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Green Book clues for taxing the wealthy

When President Biden proposed the American Families Plan, he called for an end to stepped-up basis at death. The White House later clarified that a $1 million exemption would excuse smaller estates from this new tax, but the implementation details were left fuzzy.

The picture became much clearer with the release of the Treasury Department's Green Book on May 28, outlining legislative recommendations for fiscal 2022. Death and gifts would both be treated as realization events for appreciated assets. Dynasty trusts would have to pay tax on capital gains every 90 years. Gain realization would be deferred for family-owned businesses so long as the business remains family owned. For illiquid assets, such as fine art, the tax on the gain could be spread over 15 years.

The Green Book also includes the $1 million exemption for smaller estates, and it provides that the exemption would be portable between spouses. Transfers to a spouse or a charity would not be realization events. The exemption is in addition to the exemption from tax of the first $250,000 of gain from the sale of a principal residence ($500,000 for couples). Also, for married couples the residence gain would be portable, so married couples would have $2.5 million to work with. Finally, the exemption would be indexed for inflation.

Importantly, the tax on capital gains at death would be deductible on the decedent's estate tax return, if there is one, reducing double taxation.

However, when an exemption-protected gift is made, the donee will take the donor's tax basis, and so will have to pay tax on the gain if there is a sale. Some have observed that this seems like a waste of the exemption. This new rule would not go into effect until the first of next year.

Retroactive taxes on long-term gains

Taxpayers with adjusted gross income in excess of $1 million will see the tax rate on their long-term capital gains jump from 23.8% under current law to 40.8%, according to the Green Book. (Others have mentioned a 43.4% tax rate, the sum of the new 39.6% top rate plus the 3.8% tax on net investment income.)

This rule would apply "for gains required to be recognized after the date of announcement," presumably April 28 when the fact sheet was released for the American Families Plan. In other words, the new top rate would be retroactive.

Oddly enough, the retroactive effective date was justified as preventing the wealthy from realizing gains early to avoid the tax rate increase. While it does achieve that goal, it would do so at the expense of revenue. If the wealthy did sell assets to lock in lower tax rates, much more money would flow to the IRS in the near term from their sales. Raising the rate will tend to have the opposite effect, slowing capital gain realizations. This phenomenon was observed when rates were changed in the 1986 Tax Reform Act.