate	(28.00)	(28.00)	First tax
Net earnings accumulated at the business level	$ 72.00		
Value included in taxable estate	$72.00		
Proposed capital gain tax upon death of shareholder at 43.4%	(31.25)	(31.25)	Second tax
Remaining, included in taxable estate	40.75		
Estate tax at 40%	(16.30)	(16.30)	Third tax
Remaining after taxes	$24.45	$24.45	

The illustration does not take into account any state tax liability on the income.

We believe the Administration may not be intending to do away with the two discounts mentioned and that the AICPA's concern is a result of sloppy drafting in the Green Book.

During the week of September 7th, two articles discussed the Administration's proposal for taxing unrealized gains at death or by gift. Sheppard, "*Buy, Borrow, Die: Negative Basis at Death*," Tax Notes, September 7, 2021, p. 1, is the first article and "*Biden's Tax Changes Won't Hurt Family Farmers*" is the second article by Tom Vilsack, the current Secretary of Agriculture, *The Wall Street Journal*, September 9, 2021, p. A17. Also, in a letter to the heads of the House Ways and Means Committee dated September 9, 2021, The Family Business Estate Tax Coalition, supported continuance of stepped-up basis. The letter was signed by more than 150 organizations, large and small.

The Sheppard article is a sequel to her first article on the subject, *Woke Wealth Taxation*, *Tax Notes* July 19, 2021, p. 357. The first article is a biting criticism of the Administration proposal in which she noted that (i) "Untaxed appreciation is estimated to account for more than half of high-value inheritances (Prior analysis: *Tax Notes*, Feb. 2, 2009, p. 633)" and (ii) "the Congressional Research Service says having a $1 million exclusion reduces the potential revenue available from taxing gains at death by 45 percent." Given the recent stock market performance, we believe that the percentage for (i) would be increased above 50 percent and the percentage for (ii) would be reduced.

The third paragraph of the second Sheppard article states:

There's no popular demand for taxing capital gains at death either. Demand stops at the exit from the faculty lounge. And the faculty tend to be ill-equipped to answer technical questions about their policy proposals. Doesn't matter that Haig and Simons thought it was income, or how some Scandinavian government treats it. The proposal has to fit into our layered, convoluted system. Once taxing capital gains at death is explained to them, politicians and voters alike want no part of it. The word on Capitol Hill is that this proposal is dead in the water. There's trouble when a proposal generates its own opposition lobby.

A proposed alternative is taxing gains to the extent of debt exceeding the decedent's basis in transferred property and Sheppard asserts that this approach would cover the problem of a decedent enjoying gains without tax during lifetime. She summarizes as follows:

Bottom line: Taxing all gains at death is terrible policy. Taxing gains to the extent of debt exceeding the decedent's basis in transferred property is a desirable policy because it would reach the problem of decedent enjoyment of gains without tax during lifetime. It'd be a more politically palatable approach to the fairness problem — the average congressional representative cannot argue in favor of packing on the debt. Moreover, some view taxation of gain attributable to debt in excess of basis as achievable even without a statutory change.

The Vilsack article states:

President Biden has proposed changing the way property is taxed when it is passed on to heirs. Right now, when you sell a piece of property, you pay tax on the amount it increased in value since you purchased it. If you pass it on to an heir, that heir is treated as though they bought that property the day you died, so if they sell, they pay tax only on the increase in value during the time that they hold the property.

That doesn't sound so bad, but this policy has allowed the wealthy to amass large fortunes. Millionaires and billionaires borrow against their assets, usually stock or real estate, but also art and collectibles, really anything a bank will lend against. When those assets are transferred upon death, their heirs can sell the property without being taxed to pay off the debt. This is one of the most popular ways the rich avoid taxation, and it must end.

Surprisingly, the second paragraph would be addressed by the proposal in the second Sheppard article.

Four responses to the Vilsack article are contained in the Letters to the Editor section of *The Wall Street Journal* of September 14, 2021 on page A16. The first letter is from Dennis M. Taylor, an Iowa farmer from Muscatine, Iowa, which states:

Agriculture Secretary Tom Vilsack, the former Democratic governor of Iowa, writes that "Biden's Tax Changes Won't Hurt Family Farmers" or small-business owners (op-ed, Sept. 9). Maybe he has been in Washington too long, as he has lost his grasp of today's capital-intensive, high-risk farming economics in Iowa.

Mr. Vilsack states that his 600-acre Iowa farm is worth almost $2 million, or about $3,300 an acre. It must not be quality farmland — probably more suitable for wild-game hunting. Good farm ground in Iowa sells now for about $12,000 an acre, and 600 acres of corn and soybeans are likely required to have an economically feasible family farming operation. Farming profit margins are razor-thin due to globalization, and land is becoming more expensive due to government-caused inflation. Farms must expand to survive.

In the event of a farmer's death, his gross estate value, including land and equipment, could easily exceed $8 million. With fully depreciated equipment, farmland acquired as little as 10 years ago when land was less expensive, and no family members old enough or willing to continue the farming operation, the amount of capital-gains and estate tax owed by the widow under the proposed tax changes would certainly "hurt." A $2.5 million capital-gains exemption would be woefully insufficient.

The second article, from Jim Beatty of O'Fallon, Illinois, states:

Mr. Vilsack's argument that family farms won't be hurt by eliminating the step-up basis is not based on reality. Most family farms will only support one family; when divided among two or more heirs, only one will remain on the farm. The heirs who don't remain will be subject to the new tax. The heirs of the heir who remains on the farm will also have to farm the land to avoid the capital-gains tax. Contrary to the secretary's assurances, I'd hazard that 95% of farming families will ultimately face the new tax.

The fourth article, from Dave Erchull of Tucson, Arizona, provides:

Once again, I'm being admonished that I am not paying my "fair share" of taxes. It seems I've been guilty of this for most of my working life. Even when Democrats raise taxes, it still is never enough to cover my fair share.

I'd like Mr. Vilsack and other fair-share advocates to answer two questions: First, what is the fair share of taxes for each pot of money (income, wealth, capital gains and estate)? Second, how many times is government allowed to tax the same dollar?

Likely they have no idea what a fair share is, yet they are certain I've never met it.

Additional letters to the Editor were published in *The Wall Street Journal* for September 16, 2021 (p. A18) and one of them said:

Farmers everywhere took issue with Agriculture Secretary Tom Vilsack's claim that no real farmer would be hurt by the administration's proposed tax changes ("Biden's Tax Changes Won't Hurt Family Farmers," op-ed, Sept. 9). The secretary knows full well that agriculture is an asset-rich and cash-poor enterprise.

The changes to the step-up in basis for the capital-gains tax would threaten farm families and the next generation of farmers. My grandchildren are the sixth generation to live in the family farmhouse built by my great-grandmother. We are proud of our family farm legacy and hope it remains for generations to come.

While we respect Mr. Vilsack's dedication and service to agriculture, here we fundamentally disagree. Data from his own agency shows that Iowa's average farm is 335 acres, and today's land value is 17 times as high as 1970's. That surge in value means that eliminating the step-up in basis would hurt multigenerational farms the most. Even with a $2.5 million exemption, as proposed in the Biden administration's American Families Plan, it would take only a 350-acre Iowa farm, purchased in 1970 and sold in 2020, to reach the threshold. In Iowa alone, there are over 18,000 farms larger than 500 acres. That's a lot of real farmers affected.

The effect of this policy isn't going to be felt by wealthy investors or real-estate moguls. It will be felt by the farmer who relied on the land for retirement and the young farmer who wants to start his or her own farm legacy but can't afford the tax bill.

The proposal to end the step-up in basis would cause further consolidation in agriculture, as small farms will be more likely to be forced out of business. Cash flow on most farms is much too small to pay such a large increase in capital-gains tax. Investment in new technology and sustainable practices would also be jeopardized.

Farm families haven't persisted for generations just to face a tax bill that forces them off the land. Farmers are paying close attention, and I hope Congress and the administration are listening.

Craig Hill
President, Iowa Farm Bureau
Ackworth, Iowa

On Monday, September 14, 2021, the House Democrats provided recommendations for raising taxes to pay for their proposed social policy and climate change provisions. The Administration proposal for imposing a capital gains tax on unrealized appreciation on gift transfers and transfers at death was not included. See Joint Committee on Taxation, September 13, 2021, JCX-43-21. The recommendations include (i) reducing the transfer tax applicable exclusion amount to about $6 million, (ii) changing rules applicable to GRATs and (iii) changing rules on grantor trusts.

Other House proposals include (i) defining the Administration's proposal as applying only to persons with income in excess of $400,000 as referring to "taxable income" of $400,000 for a single spouse and $450,000 for two spouses; (ii) raising the rate on capital gains to 25 percent from 20 percent.

An article in *Tax Notes Federal*, September 13, 2021, p. 1705, Sapirie, "A Scorecard for Reconciliation, Round 2," mentions Senate proposals being considered that would be different from the House proposals. The article mentions a $5 million exemption for each of two spouses, a significant increase from the Administration's proposed exemption of $1 million.

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