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Taxing Unrealized Appreciation on Lifetime Transfers and at Death

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A. Background

The Biden administration will propose a change in the tax-free basis step-up at death which has been a part of the tax law for a long period of time. Carter Ledyard's first relationship with this subject occurred in 1970 when Richard B. Covey was contacted by the Trust Division of the American Bankers Association. In the Tax Reform Act of 1969, changes were made in the trust income tax laws relating to accumulation distributions and an unlimited throwback rule was enacted. The ABA determined that it needed outside help for modifying the newly passed throwback rules. In addition, the ABA felt it needed help concerning changes in the transfer tax laws which, because of a lack of time, were not included in the 1969 Tax Act and would be dealt with later. One of those changes was in the tax-free step-up in basis at death (the "Basis Increase"). Covey was retained as special tax counsel for the Trust Division, a status which continued until around 2000. In the 1976 Tax Reform Act, the Basis Increase was changed to carryover basis but before its effective date, Congress repealed this change and continued the Basis Increase.

On April 28, 2021, the Biden administration released a fact sheet describing the American Families Plan. It states:

End capital income tax breaks and other loopholes for the very top. The President's tax reform will end one of the most unfair aspects of our tax system: that the tax rate the wealthy pay on capital gains and dividends is less than the tax rate that many middle-class families pay on their wages. Households making over $1 million — the top 0.3 percent of all households — will pay the same 39.6 percent rate on all their income, equalizing the rate paid on investment returns and wages. Moreover, the President would eliminate the loophole that allows the wealthiest Americans to entirely escape tax on their wealth by passing it down to heirs. Today, our tax laws allow these accumulated gains to be passed down across generations untaxed, exacerbating inequality. The President's plan will close this loophole, ending the practice of "stepping-up" the basis for gains in excess of $1 million ($2.5 million per couple when combined with existing real estate exemptions) and making sure the gains are taxed if the property is not donated to charity. The reform will be designed with protections so that family-owned businesses and farms will not have to pay taxes when given to heirs who continue to run the business. Without these changes, billions in capital income would continue to escape taxation entirely.

The fact sheet does not mention other transfer tax changes such as reducing the exemptions and curtailing the use of zeroed-out GRATs.

B. Gutman Article – Introduction

An article by Harry L. Gutman captioned "*Taxing Gains at Death*" was published in the January 11, 2021 issue of Tax Notes Federal (the "Gutman Article"). On May 12, 2021, at a meeting of the Select Revenue Measures Subcommittee of the House Ways and Means Committee on Funding Our Nation's Priorities: Reforming the Tax Code's Advantageous Treatment of the Wealthy, Gutman was one of several witnesses. His testimony was based upon his prior article referred to. He is a former Deputy Tax Legislative Counsel in the Treasury Office of Tax Policy from 1977 to 1980 and was later Chief of Staff of the Joint Committee on Taxation from 1991 to 1993. The Article contends that the basis step-up at death should be repealed and replaced by a policy in which death and lifetime transfers are income tax realization and/or recognition events (the "Appreciation Tax"). The Article is comprehensive, well-written and covers many, but not all, of the issues which would arise under the system he proposes (the "Gutman Proposal"). Knowledgeable people thought that the Gutman Proposal was a forecast of what the Biden administration would recommend.

When we decided the main subject of this issue, the results of the Georgia Senate races were in and the Senate was in a 50/50 division with the Democratic Vice President to resolve any tie votes. President Biden had indicated his decision to repeal the step-up in basis for a decedent's assets and his desire to make changes in the treatment of capital gains. Therefore, a discussion of the Gutman Proposal seemed an appropriate subject.

Subsequent events confirmed that decision but "muddied the waters" because of Democratic proposals for changes in the tax laws. First, President Biden's position on infrastructure included social programs supported by progressives in significant amounts. Second, proposals in both the Senate and House included a change which broadened the elimination of the step-up in basis to include a periodic taxation of appreciation in trust assets but not in entities which could achieve purposes similar to those by trusts. Also, Chairman Wyden of the Senate Finance Committee announced that he was going to file a bill later this year which would accomplish the purpose of marking-to-market assets held by individuals and entities.

Several major concessions are made in the Gutman Article. First, a deduction would be allowed against the estate tax for the Appreciation Tax paid. This is not really a concession, but rather a "fairness" point. Without it, the total taxes at death, federal and state, could exceed 80 percent of some estates. Second, assets currently owned would be exempt from the tax. Stated another way, only assets acquired after the effective date would be subject to tax. The second item contrasts with another approach which would subject to tax assets currently owned but only appreciation accruing after the effective date (a "fresh start" approach). The Article states that a liberal transition rule is necessary to gain adequate political support for the Proposal and, in a section captioned "Inadequate transition relief," states:

Transition has proven to be a particularly difficult issue. There is no agreement on whether the regime should apply to all realizations occurring after the effective date, only appreciation occurring after the effective date, or assets acquired after the effective date. As detailed later, each option has a different effect. Ideally, transition should not create winners and losers. But sometimes the search for equitable transition rules produces perceived inadequate relief or political impracticality and, as a consequence, a desirable law change is not enacted. In my view, we should not let the perfect be the enemy of the good. The most important objective is the enactment of the general rule; transition relief is, by definition, temporary.

Gutman makes a "political" judgment that without the exemption, passage of an appreciation tax would be unlikely. Whether that judgment is correct in the current fiscal and political climate is unclear. The opposite concern is that the rule would not be accepted by progressives, who are the strongest supporters of taxing appreciation upon death and may oppose even a fresh start.

Another concession relates to proof of basis problems. The Gutman Proposal says:

2. Lack of basis records. Whether one finds credible the claim that basis records somehow disappear at death (recall that they were necessary to establish gain or loss on a lifetime sale), the proposed system would put taxpayers on notice prospectively of the need for basis records, and it would provide relief for problematic asset areas – namely, personal residences and noncollectible tangible personal property. Also, a lookback rule would be provided to determine unknown basis. Under that rule, the basis of an asset could be determined by discounting its value at the relevant tax date back to its acquisition date.

Of course, if the acquisition date was also unknown, the relief would be ineffective. The problem of proof is particularly significant with respect to elderly persons who are now in their 80s and 90s.

C. Objectives of Gutman Proposal and Our Conclusion

The Gutman Proposal states:

The challenge is to design a system that is comprehensive in coverage, administrable, perceived as fair, and not subject to abuse. The task involves not only identifying the assets that would be subject to the regime but also the exclusions and exemptions deemed necessary to promote administrability and perceptions of fairness. One must resolve the fundamental question of what constitutes the taxable unit to which the new regime would apply. The need for and design of antiabuse protections must be examined. Further, provisions to assist in valuation problems and the determination of unknown basis must be devised. And finally, one must select an effective date provision that will be viewed as acceptable by the affected community of taxpayers and advisers. The proposal reflects my judgment on the appropriate balance of conceptual purity, administrability, and political reality.

In summary, we believe the Gutman Proposal needs changes in respects discussed below.

D. Discussion of Details of Gutman Proposal

A fundamental departure from past proposals would exempt nonmarketable property held at death from immediate taxation. The gain on a nonmarketable asset would be "realized" but not "recognized" at death. The tax due would be calculated, but payment deferred until the asset was disposed of by the decedent's estate or by the owner who inherits it during the owner's life. Interest would be charged on the tax for the deferral period. This deferral would not apply to lifetime transfers.

Life insurance would be exempt from the Appreciation Tax but Gutman notes that internal interest buildup on permanent life insurance should be taxed to the policyholder. A $250,000 exclusion would apply to gain on a principal residence. See IRC Sec. 121. The exclusion would be portable for transfers to a surviving spouse. Thus, for spouses, the exclusion would be $500,000. All nonbusiness tangible personal property (other than collectibles as defined in IRC Sec. 408(m)(2)), would be exempt from tax. Transfers to charity would also be exempt. An alternate valuation date similar to IRC Sec. 2032 would apply. On another subject, the present gift tax interest exclusion in IRC Sec. 2503(b) would be repealed, thus ending the exemption for property subject to powers of withdrawal.

As to marital transfers, the Article states:

Unless recognition was elected, all transfers to a surviving spouse in any form that would qualify for the estate tax marital deduction would be treated as realization-but-nonrecognition events in accordance with the rules governing outright transfers of nonmarketable property. The effect would be to determine the tax due for all property held by the decedent but defer the tax on appreciated property transferred to a surviving spouse until the earlier of the sale of the property, the *inter vivos* transfer of the property (whether marketable or not), the death of the surviving spouse in the case of marketable property, or the taxable disposition of nonmarketable property in the hands of a testamentary distributee of the surviving spouse. Immediate recognition could be elected for loss property.

Payment of the tax and interest would be deferred until the last of the events referred to in the quotation. This result contrasts with what occurs with transfers in trust where deferral could be extended through several transfers. See the discussion below under the heading "Transfers in trust." A simpler and fairer alternative would be to apply the Appreciation Tax upon the surviving spouse's death or earlier disposition and providing for carryover basis on the first death for spousal assets.

The Article summarizes the overall approach as follows:

Subject to specified exclusions and exemptions, all deathtime and lifetime transfers would be income tax realization events. All non-spousal deathtime transfers of marketable assets[20] would be recognition events. All non-spousal lifetime transfers would be recognition events. Recognition could be elected by the taxpayer-transferor for any realized gain on an asset-by-asset basis. The tax on realized but unrecognized gain, together with a deferral charge to equate the total payment to what would have been due upon realization, would be payable when the subject property is later disposed of in a recognition event.

[20]Marketable securities are defined in Section 731(c). Actively traded personal property, as defined in reg. section 1.1092(d)-2, would also be subject to recognition.

The use of the cross-reference to IRC Sec. 731(c), part of the income tax partnership provisions, to define "marketable assets" and to distinguish them from non-marketable assets without further explanation is unfortunate. Many members of the Trusts and Estates bar, an important constituency in winning approval for the Proposal, will not be conversant with these provisions. We will provide further explanation later in this article.

In dealing with the administrative problems of the Appreciation Tax discussed later, they will be simplified by having assets either "in" or "out" of the system instead of having each asset partly in and partly out.

President Biden has suggested that for taxpayers with more than $400,000 of income, ordinary income tax rates would apply to capital gains. His Press Secretary has clarified that the $400,000 figure covers families and not individuals. He has not gotten into the details of "closing the loophole" step-up basis at death. One of those details is providing a period of time for updating estate plans to address the change in the law.

The Gutman Article discusses the treatment of nonmarketable property and comments upon the transfer of such an asset, including multiple nonrecognition transfers such as where A dies and transfers property to B which is followed by the death of B and the distribution of the property to C. The tax computed at A's death would not be changed by B's death (even if assets had declined in value). Any additional tax at B's death would be imposed on the difference between the value of the property at B's death and B's basis of the property determined by reference to the value of the property upon A's death. If C disposes of the property during life, he would be responsible for the payment of deferred taxes and interest on both the transfer from A to B and the transfer from B to C. This may be illustrated by the transfer of a farm (presumably a nonmarketable asset) with A dying and transferring the farm to B, his son, and B then dying and transferring the property to C, a son of B. C sells the farm. At A's death, the transfer of the property to B would not be taxable. At B's death, the transfer of the property to C would also be nontaxable and would include both the increase in value at A's death and any further increase in value at B's death. Upon C's sale, the taxes deferred at A's death and B's death, plus interest, would be payable, as would the "regular" tax on C's sale, with C's basis based on the value of the farm at B's death.

Interest would be payable commencing with the transfer from A to B and from B to C. The Article does not discuss whether interest payable is deductible by any person owing the interest.

In a letter To the Editor of Tax Notes Federal posted on June 1, 2021 captioned "*Farmers: The 'Gains at Death' Liquidity Issue is a Straw Man*," Gutman said:

Members of Congress from both sides of the aisle as well as numerous commentators have expressed concern about the impact on family farms and closely held businesses of treating death as an income tax recognition event. They are correct.

Treating death as an income tax recognition event requires the valuation of the affected asset, identification of its basis, and calculation and payment of the tax due. While these requirements do not generally pose significant issues for marketable property, they raise legitimate concerns for nonmarketable property. And in the case of business property, including both farms and closely held businesses, the most acute problem is finding the funds to pay the tax. Forcing a sale of some portion of the business interest, borrowing to secure the funds to pay the tax, or providing for payment of the tax in installments is not an acceptable solution. The following addresses the problem directly.

We first divide the world into marketable and nonmarketable assets. The latter category includes ALL nonmarketable assets — not just farms and closely held businesses. The liquidity problem is not restricted to them, and a broader category eliminates messy design questions in determining the characteristics of the entity entitled to relief. In all cases, there will be exclusions for noncollectible tangible personal property and some level of net gain.

For marketable property, the tax is due and payable at death. For nonmarketable property, the first (and my preferred) option would be to calculate the tax due at death but defer its payment until the subject property is sold. The taxable event would not turn upon material participation in the enterprise by a family member, but rather would occur upon the identifiable event of sale. In an ideal world, that deferred tax payment would bear interest at a rate designed to make the present value of the deferred payment equal to the tax that would have been paid at death. Thus, from the perspective of horizontal equity, these interests would not receive favorable treatment when compared with marketable assets for which the tax is payable immediately. A second-best solution would be to omit the interest charge and simply defer the tax. One must recognize, however, that this solution would treat this class of assets more favorably than marketable assets (and would provide significant incentives to transform marketable assets into nonmarketable assets). In addition, if this recognition route is chosen, it would be possible to provide that the value of the affected property could be determined under the special use valuation provisions of the estate tax, thus establishing the value of property at its actual rather than "highest and best" use. This would be of particular importance to farms.

A distinctly less favorable alternative would be to simply provide a carryover basis for nonmarketable property, thus deferring the calculation and payment of the tax until the property is sold.

Here is the takeaway: Any of the forgoing eliminates tax liability at death. The tax payment is deferred until funds are available from a sale of the affected property. The liquidity straw man is eliminated.

E. Level of Taxation

The attached table in Appendix A compares the total estate tax and Appreciation Tax on three New York estates. Each estate has a value of $50 million. One estate has no appreciation, a second consists entirely of appreciation and the third consists of 50 percent appreciation. The assumptions on rates are beneath the table. As noted, the computation of the Appreciation Tax assumes the stated Biden proposal for ordinary income rates on part of the capital gain. If the estate is in the top brackets, a dollar of appreciation results in about 20 cents of additional total tax as compared to a dollar that is not appreciation.

The comment is often made that "people should pay their 'fair share'". Is such an increase "fair"? The Proposal does not discuss the appropriate rate of combined taxation on transfers of property. An Appreciation Tax would be a new level of taxation in addition to the current levels which consist of gift tax, estate tax, generation-skipping tax and corresponding state taxes. We do not believe an appreciation tax would be fair unless the basis of capital assets is indexed for inflation.

Any tax payable upon death and paid would be deductible from a decedent's gross estate. Deferred tax paid upon a sale by the executor should be made deductible for estate tax purposes as an administration expense by an amendment to IRC Sec. 2053. Deferred tax not paid during estate administration is not a liability of the estate and is payable by the owner of the property when it is disposed of in a taxable transaction. Since the value of property that passes to a recipient is reduced by the deferred tax liability, the deferred tax should reduce the value of the asset in the recipient's estate. However, this does not reduce estate tax in the first estate.

F. Offsetting Gains and Losses

1. Transfers at Death

a. General Rules

A decedent's marketable assets may have an overall net gain, which is "recognized" and subject to the Appreciation Tax, and nonmarketable assets which have an overall "realized" net loss. Does the net loss on nonmarketable assets offset the net gain on marketable assets, reducing the net gain that is subject to the Appreciation Tax? In the converse case, where marketable assets have a net loss and nonmarketable assets a net gain, does the net loss offset the net gain, reducing the realized gain that determines the deferred tax on nonmarketable assets? The answer is yes, which it should be if the goal is to produce the same result as if all the assets had been sold immediately prior to death.

The Article states:

Net recognized gain, determined after accounting for any net realized loss from nonmarketable property, would be taxed separately from all other income realized during the decedent's final tax year, at the rate then applicable to capital gain. The gain would be spread over five years, so the effect of progressive rates would be moderated. A net recognized loss would first be used, on a pro rata basis, to offset net realized gain from nonmarketable property held at death. Any remaining loss may be used to offset net capital gain on the decedent's final income tax return, and to the extent necessary, may be carried back to the three preceding tax years. Losses in excess of net capital gain for the preceding three years may be used to offset ordinary income commencing in the year immediately preceding death. (footnote omitted)

Does the five-year "spread" refer to payment in five annual installments or to an income averaging computation? Based on language elsewhere in the Article, it means averaging.

A net recognized loss on marketable property that exceeds net realized gain on nonmarketable property can be used on the decedent's income tax returns as described in the quotation. Is the converse true? The paragraph quoted above could be read to say that a net loss on nonmarketable property that exceeds the net gain on marketable property cannot be used on an income tax return. However, the issue is clarified in a subsequent paragraph which states:

Realized losses in excess of realized gains on nonmarketable property (net realized losses) could be used to offset net recognized gain, with any excess treated in the same manner as net losses on marketable property.

This is the correct result. The ability to use an overall excess loss on the decedent's income tax returns should not turn on whether the excess is attributable to marketable or nonmarketable assets. If both marketable and nonmarketable assets have a net loss, the combined excess loss should be usable in the same manner as an excess loss attributable to one group of assets.

To the extent an excess loss is unusable on the decedent's income tax returns in the way described above, the unused amount could be used to increase the basis of some, or perhaps all, loss assets, pro rata, by the amount of the unused loss. The calculation of an adjusted basis for the affected assets would be complex, disrupting one of the simple aspects of the Proposal, that an asset's post-death basis is its value for estate tax purposes.

The application of these rules to spousal transfers raises an issue. If a spousal transfer includes marketable property, a third category of property is introduced: marketable assets that are treated on the decedent's death in the same manner as nonmarketable assets, but will be treated as marketable assets upon the surviving spouse's death. A simple and seemingly correct approach is to treat these marketable assets as nonmarketable assets on the first spouse's death in applying the rules discussed above in this section.

b. Election to Recognize Gain or Loss

At several points, the Proposal refers to an election to treat a realized gain as a recognized gain, and (less clearly) to treat a realized loss as a recognized loss:

. . . unless immediate recognition is elected, the tax due for illiquid nonmarketable property would be deferred until that property is sold. Part I(C)(1).

Recognition could be elected by the taxpayer-transferor for any realized gain on an asset-by-asset basis. Part I(E).

The transferor of any nonmarketable asset may elect recognition treatment on an asset-by-asset basis. Part II(A)(3).

. . . I propose that the immediate recognition of gain be limited to marketable assets other than those transferred to a surviving spouse (and for which recognition is not elected) . . . Part II(A)(2)

Unless recognition was elected, all transfers to a surviving spouse in any form that would qualify for the estate tax marital deduction would be treated as realization-but-nonrecognition events in accordance with the rules governing outright transfers of nonmarketable property . . . Immediate recognition could be elected for loss property. Part II(A)(5).

As noted, the recognition rules are referred to piecemeal in the Article, and no examples are given. A consolidated statement of the recognition rules with examples is needed. Apparently, however, for transfers at death it is possible, on an asset-by-asset basis, to elect to recognize a gain or a loss that would otherwise only be realized. In some cases, the rules permitting a net loss in one category of assets to be offset against a net gain in the other will eliminate the incentive for an election to recognize gain or loss, but this will not always be the case.

For example, suppose the estate has two marketable assets, each with a built-in $100 gain, and two nonmarketable assets, each with a built-in $100 loss. The net recognized gain of $200 is offset by the net realized loss of $200. The Appreciation Tax payable at death is zero and there is no deferred tax. No election is needed. However, if one of the nonmarketable assets instead has a $100 built in gain, the net realized loss is zero, and no portion of the $200 recognized gain is offset. If an election can be made to recognize the loss on the $100 loss asset, recognized gain is reduced to $100. Of course, this must be reflected in the calculation of the deferred taxable amount, which after the election should be based solely on the nonmarketable asset with a $100 gain. As a result of the election, the Appreciation Tax immediately due will be reduced, but deferred tax will be correspondingly increased.

2. Transfers During Life

The Article states:

The guiding principle of this proposal is that, to the extent practicable and consistent with other applicable income tax rules, all transfers of property should be accounted for in the tax return of the transferor at the time of the transfer. Consequently, apart from interspousal transfers, charitable transfers, and transfers of nonbusiness tangible personal property (other than collectibles), all gratuitous lifetime transfers would be recognition events. Recognition (rather than realization) is appropriate because the lifetime transfer is a voluntary event, and liquidity issues can be anticipated and resolved. An election to treat interspousal transfers as recognition events is provided in the proposal.

A threshold question is what is meant by "all transfers of property should be accounted for in the tax return of the transferor at the time of the transfer?" Apparently it means that gains and losses on lifetime transfers are not, as with transfers at death, the subject of a separate calculation of the Appreciation Tax, but are reported on the transferor's income tax return and enter into the overall taxation of the transferor's net gains and losses for the year of the transfer.

Gain is recognized on a lifetime transfer of property, whether marketable or nonmarketable. Recognition of losses, however, is limited:

Except as provided below, an outright transfer of property other than to a spouse or charity would be a recognition event. Gain would be recognized to the extent of the difference between the FMV of the property and its basis. Losses would not be recognized for transfers of nonmarketable property or property transferred to related parties within the meaning of section 267. The recipients of such property would receive a carryover basis.

Under these rules, the ability to offset gains and losses upon a transfer at death is largely eliminated. Although losses on gifted marketable assets are recognized under the general rule, in practice most gifts will be to a "related party" within the meaning of IRC Sec. 267 and any loss will be denied.

Lifetime transfers to a spouse are treated differently:

Consistent with the general principle of the proposal and the suggested deathtime transfer rule, outright transfers to a spouse (as well as transfers that qualify for the gift tax marital deduction) would be treated as realization events. Recognition would occur upon the disposition of the property by the transferee spouse, with the tax determined in accordance with the rules set forth earlier. However, immediate recognition of gain property could be elected. (footnote omitted)

Clarification of this rule is needed, in particular of the words "[c]onsistent with . . . the suggested deathtime transfer rule." Would both gains and losses be realized upon a lifetime transfer to a spouse, and would nonmarketable property be eligible for loss treatment? Or would the spouse's status as a "related party" under IRC Sec. 267 mean that no loss is realized? If the gift is to a trust for a spouse covered by IRC Sec. 677, the trust will be a grantor trust and the transferor will remain the owner of the property for income tax purposes. Therefore, the gift will not be a transfer for purposes of the Appreciation Tax (see below). An *inter vivos* QTIP trust is also a grantor trust, but under the quoted language is perhaps treated the same as an outright transfer because it will "qualify for the gift tax marital deduction."

Given the limits on loss recognition for gifts, when would it make sense to elect to recognize gain on property transferred to a spouse? If the transferor will have losses from non-donative transactions on his income tax return, gain recognized by the election may be offset by those losses. This reduces the deferred Appreciation Tax, and would be beneficial only if there were no "real" gains on the return subject to immediate tax that could be offset.

These, and probably more, complexities will arise from application of the "realization" rule to inter-spousal transfers. As discussed below, we favor the simpler carryover basis approach for spousal lifetime transfers.

G. Problems With Proposal

1. Marital Transfers

The Article does not adequately discuss whether interest is payable when the Appreciation Tax is deferred upon a predeceased spouse's death and later paid upon a transfer by or the death of the surviving spouse. Under the general approach, the predeceased spouse's death would be a "realization event" but not a "recognition event," even for marketable securities; this suggests that interest would be payable from the predeceased spouse's death. Appendix B compares the results in several examples with what would occur under carryover basis. The differences are significant.

The Article says:

Prior proposals have treated the marital unit as a single taxpayer for realization purposes. Thus, transfers to a surviving spouse would not be treated as realization events, and the decedent's basis in the transferred property would carry over to the recipient spouse. However, the decision to treat the marital unit as a single taxpayer is a policy choice that introduces several issues that must be addressed.

First, a marital exemption gives an executor the incentive to transfer low-basis property to a surviving spouse and transfer high-basis property to other beneficiaries . . . Second, the assets used to fund a marital bequest would have to be identified before the income tax liability of the decedent was calculated. Thus, an executor would be required to claim tentative exemptions on the decedent's income tax return that reflected the property to be transferred after death. Amended returns would be required if the distribution differed from that originally claimed on the return.

An alternative, which would be consistent with the objective of determining all gain and loss at the decedent's death, would recognize the special status of the marital unit but remove the gaming opportunities and administrative difficulties presented by treating the marital unit as a single taxpayer.

The Proposal does not eliminate the incentive to transfer low basis property to the spouse and high basis property to others because doing so still reduces the gain recognized upon the first spouse's death. Nor does it eliminate the possible need for an amended return based on the final determination of the property received by the spouse and other beneficiaries. The final dispositions will determine the amount realized, which must be reported along with the resulting deferred tax on an information return. These arguments do not make a persuasive case against treating the spouses as a unit.

Also, current IRC Sec. 2014 creates an incentive to rely on portability of the estate tax unified credit rather than a bypass trust. Property in a bypass trust will not receive a second step-up upon the surviving spouse's death. The Article's approach would eliminate this particular incentive to avoid use of a bypass trust but would replace it with a stronger incentive, because appreciated property passing to the trust may be subject to the Appreciation Tax on the first death. The size of the basic exclusion from the Appreciation Tax and how it compares in scope to the estate tax AEA are relevant in measuring this incentive.

The Article's concern is overridden by the opposition that will arise against any imposition of a tax on a transfer from spouse to spouse, even a deferred tax (which may eventually be paid by the recipient spouse). The forty years since introduction of the unlimited marital deduction have confirmed the belief that the taxable moment for a married couple is the surviving spouse's death, not the predeceased spouse's death.

The correct approach to marital transfers, both during life and at death, is a carryover basis approach, under which no interest would be payable for any period prior to the death of, or the disposition of an asset by, the surviving spouse. If the asset is sold, it will be replaced by another asset of the same value. If the asset is distributed to the surviving spouse and is retained by her until her death, no interest is payable because she is receiving the income from the asset whether or not it is held in the trust. However, if she makes a gift of the asset, interest would be payable from the date of the gift in the same way the interest would be payable if she received the asset outright instead of through a QTIP trust.

For lifetime transfers, footnote 35 of the Article states:

An *inter vivos* spousal transfer does not raise the same administrative issues as a deathtime transfer. *See supra* Section II.A.5. Consequently, the decision could be made to exempt those transfers from the general rule and account for the property only upon disposition by the transferee spouse.

More fundamentally, under IRC Sec. 1041, no gain or loss is recognized on a lifetime transfer of property from an individual to (or in trust for the benefit of) the individual's spouse. The basis of the transferee spouse in the property is the adjusted basis of the transferor. There is no sound reason for the Appreciation Tax to seek to "override" IRC Sec. 1041. It is wrong to treat a transfer that would not result in gain under the applicable income tax rules, even if a sale, as a "realization event" resulting in a deferred gain on which a deferred tax will be paid, possibly with interest during the period of deferral.

The Article concedes no reason exists to impose the realization-deferred tax-interest regime on a lifetime marital transfer. The administrative arguments for imposing it on marital transfers at death are not persuasive. The correct approach, in terms both of policy and of politics, is to exempt marital transfers from the Appreciation Tax, and instead impose a carryover basis.

If a carryover basis regime is not adopted for marital transfers, clarification is needed with respect to the treatment of QTIP marital trusts. A lifetime QTIP trust is a grantor trust and in general a transfer to a grantor trust is not subject to Appreciation Tax. However, because the transfer would be eligible for the gift tax marital deduction, the Article appears to intend that it would be treated in the same manner as an outright transfer to a spouse, resulting in a realization event. Clarification is also needed that upon the death of a spouse who is the beneficiary of a QTIP trust, the trust is subject to Appreciation Tax even though the trust property is neither owned by the spouse nor subject to a general power of appointment, and that the trust property should be aggregated with the spouse's property in calculating net gains and losses. These issues are discussed further in Appendix B.

Inherited nonmarketable property generates a deferred tax liability. The tax is not payable until the property is disposed of in a recognition event. Death as such is not a recognition event, and therefore the deferred tax generally will not be payable when bequeathed by a recipient to a subsequent recipient. As discussed above, although the deferred tax does not reduce the value of property in determining the gross estate of the original owner, it can be argued that the deferred tax liability reduces the value of the property in the recipient's estate, even though the tax is not payable upon the recipient's death. That would be a favorable result, but in the context of a transfer between spouses there may be a catch. If the deferred tax reduces the value of property received by a spouse, it may reduce the value of the property for marital deduction purposes in calculating the original owner's taxable estate, creating a gap between the gross estate value and the marital deduction value. Perhaps the best rule is that deferred tax does not reduce valuation for estate tax purposes in any estate, reducing the taxable estate only when it becomes payable, and therefore deductible. An executor should have the power to elect to pay a prior decedent's deferred tax, similar to the election to recognize the decedent's current realized gain on nonmarketable property.

2. Nonmarital Lifetime Transfers

Additional lifetime transfers that should not result in an Appreciation Tax are:

(i) A transfer for full and adequate consideration, taking into account Treas. Reg. §25.2512-8. Transfers for full consideration should not be taxable even if the transfer does not result in the realization or recognition of gain for income tax purposes and even if the transfer changes the ownership of the transferred property for income tax purposes. An example would be the transfer of appreciated securities for a partnership interest.

(ii) A transfer that does not change the ownership of the transferred property for federal income tax purposes, provided that property owned by an individual that ceases to be owned by the individual during life or upon death shall be subject to the Appreciation Tax whether or not the cessation is a taxable gift or is included in the individual's gross estate. An example would be a sale of property to a grantor trust for full and adequate consideration, including a sale for a note. The sale would not be subject to the Appreciation Tax, because the grantor continues to be the owner of the trust property. The gain in the trust at the grantor's death or earlier if the trust ceases to be a grantor trust, would be taxed, even if the trust is not includible in the transferor's gross estate.

3. Marketable Securities

"Marketable securities" are defined in IRC Sec. 731(c), a partnership income tax provision which, in general, treats marketable securities as equivalent to money in determining whether a partner receives a distribution of money in excess of the basis of the partner in the partnership interest.

Marketable securities include "actively traded" stocks, other equity interests, debt instruments, options, forward or futures contracts, notional principal contracts, derivatives, and foreign currency as well as interests in common trust funds, mutual funds, instruments which are readily convertible into marketable securities, instruments whose value is determined substantially with reference to the value of a marketable security, and most interests in actively traded metals. Interests in entities substantially all of whose assets (90% or more by value) consist of marketable securities and interests in other entities, to the extent the value of their marketable securities is between 20% and 90% of the entity's total value ("look-through entities"), are also treated as marketable securities. Whether bitcoin or other cryptocurrencies qualify will need to be clarified. Property is actively traded if it is property for which there is an established U.S. or foreign financial market.

Although the emphasis in the definition of marketable security is on liquidity, some illiquid assets qualify. Thus, a share of stock that is part of a class that is actively traded is a marketable security even if its transfer is restricted by an investment letter or if it is subject to an IRC Sec. 83 substantial risk of forfeiture after an IRC Sec 83(b) election has been made. No policy reason exists for treating property of this sort as marketable securities while there are restrictions on sale.

4. Entities Owning Marketable Securities

How to treat a nonmarketable asset that owns marketable securities is a difficult issue. Despite the breath of the definition of look-through entities, it can be expected that much attention will be directed to converting marketable securities to nonmarketable property (as long as that can be done in a way that will avoid gain recognition under current law) to avoid the full impact of the Appreciation Tax.

Transfers of property to a wholly-owned corporation can be accomplished without current gain recognition and as long as less than 20% of the corporation's assets are marketable securities, the interest in the corporation would not qualify as a marketable security. The disregarded entity status of wholly owned limited liability companies would presumably apply for Appreciation Tax purposes whether or not less than 20% of the LLC's assets were marketable.

The transfer by multiple transferors of appreciated property to a partnership, LLC or corporation controlled after the transfer by the transferors is, in general terms, not an income tax recognition event under current law. However, the general rule does not apply to transfers to an "investment company" where the transfer results in a diversification of the transferor's interests and the transferee entity is a regulated investment company (mutual fund), real estate investment trust or an entity more than 80% of whose assets are held for investment and are readily marketable stocks or securities (with the term "stock or securities" being defined in a manner similar to the IRC Sec. 732(c) list). "Diversification" is present where the transferors transfer non-identical assets unless each transferor transfers a diversified (as defined) portfolio of stocks and securities.

Accordingly, there are possible avenues for a transferor, with or without family members, to form an entity that will fail the test for marketability.

A difficult issue for look-through entities is the time at which the marketability test is applied. Could carefully balanced deathbed transfers to a newly formed corporation convert marketable securities into nonmarketable assets? Is the test applied at formation or, given the possibility of asset value fluctuation and asset re-deployments, only when there is a transfer subject to the Appreciation Tax? Consistent with their purpose the IRC Sec. 731 regulations test for marketability at the time of a partnership distribution, but this is a concept that would need to be modified for purposes of an Appreciation Tax.

The Article's proposed reliance on IRC Sec. 731(c) without adjustments to define marketable securities seems misplaced. Arguably this is the most significant unresolved issue in the Article, and casts doubt on its fundamental proposal to treat marketable and non-marketable assets differently. It should be addressed in the statute, and not left solely to regulations.

5. Dynasty Trusts

The transfer of property during life or at death to an irrevocable long-term "dynasty" trust may incur Appreciation Tax, but subsequent appreciation within the trust could remain free of Appreciation Tax indefinitely as long as the trust is not included in any beneficiary's gross estate. A solution would be to provide that the Appreciation Tax applies to any GST taxable distribution or taxable termination, with an appropriate deduction to avoid double taxation. A strict version of the rule would disregard the GST exemption and the trust's inclusion ratio in applying the Appreciation Tax.

A more difficult question is the treatment of a distribution of appreciated property from a trust that is not a GST taxable distribution, e.g., a distribution to a child from a trust for the child. Should the distribution be subject to Appreciation Tax if it does not otherwise result in recognition of gain? If so, how is the basic exclusion from Appreciation Tax determined?

H. Other Developments

1. Van Hollen Proposal – the Sensible Taxation and Equity Promotion (STEP) Act of 2021

On March 29, 2021, Senator Chris Van Hollen released a discussion draft captioned "Sensible Taxation and Equity Promotion Act 2021" which would provide for the realization of property gains at the time of death and when transferred during life. He said:

The stepped-up basis loophole is one of the biggest tax breaks on the books, providing an unfair advantage to the wealthiest heirs every year. This proposal will eliminate that loophole once and for all.

Other sponsors of the draft legislation are Senators Booker, Sanders, Warren and Whitehouse. A similar proposal was also introduced in the House of Representatives by Representative Bill Pascrell, a senior member of the House Ways and Means Committee. H.R. 2286.

The major points in the STEP Act are:

(i) Any transfer of property by gift or upon death would be treated as sold. Thus, a tax on the unrealized appreciation would be payable. A $1 million exclusion would be available. An exclusion of $500,000 would be available for personal residences. An exemption would be provided for (1) transfers to charitable organizations and assets held in retirement accounts and (2) transfers qualifying for the gift or estate tax marital deduction.

(ii) The proposal would be effective for transfers made on or after January 1, 2021 and would contain no exception for appreciation occurring before that date. A retroactive effective date is unwarranted given the need to make changes in many estate plans because of a new tax on appreciation.

The proposal contains no special rules for valuating farms and other closely held businesses but does contain deferred payment rules similar to IRC Sec. 6166 which defer tax for five years and provide for payment over a ten-year period with interest at a reduced rate.

(iii) A new section 1261 captioned "Gains from Certain Property Transferred by Gift or at Death" would read:

(a) IN GENERAL. — Any property which is transferred by gift, in trust, or upon death shall be treated as sold for its fair market value to the transferee on the date of such gift, death, or transfer.

(b) SPECIAL RULES FOR TRUSTS. —

(1) GRANTOR TRUSTS. —

(A) IN GENERAL. — In the case of a trust for which the transferor is considered the owner under subpart E of part I of subchapter J —

(i) except as provided in subparagraph (C), subsection (a) shall not apply to property transferred to such trust, and

(ii) subparagraph (B) shall apply.

(B) DEEMED TRANSFERS. — Property held by a trust described in subparagraph (A) —

(i) shall be treated as transferred by the owner in a transfer to which subsection (a) applies on any date that —

(I) the owner ceases to be treated as the owner under this chapter,

(II) such property is distributed to any person other than the owner, or

(III) the property would no longer be included in the owner's gross estate under chapter 11, or and

(ii) shall be treated as transferred by the owner upon the death of the owner.

(C) EXCEPTION. — Subparagraph (A)(i) shall not apply to property if such property would not be included in the gross estate of the transferor immediately after the transfer.

(2) NONGRANTOR TRUSTS. — In the case of any trust not described in paragraph (1) —

(A) all property held by such trust shall be treated as sold for fair market value on the last day of the taxable year ending 21 years after latest of —

(i) December 31, 2005,

(ii) the date such trust was established, or

(iii) the last date on which such property was treated as sold by reason of this subsection [emphasis added], and

(B) proper adjustment shall be made in the amount of any gain or loss subsequently realized for gain or loss taken into account under subparagraph (A).

(c) EXCEPTIONS AND OTHER SPECIAL RULES. —

(1) TANGIBLE PROPERTY. — This section shall not apply to any tangible personal property other than a collectible (as defined in section 408(m) without regard to paragraph (3) thereof) which is not held—

(A) in connection with a trade or business, or

(B) for any purpose described section 212.

The effect of the quoted language above in (2)(A) is that a constructive transfer resulting in the realization of gain and loss is considered made every 21 years. A constitutional issue may be raised concerning the constructive transfer because there is nothing that changes in the trust on which to base the imposition of a tax. Arguably, some change is needed.

(iv) Section 1014 is amended to provide that for marital deduction property the "transferee" takes the "transferor's" basis.

(v) A new section 6048A would require that certain trusts having a value of $1 million or gross income of $20,000 supply information concerning the trust to the Secretary of the Treasury.

(vi) A new section 199B would provide a deduction for costs incurred in making a valuation appraisal.

(vii) A new section 6168 would provide an extension of time for the payment of gains on certain assets for up to ten years and would be available for an "eligible asset." This term is defined as:

any property other than personal property of a type which is actively treated (within the meaning of section 1092(d)(1)).

Interest would be charged on any deferral of payment.

(viii) A special lien for taxes deferred under section 6168 would be created in section 6324C.

(ix) A severability clause stating that if part of the Act is deemed unconstitutional, the remaining provisions continue in effect.

An article discussing the STEP Act is Curry, *STEP Act Highlights Difficulty of Tackling Stepped-Up Basis*, Tax Notes Federal, April 22, 2021.

2. H.R. 2286

H.R. 2286 is a "condensed" version of the Van Hollen proposal with some changes. Its version of the constructive transfer provision quoted and underscored above states:

DYNASTY TRUSTS. —

(A) IN GENERAL. — Any property that is continuously held in trust and is not subject to subsection(a) for a period of 30 years shall be treated as transferred pursuant to subsection (a) at the end of such 30 year period.

(B) PROPERTY HELD IN TRUST ON THE EFFECTIVE DATE. — Any property held in trust on January 1, 2022, that has been continuously held in trust for more than 30 years as of such date shall be treated as transferred pursuant to subsection (a) on such date.

The reason for the differences in periods in the two bills is uncertain. The constructive transfer provision in 1 and 2 would attack dynasty trust.

I. General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals (the "Green Book")

On May 28, 2021 General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals (the "Green Book") was released. It refers to a tax on unrealized appreciation as follows:

Proposal

Treat transfers of appreciated property by gift or on death as realization events.

Under the proposal, the donor or deceased owner of an appreciated asset would realize a capital gain at the time of the transfer. For a donor, the amount of the gain realized would be the excess of the asset's fair market value on the date of the gift over the donor's basis in that asset. For a decedent, the amount of gain would be the excess of the asset's fair market value on the 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. The use of capital losses and carry-forwards from transfers at death would be allowed against capital gains income and up to $3,000 of ordinary income on the decedent's final income tax return, and the tax imposed on gains deemed realized at death would be deductible on the estate tax return of the decedent's estate (if any).

Gain on unrealized appreciation also would be recognized by a trust, partnership, or other non-corporate entity that is the owner of property if that property has not been the subject of a recognition event within the prior 90 years, with such testing period beginning on January 1, 1940. The first possible recognition event for any taxpayer under this provision would thus be December 31, 2030.

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. Second, transfers of property into, and distributions in kind from, a trust, partnership, or other non-corporate entity, other than a grantor trust that is deemed to be wholly owned and revocable by the donor, would be recognition events. 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 the U.S. spouse of the deemed owner, other than a distribution made in discharge of an obligation of the deemed owner. All of the unrealized appreciation on assets of such a revocable grantor trust would be realized at the deemed owner's death or at any other time when the trust becomes irrevocable.

Certain exclusions would apply. Transfers by a decedent to a U.S. spouse or to charity would carry over the basis of the decedent. Capital gain would not be recognized until the surviving spouse disposes of the asset or dies, and appreciated property transferred to charity would not generate a taxable capital gain. The transfer of appreciated assets to a split-interest trust would generate a taxable capital gain, with an exclusion 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 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. Finally, the exclusion under current law for capital gain on certain small business stock would also apply. [See IRC Sec. 1202.]

In addition to the above exclusions, the proposal would allow a $1 million per-person exclusion from recognition of other unrealized capital gains on property transferred by gift or held at death. The per-person exclusion would be indexed for inflation after 2022 and would be portable to the decedent's surviving spouse under the same rules that apply to portability for estate and gift tax purposes (making the exclusion effectively $2 million per married couple). The recipient's basis in property received by reason of the decedent's death would be the property's fair market value at the decedent's death. The same basis rule would apply to the donee of gifted property to the extent the unrealized gain on that property at the time of the gift was not shielded from being a recognition event by the donor's $1 million exclusion. However, the donee's basis in property received by gift during the donor's life would be the donor's basis in that property at the time of the gift to the extent that the unrealized gain on that property counted against the donor's $1 million exclusion from recognition.

Payment of tax on the appreciation of certain family-owned and -operated businesses would not be due 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. The Internal Revenue Service (IRS) would be authorized to require security at any time when there is a reasonable need for security to continue this deferral. That security may be provided from any person, and in any form, deemed acceptable by the IRS.

Additionally, the proposal would include other legislative changes designed to facilitate and implement this proposal, including: the allowance of a deduction for the full cost of appraisals of appreciated assets; the imposition of liens; the waiver of penalty for underpayment of estimated tax to the extent that underpayment is attributable to unrealized gains at death; the grant of a right of recovery of the tax on unrealized gains; rules to determine who has the right to select the return filed; the achievement of consistency in valuation for transfer and income tax purposes; coordinating changes to reflect that the recipient would have a basis in the property equal to the value on which the capital gains tax is computed; and a broad grant of regulatory authority to provide implementing rules.

To facilitate the transition to taxing gains at gift, death and periodically under this proposal, the Secretary would be granted authority to issue any regulations necessary or appropriate to implement the proposal, including rules and safe harbors for determining the basis of assets in cases where complete records are unavailable, reporting requirements for all transfers of appreciated property including value and basis information, and rules where reporting could be permitted on the decedent's final income tax return.

The proposal would be effective for gains on property transferred by gift, and on property owned at death by decedents dying, after December 31, 2021, and on certain property owned by trusts, partnerships, and other non-corporate entities on January 1, 2022.

The Green Book also states:

Tax capital income for high-income earners at ordinary rates.

Long-term capital gains and qualified dividends of taxpayers with adjusted gross income of more than $1 million would be taxed at ordinary income tax rates, with 37 percent generally being the highest rate (40.8 percent including the net investment income tax),[1] but only to the extent that the taxpayer's income exceeds $1 million ($500,000 for married filing separately), indexed for inflation after 2022.[2]

This proposal would be effective for gains required to be recognized after the date of announcement.

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1 A separate proposal would first increase the top ordinary individual income tax rate to 39.6 percent (43.4 percent including the net investment income tax).

2 For example, a taxpayer with $900,000 in labor income and $200,000 in preferential capital income would have $100,000 of capital income taxed at the current preferential tax rate and $100,000 taxed at ordinary income tax rates.

The date referred to is April 28, 2021. The Green Book does not mention some items as to which changes had been mentioned as possibilities, namely, (i) a cap on the income tax charitable distribution deduction, (ii) reducing the applicable exclusion amount, (iii) a change dealing with GRATs, (iv) other transfer tax changes.

The discussion of the appreciation tax does not refer to the use of the alternate valuation date in IRC Sec. 2032, which the Gutman Proposal uses. Also, because carryover basis will be applied to marital deduction property, a section formerly in the Code should be reinstated, namely, IRC Sec. 2040 which was repealed when carryover basis was repealed many years ago. It dealt with limiting gain on the funding of a pecuniary legacy to post-death gain and reducing the recipient's basis by the unrecognized gain.

The effective date provision makes clear that trusts created before January 1, 2022 are not subject to tax. Passage occurring before Labor Day seems unlikely and would leave at most four months for clients to make changes in existing estate plans. This is not sufficient time for the process to work in a reasonable way. Also, the use of the word "certain" needs to be explained in detail.

It is useful to set forth a rule concerning the appreciation tax as background for specific comments. The rule is that, leaving aside the allocation of the $1 million exemption to a trust, every distribution in kind of appreciated property by a trust is subject to tax except for marital deduction dispositions and charitable dispositions. Another point is that the Green Book refers to outright marital dispositions but not to trust dispositions, which should be covered.

No reference is made to state taxes on unrealized appreciation. A deduction or credit should be allowed for some part of a state tax.

We criticized the Gutman Proposal for making a distinction as to carryover basis property between a recognizable and a realization event with the result that upon a disposition of the property by a spouse, interest was payable for the period from a decedent's death to the disposition. It appears that this distinction will not be part of the Administration proposal and marital deduction property will have a carryover basis with no interest until the date of disposition.

The treatment of loss assets needs more explanation.

Will interest paid on deferred tax be deductible for estate tax purposes?

The Green Book says nothing about community property.

Decanting statutes apply in some states which permit the amendment of certain trusts. What effect does such a statute have on the application of the appreciation tax?

Are outright distributions of appreciated property from a non-marital trust to a surviving spouse subject to tax?

The discussion of property transfers into and distributions in kind from a trust, partnership or other non-corporate entity other than a revocable trust is confusing and is inconsistent with the general rule referred to above. No exception for a distribution to the settlor's spouse or a marital trust for the settlor's spouse is referred to.

IRC Sec. 2514(e) deals with a lapse of a power of appointment and provides that a lapse is not treated as a release if it is restricted to an amount that does not exceed the greater of $5,000 or five percent of the property subject to the power. Such a power is often used to provide flexibility regarding the distribution of trust property. If the power is granted to a descendant and is exercised, the question becomes whether a tax would be incurred on any appreciated property distributed to the descendant upon the exercise of the power. If the answer is yes, a further question is whether the powerholder has control over what property is deemed to be exercised.

In some cases, a single family trust is created and the trustees are given authority to divide the trust into separate trusts for each child and his or her descendants. Does the exercise of such a power cause a distribution of appreciated property to result from the division?

The $1 million exclusion from recognition, which is indexed for inflation, is too low even under the President's test of not increasing the tax for middle-income taxpayers and should be increased.

J. Senator Wyden Proposal

In 2019, Senator Wyden, the current Chairman of the Senate Finance Committee released a white paper captioned "Treat Wealth Like Wages" which contains a basic framework for a mark-to-market proposal to which would apply a lookback charge to capital assets owned by individuals, estates or trusts with more than $1 million in annual income or more than $10 million in assets. Tradable assets would be marked-to-market and non-tradable assets would have a lookback charge. See Tax Notes Federal, February 8, 2021, p. 995. An article in Tax Notes Federal, Sapirie, "A Time of Renewal for Mark-to-Market?" updates developments concerning Wyden's proposal. Tax Notes Federal, April 12, 2021, p. 174. Also, Senator Wyden intends to introduce a "mark-to-market" bill later this year. See Cadwalader Cabinet, April 7, 2021. Wilhelm, Top Senate Democrat Pushing Forward With Capital Gains Overhaul, Daily Tax Report, June 28, 2021. This bill would apply the proposal to living individuals as well as to trusts.

K. Congressional Activity

After the brief description by the Biden administration of its proposal for taxing unrealized gains (see page 2), reaction from Congressional sources was quick.

Speaking for Senate Republicans, the Minority Leader said it was "a second estate tax" and "This is a devastating blow to family farms and small businesses all across America." This statement did not recognize the exception quoted on page 2 concerning family farms and small businesses.

On the other hand, 13 Democratic House members sent a letter dated May 6, 2021 to three Democratic House leaders, Nancy Pelosi, Speaker, Steny Hoyer, Majority Leader and Richard Neal, Chairman of the Ways and Means Committee, which states:

As you work to develop a comprehensive infrastructure package that prepares the American economy to grow and thrive over the coming years and decades, and expands support for American families, we write to express concern over the impact that certain tax changes enacted to pay for this package could have on our family farms and local economies. The repeal of stepped-up basis for capital gains and immediate taxation could especially hurt family farms, some of which have been in families for generations; therefore, we strongly urge you to provide full exemptions for these family farms and small businesses that are critical to our communities.

We support many of the concepts outlined in recent weeks in the American Jobs Plan and American Family Plan, including ensuring that the wealthiest Americans pay their fair share. And while the clear intention of making changes to stepped-up basis is to ensure vast fortunes worth tens or even hundreds of billions are not passed on without any income taxes paid at any point, we are concerned about the unintended burden this could place on farms and family businesses. We appreciate the President's reference to this burden and the need to address it in the outline of the American Family Plan; and as representatives for districts that would be directly impacted by that change, we hope you will see us as a resource as we work to make that exemption a reality.

The requirement to recognize capital gains at death runs the risk of forcing farms and ranches to sell part, or all, of a farm that may have been passed down for several generations in order to pay the tax burden. While the ability to simply sell a small part of an asset may work for those with shares of stocks, it would force farmers to break up land that may have been in their family for decades and seriously impact their ability to remain economically viable. Additionally, eliminating stepped-up basis without an exemption for our farmers presents administrative difficulties. For example, shares of stock or many other assets are relatively simple to value, and taxing other assets when they're sold gives a clear reference price for valuation, so capital gains taxes have thus far been relatively simple to administer. However, since farms, machinery, and some small businesses may be illiquid or difficult to value, the administrative difficulty is increased.

We look forward to working with you as we develop a full infrastructure package, and we again urge you to take additional care in considering changes to stepped-up basis for capital gains taxes. Farms, ranches, and some family businesses require strong protections from this tax change to ensure they are not forced to be liquidated or sold off for parts, and that need is even stronger for those farms that have been held for generations. We would ask that you work closely with representatives of rural districts like us to ensure those protections are well executed. Many of our constituents started working on their family's farm when they were children, or built their farm with the intention of passing it on to their relatives, and we must ensure that their kids or grandkids are able to continue working that land for future generations. Thank you for your attention to this important matter.

Also, more than 30 House Democrats have taken a similar position on another issue saying they would not support an infrastructure bill that did not include repealing the SALT deduction limitation.

Without the support of the representatives referred to, the House would have problems in passing a bill dealing with the taxation of unrealized appreciation of property included in a decedent's gross estate.

On May 13, 2021, Senators Cotton and Boozman, both from Arkansas and Ernst from Iowa introduced the Estate Tax Reduction Act which would reduce the estate tax to 20 percent. The same bill was introduced in the House by Representatives Arrington, a Republican from Texas and Cueallar, a Democrat from Texas. Tax Notes Document Service, Doc. 2021-19747.

During her hearing before the Senate Finance Committee concerning her appointment as Undersecretary for Tax Policy, Ms. Batchelder answered a question from Senator Grassley of Iowa and indicated that the Administration's proposal to impose a tax on unrealized gains would include an exemption for family farms. See Bloomberg Law News, May 25, 2021, Condon and Davison, *Treasury's Batchelder Aims to Bolster IRS, Opposes Digital Tax*.

The House Ways and Means Committee is considering allowing beneficiaries of estates to defer tax on unrealized appreciation while the beneficiaries continue to hold the assets. See Cook and Davison, *Democrats Mull Weakening Biden Tax on Capital Gains for Estates*, Bloomberg Law News, May 24, 2021.

A Wall Street Journal article on June 8, 2021 contains an article by Eliza Collins on page 4 of an interview with Senator Jon Tester, a Democratic senator, which states:

Mr. Tester has raised objections to Mr. Biden's proposal to impose capital-gains taxes on unrealized asset appreciation upon a person's death, with the new revenue used to fund Mr. Biden's antipoverty or infrastructure plans. The tax has a $1 million per-person exemption, plus the existing exemption for principal residences and special rules that would let farms and other businesses defer payments so long as they are family-owned and operated. Mr. Tester, like other rural Democrats, said the proposal would hurt farmers and called it a nonstarter.

L. Increased Reporting for Trusts

The bills referred to in H.1. and 2. above contain a proposed new Section 6048A which requires reporting of information concerning trusts to the Secretary of the Treasury. The purpose of this requirement is unclear. Perhaps it resulted from a recent article in the November 30, 2020 issue of Tax Notes Federal, by Rossotti, Sarin and Summers, *Shrinking the Tax Gap: A Comprehensive Approach*. The article asserts that more resources should be devoted to attacking the tax gap of underpayment of owed tax liabilities and includes not only income tax underpayments but estate and gift tax as well. The article blames insufficient information reporting and inadequate technology and lists specific areas where the

Treasury "in consultation with the IRS" can take immediate steps. One such area is "an IRS notice can add gift and estate tax avoidance strategies to the set of transactions that must be reported by tax advisors";[30]

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[30] For example, grantor retained annuity trust, family limited partnerships, and dynasty trusts. Cross-party reporting in those cases could help the IRS target attention on the most suspicious transactions.

However, the problem is not primarily "transactions" but rather the law itself, as illustrated by *Audrey Walton v. Comm'r*, 115 T.C. 589 (2000). The enactment of IRC Sec. 2701 created a loophole for GRATs that was not recognized. Also, as to dynasty trusts, statutory change is necessary.

M. Conclusion

As previously noted, consideration and passage of the Administration proposal in the year 2021 seems unlikely. The proposal includes some elements of mark-to-market which involve more than taxing unrealized appreciation at death of decedents. The difficulties of developing an overall policy on the subject are substantial. See Curry, *Biden's Vague Plan on Partnerships Sparks Rampant Speculation*, Tax Notes Document Service 2021-25020.

The Administration may be delaying moving forward with repealing step-up in basis at death until it has resolved the question of how to handle farms and small businesses. Whether a delay in the payment of taxes on such assets will be sufficient to satisfy Congressional concern is uncertain. Unless this problem is solved, sufficient votes may not be available for passage.

A compromise solution would be to reduce the applicable exclusion amount to $5 million plus an inflation adjustment and provide that the repeal of step-up in basis applies only to property acquired after the effective date. The latter change would "protect" existing farms and small businesses from change for about a generation. The acquisition date of property acquired by gift or bequest from a spouse would "relate back" to the original acquisition date of the spouse.

Addendum

Shortly after this article was completed another analysis concerning the Administration's taxing unrealized gains at death was written. Jackel, No Escape: Proposals for Taxing Gains at Death, Tax Notes Federal, July 5, 2021. This article confirms that many issues are involved in doing a complete job.

APPENDIX A

Table Comparing Estates

Gross estate	50,000,000	50,000,000	50,000,000
Appreciation	zero	50,000,000	25,000,000
Appreciation Exclusion	n/a	1,000,000	1,000,000
Taxable appreciation	zero	49,000,000	24,000,000
Appreciation tax	zero	21,032,000	10,182,000

NY taxable estate (gross estate less appreciation tax)	50,000,000	28,968,000	39,818,000
NY estate tax	7,466,000	4,100,880	5,836,880
Appreciation tax plus NY estate tax	7,466,000	25,132,880	16,018,880
US taxable estate	42,534,000	24,867,210	33,981,120
US estate tax	17,565,300	9,615,245	13,716,504
Total tax: appreciation tax + NY estate tax + US estate tax	25,031,300	34,748,125	29,735,384
Effective tax rate	50.0626 percent	69.4962 percent	59.4708 percent

Assumptions:

US estate tax: 45% rate on US taxable estate over $3.5 million

NY estate tax: 16% rate on NY taxable estate (less 534,000 to reflect lower brackets)

Assumes New York has not adopted its own appreciation tax and that New York recognizes the federal deduction of appreciation tax in calculating the New York taxable estate.

Capital gains tax: Biden proposal: 20% on first million of taxable appreciation, and 43.4% (39.6% + 3.8%) on balance. Gutman article suggests exclusion, and we have assumed $1 million nontaxable exclusion.

Switching dollar to appreciation generates .434 of appreciation tax, and reduces estate tax by .1953 (.434 * .45) + .06944 (.434 * .16) but increases tax by .031248 (.45 * .434 * .16). Net result is +.434 – .1953 -.06944 + .031248 = .200508.

CHECK: A. .200508 * 25,000,000 = 5,012,700 B. 34,748,125 – 29,735,384 = 5,012,741

APPENDIX B

Questions Raised by the Proposed Approach to Spousal Transfers

1. When tax is deferred upon a predeceased spouse's death, and later paid upon a transfer by, or the death of, the surviving spouse, will the deferred tax be increased by the interest charge that applies to deferred tax generally? The Article does not address this question specifically for marital transfers, but under general scheme the predeceased spouse's death would be a "realization event" but not a "recognition event," even for marketable securities, and therefore interest would apply. This creates a significant difference from a carryover basis regime, where there would be no interest charge when tax is paid upon the surviving spouse's death.

Marketable property passing to descendants upon the surviving spouse's death would immediately be taxed, in two tiers: the first spouse's deferred tax and the survivor's separate tax. Nonmarketable property would not be taxed on the surviving spouse's death. A nonmarketable asset passing from a predeceased spouse to the survivor, and then to a child, would have two deferred taxes when eventually transferred by the child: a deferred tax computed upon the predeceased spouse's death and carrying interest from that date, and a deferred tax computed upon the surviving spouse's death and carrying interest from that date. The second tax would be computed using the surviving spouse's basis, i.e., the value of the asset at the predeceased spouse's death.

Example 1: H dies leaving stock with a basis of 50 and a value of 100 to W. During W's life, the stock increases in value to 150. Under the Article's proposal, there would be two taxes payable: (i) a tax on H's gain of 50 computed upon H's death but payable upon W's death, with an interest charge for the period of deferral between the two deaths, and (ii) a tax on W's gain of 50 (W acquired a basis of 100 upon H's death), with no interest charge. The total gain subject to tax is the same as under a carryover basis rule, but the interest charge increases the tax paid.

Example 2: Same as Example 1, except that during W's life the stock falls in value to 50. In a carryover basis regime there would be no tax at H's death or W's death. Under the Article's proposal, W has a loss of 50 upon her death, which does not offset the tax owed by reason of H's death, but can be used to offset W's recognized gain on her other marketable assets, and if the loss exceeds all such gains, to offset her gain on her nonmarketable assets.

Example 3: H bequeaths a stock with a basis of 50 and a value of 100 to a testamentary QTIP trust. This transfer qualifies for marital treatment because it is made "in any form that would qualify for the estate tax marital deduction." A gain of 50 is realized but not recognized upon H's death. During W's life and upon W's death, the intended result of the proposal appears to be that if the trustee sells the stock, the deferred tax on H's sale would be payable, with interest. However, the trust is a separate owner and taxpayer from W, so clarification is needed that this is the case. With respect to the gain realized and/or recognized on W's death, the QTIP trust presents questions. The first is whether the trust property is subject to appreciation tax by reason of W's death. Clearly the answer should be yes, but the Article's general rule does not accomplish this result. The general rule is that "death would be treated as an income tax realization event for all property owned by a decedent, as well as any property subject to a general power of appointment in the hands of the decedent." And footnote 21 to this language states: "This realization rule would not depend on estate tax inclusion rules." The QTIP property is not owned by W or subject to a general power, and therefore does not fall within the general rule. Assuming that the general rule is revised to make W's death a taxable event for the QTIP property, upon W's death are there two taxpayers or one? Is gain realized and/or recognized computed by a single calculation treating W's property and the QTIP property as one fund, or is the QTIP property treated separately? Can W's losses be offset against the trust's gains, and vice versa? The answer should be to treat all property as if owned by W in calculating realized and recognized gain.

Example 4: H makes a lifetime gift to a QTIP trust of stock with a basis of 50 and a value of 100. Under the general rule, an outright transfer to W would cause a realization of 50 of gain, with tax deferred until a subsequent taxable event. The outright lifetime transfer to W would clearly be a transfer for purposes of the appreciation tax. The transfer to the QTIP trust should be treated like an outright transfer, but the Article's general rule does not clearly accomplish this result. The general rule for lifetime transfers is that "noncharitable transfers to trusts would be recognition events when and to the extent the transferor is no longer treated as the owner of the property for income tax purposes." The QTIP trust is a grantor trust and H remains the owner of its property for income tax purposes. Clarification is needed that the transfer to the trust is a taxable event treated as if a transfer to W. (As such, it would be a "realization" but not a recognition event, because "outright transfers to a spouse (as well as transfers that qualify for the gift tax marital deduction) would be treated as realization events". Additionally, clarification is needed that subsequent sales by the trust are recognition events for H even though they are not sales by W. The alternative would be not to treat the initial transfer to the QTIP trust as a taxable event because H remains the owner for income tax purposes, with the appreciation tax applying only upon a sale by the trustee or upon W's death. This approach would eliminate interest on the tax. The treatment of the trust assets upon W's death would raise issues discussed under Example 3.

Footnote 37 of the Article provides: "The proposal's application to lifetime transfers in trust, as well as to deathtime transfers of property included in the decedent's estate, invites a reexamination of the differing rules regarding the income and transfer tax treatment of transfers to trusts, with the goal of establishing identical rules for the taxable event for both." Pending such a reexamination, the proposal needs to state specific rules for QTIP trusts.

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