IOWA STATE UNIVERSITY
Center for Agricultural Law and Taxation

A Look at the American Families Plan

May 5, 2021 | Kristine A. Tidgren

As President Biden wrapped up his first 100 days, he rolled out the last of three proposals forming the backbone of his tax and spending policies, the "Build Back Better" plan. With his COVID-19 relief plan—the American Rescue Plan—signed into law, his focus now turns to the latter two proposals, a physical infrastructure plan and a "human infrastructure" plan. Significant tax increases would fund each proposal, the first mostly impacting corporations and the second directly impacting individuals. This post focuses on the latter proposal, the American Families Plan, which would dramatically transform estate and business transition planning for agricultural producers, ranchers, and rural landowners across the country.

Background

On March 11, 2021, President Biden signed the $1.9 trillion **American Rescue Plan** into law. Congress passed this legislative package, described as providing COVID-19 relief to businesses and families, through the budget reconciliation process with a vote of 50-49 in the Senate (one Senator did not vote) and 220–211 in the House.

On the heels of this legislative victory, the White House proposed the $2.4 trillion **American Jobs Plan** on March 31. This "infrastructure" plan would allocate money for projects such as fixing highways, rebuilding bridges, upgrading ports, incentivizing clean energy, and protecting the right of workers to unionize. The wide-reaching American Jobs Plan—currently no more than a fact sheet—would pay for its proposed benefits through changes to the corporate and global tax system. Dubbed the "Made in America Tax Plan," the proposed tax changes include raising the corporate income tax rate from 21 percent to 28 percent, increasing the global intangible low-taxed income tax rate to 21 percent, imposing a minimum tax on corporate book income, and substantially increasing IRS enforcement of corporate tax provisions.

The American Families Plan – An Overview

Nearly one month later, on April 28, President Biden unveiled the $1.8 trillion **American Families Plan**. Although detail is again restricted to a bulleted fact sheet, the Plan proposes to "grow the middle class, expand the benefits of economic growth to all Americans, and leave the United States more competitive." The Plan calls for two years of free community college, free universal preschool, direct support for families with children, paid family and medical leave, and much more (read about the promised benefits in the Plan). It purports to pay for its broad swath of benefits by significantly changing the tax code, particularly with respect to the way capital gain is taxed. The plan promises a "tax code with fewer loopholes for the wealthy and more opportunity for low- and middle-income Americans." The Plan states that it would focus on the highest income Americans to raise approximately $1.5 trillion across a decade. It proposes to accomplish this through three new strategies: (1) increasing IRS enforcement activities, (2) restoring the top individual tax bracket to what it was before the Tax Cuts and Jobs Act of 2017 (TCJA), and (3) dramatically transforming the tax treatment of appreciated property at death, gift, or sale.

The American Families Plan is significant because of the extent to which it would transform the current law. Although details matter (and we lack detail), we review the high-level proposal, as released, keeping in mind that the ultimate impact of any future legislation will depend upon the legislative text. One month before the release of the American Families Plan, Senators Van Hollen, Booker, Sanders, Whitehouse, and Warren released the Step Act of 2021,[1] which included a discussion draft of sample legislative text. Many of the provisions in the American Families Plan appear modeled after language in the Step Act, although differences exist, even at a high level.[2] This post reviews the provisions proposed in the American Families Plan (Plan). Where relevant, it references language included in the proposed Step Act.

Eliminate the Preferential Capital Gain Tax Rates for Taxpayers with > $1 million in Income

The Plan proposes to subject long-term capital gain to ordinary income tax rates where overall income (including gain) exceeds $1 million.

Extend the Application of the Net Investment Income Tax

The plan also appears to propose that all income over $400,000[3] (not otherwise subject to FICA or self-employment tax) would be subject to the 3.8 percent net investment income tax (Medicare) tax.[4] In other words, the "net investment" income tax (NIIT) would apparently be extended to non-investment income above this threshold as well.

Increase the Top Individual Tax Rate

The Plan proposes to restore the 39.6 percent individual tax rate that was in effect before the TCJA. For tax years beginning in 2018, the TCJA lowered the top tax rate from 39.6 percent to 37 percent. This would also mean that capital gain for those earning more than $1 million would be taxed at a top rate of 39.6 percent, plus the 3.8 percent Medicare tax, for a top federal rate of 43.4 percent

> **Note**: The Plan states that it would restore the "top tax bracket" to what it was in 2017. It does not give further detail, but this could include lowering the income threshold impacted by the higher top tax rate as well. In conjunction with lowering the top tax rate to 37 percent, the TCJA also raised the income threshold to which the top tax rate applied. In 2018, for example, the 37 percent tax rate applied to income over $500,000 for single taxpayers and $600,000 for married filing jointly. Without the TCJA changes in 2018, a 39.6 percent tax rate would have applied to income over $426,700 for single taxpayers and $480,050 for MFJ.

Treat Property Transfers at Death As a Sale

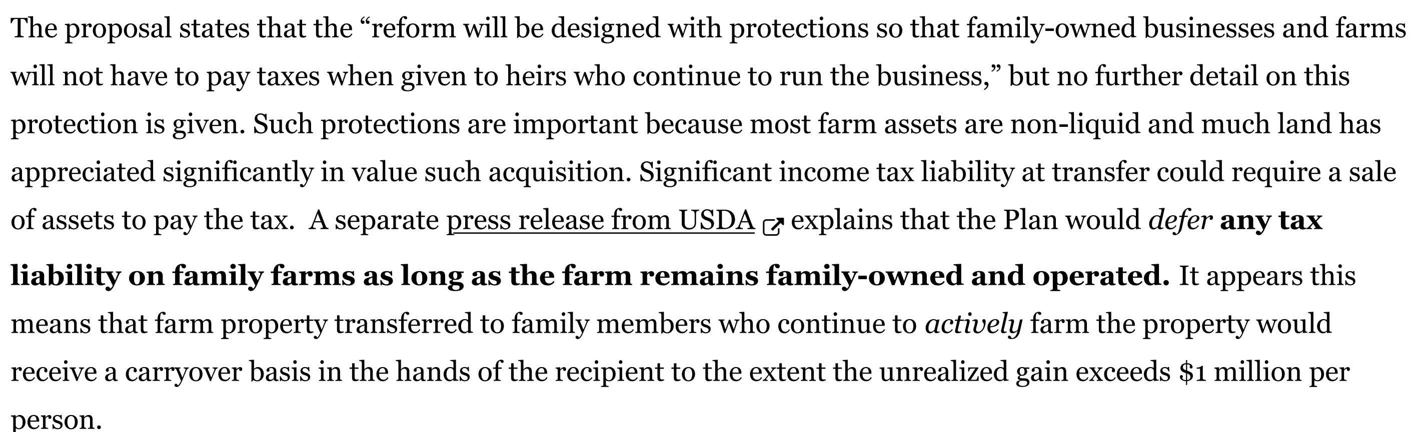
The proposal would treat **the transfer of appreciated property at death as a sale**, meaning that unrealized capital gain in the hands of the decedent would be taxed at the time of transfer. In other words, passing appreciated property to a child through a will or trust at death would trigger a hefty tax bill, presumably on the final return of the decedent. The bill would be especially high given the proposal's other provisions that would increase the top tax rate, subject gains to ordinary income tax rates where income is more than $1 million, and apply the NIIT to the sale of business assets, like farmland.

The proposal states that each person would be allowed to exclude up to $1 million in gain from taxation. Married people would each get their own exemption, which is presumably portable, meaning that a couple could exempt $2 million in gain from tax. The proposal would also preserve the current rule excluding up to $250,000 in gain from taxation for the sale of a personal residence ($500,000 for married filing jointly)[5] and apply it to death transfers as well, meaning that a married couple could potentially exempt up to $2.5 million in gain from

taxation at death.

> **Note**: Although not spelled out clearly in the high-level overview, it appears that basis would continue to be adjusted (usually stepped up) for assets transferred at death. Those assets with unrealized gain of $1 million or less would receive a tax-free step up, and the basis of those assets with gain above that amount would be stepped up in conjunction with the payment of the tax. It also appears that these new realization provisions apply only to capital gain, although further details are needed.

Protection for Family-Owned Businesses and Farms



The proposal states that 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," but no further detail on this protection is given. Such protections are important because most farm assets are non-liquid and much land has appreciated significantly in value such acquisition. Significant income tax liability at transfer could require a sale of assets to pay the tax. A separate press release from USDA explains that the Plan would *defer* **any tax liability on family farms as long as the farm remains family-owned and operated.** It appears this means that farm property transferred to family members who continue to *actively* farm the property would receive a carryover basis in the hands of the recipient to the extent the unrealized gain exceeds $1 million per person.

The Plan does not discuss the definition of "family owned and operated," the impact of lapses in farming activity, or the application of recapture and penalties in the event the property is no longer used in a family farming operation. The language suggests an exemption with definitions perhaps similar to the current special use valuation under IRC § 2032A; however, the rules for this provision, enacted in 1976, are complex and the penalties for missteps are great. And there is no suggestion there would be a 10-year limit under the family business exemption proposed by the American Families Plan. While the proposed exemption would presumably defer the recognition of tax while a family member was actively farming the property, it would appear to provide no protection to ongoing rental or business relationships with non-family members, such as neighbors or beginning farmers. Nor would it appear to recognize that for many multi-generational farmers, their *family* "retirement plan" is not a tax-advantaged 401K or IRA, but a section of farmland. Generational farms may have transitional periods where farmland is rented to others, rather than actively farmed by a family member. The owners of these farms are not wealthy speculators or investors, but heirs to a family legacy. Where the basis of a small to moderate-sized farm is very low because of a transfer through a life estate or a purchase or gift early in a farming career, steep transition taxes could exceed the reasonable ability of heirs to cash flow a loan to pay the tax.This would lessen the chances that any one of these heirs could hold onto the family property and hasten the transfer of these parcels to wealthy investors.

What About Gifts?

The Plan does not specifically discuss lifetime gifts. Presumably, however, the same or similar general rules (with perhaps lower exemptions) would apply to lifetime gifts. Without a complementary rule, property could be serial gifted to younger family members in an attempt to avoid the recognition of gain at death.

Limit Section 1031 Exchange Deferral to $500,000 in Gain

The proposal would end the application of IRC § 1031 like-kind exchange tax deferral rules for gains greater than $500,000.

Increase IRS Enforcement Activities: “Revitalize enforcement to make the wealthy pay what they owe”

The Plan states that it would generate $700 billion over 10 years by devoting more money to IRS enforcement and increasing information reporting requirements. These increased audit activities would be targeted toward those Americans with “actual income” of $400,000 or more. The Plan would also “require financial institutions to report information on account flows so that earnings from investments and business activity are subject to reporting more like wages already are.”

Other Changes

The proposal also states that it would eliminate carried interest and extend the excess business loss limitation rules originally implemented by the TCJA.

Impact of the American Families Plan on Agriculture

We now provide a high level discussion of the above provisions, first by reviewing current law and then by applying several simple examples to demonstrate (at a very basic level) how the proposals could change the current landscape.

Lifetime Sale – Appreciated Assets

Under current law, taxpayers must pay a tax upon the sale of appreciated assets during their lifetime. This tax is calculated based upon whether the gain is short-term capital gain, which generally arises when the asset is held for one year or less, or long-term capital gain, which usually arises when the asset is held for more than one year. Current law affords a preferential rate schedule for long-term capital gain. Short-term capital gain is generally taxed as ordinary income. In either case, the gain is calculated based upon the difference between the owner’s basis (generally cost plus improvements) and the sales price. As shown in the chart below, the top long-term capital gains tax rate is presently 20 percent.

Tax Rates - 2021

Ordinary Income Tax Rates					Long-Term Gain		
Single		MFJ			Single	MFJ	
0	9950	0	19,900	**10%**	0	0	
9951	40,525	19,901	81,050	**12%**	40,400	80,800	**0%**
40,526	86,375	81,051	172,750	**22%**	40,401	80,801	
86,376	164,925	172,751	329,850	**24%**			
164,926	209,425	329,851	418,850	**32%**			
209,426	523,600	418,851	628,300	**35%**	445,850	501,600	**15%**
523601+		628,301+		**37%**	445,851	501,601	**20%**

Present law also imposes a net investment income tax (NIIT) on the gain arising from the sale of **investment** assets. This 3.8 percent tax is imposed upon taxpayers with net investment income and modified adjusted gross income above the following threshold levels:

Filing Status	Threshold Amount
Married filing jointly	$250,000
Married filing separately	$125,000
Single	$200,000
Head of household (with qualifying person)	$200,000
Qualifying widow(er) with dependent child	$250,000

Also called the “Medicare” tax, Congress instituted the NIIT in 2013 to help pay for the Affordable Care Act. In addition, capital gain is often subject to taxation at the state level.

Current Law Example

Harris and Harriet are retiring farmers who accumulated 1,000 acres of farmland during their lifetime. They acquired 500 acres in 1974 at a cost basis of $550/acre. They acquired the additional 500 acres in 1987 for $800 an acre. If Harris and Harriet sell their farmland in 2021 for $7,200/acre, they will have taxable long-term gain of $6,525 per acre or $6,525,000. At current rates, assuming other income is offset by the standard deduction, this sale would result in tax of approximately **$1,267,800 (17.6 percent of the sales price)**.[6] Because Harris and Harriet are farmers, their land is a business asset, and they are not subject to the NIIT. In Iowa, they would also be allowed a capital gains tax deduction because they had farmed the land they owned for at least five of the last 10 years.[7]

This result would change if Harris and Harriet had begun cash renting their land 10 years before retiring.

In that case, the sale would also trigger the 3.8 percent NIIT and an Iowa tax on the capital gain. This would mean an additional $238,450 in NIIT and approximately $556,000 in Iowa tax, for a total tax bill of **$2,062,250 (28.6 percent of the sales price).**

Impact of the American Families Plan?

In the first example, where Harris and Harriet continued to farm, the American Families Plan would more than double their tax liability from **$1,267,800 to approximately $2,594,700 (36 percent of total sales price)**. This increase would flow from the taxation of most of the gain at a new higher ordinary income tax rate and the imposition of the 3.8 percent Medicare tax on the gain above $400,000. If Harris and Harriet were not farming, they would also owe approximately $556,000 in Iowa tax, for a total tax bill of **$3,150,700 (43.8 percent of sales price).**

Lifetime Sale – Depreciated Assets

Some business assets that do not appreciate in value nonetheless trigger tax at sale under law requiring the **recapture** of depreciation and expensing benefits. *See* IRC § 1245. The sale of *depreciable* personal property, for example, triggers an *ordinary* income tax on the difference between the original cost basis and any depreciation or expensing taken against the cost of those assets.[8] This tax recaptures the tax benefit received by the taxpayer through accelerated cost recovery. Although the gain is taxed as ordinary income, it is not subject to self-employment tax.

Current Law Example

Harris and Harriet also own farm equipment that they have fully expensed. If they sell the equipment for $675,000 in 2021, they must pay ordinary income tax on the proceeds of the sale to recapture depreciation and expense deductions taken in prior tax years.

Impact of the American Families Plan?

Under the Plan, a portion of this income would likely be taxed at a higher top tax rate of 39.6, the amount taxed at the higher rate would depend upon any bracket adjustments made by the plan. $275,000 of the income (even in the absence of additional income), would potentially be subject to the 3.8 percent Medicare tax under the new rules for taxing non-investment income (additional $10,450).

Lifetime Sale – Business Inventory

The tax treatment of assets grown or raised by a farmer is different. Any business inventory sold by the farmer is subject to ordinary income tax and self-employment tax.

Current Law Example

Harris and Harriet own a grain bin full of corn they grew and stored while they were farming. If they sell the corn for $700,000 in 2021, they will owe ordinary income tax and self-employment tax on the proceeds of the sale.

Impact of the American Families Plan?

Under the Plan, a portion of this income would be taxed at a higher top tax rate of 39.6 percent (the income brackets for the new tax rates are unclear).

Gifts at Death – All Assets

Under current law, property transferred at death receives a basis adjustment in the hands of the recipient.[9] Generally, the basis in the hands of the recipient will equal the fair market value[10] of the property at the date of the death or six months thereafter. This is usually referred to as a "step up" in basis, although it can be a "step down" as well.

The tax free step-up in basis rule has been explicit in the tax code since at least 1921.[11] Although sometimes explained as a tool to prevent the double taxation of assets subject to the estate tax, the basis adjustment and the estate tax have never been expressly synced. The step-up in basis, for example, applies even when estate property is exempt from a transfer tax. This was as true in 1921 as it is 100 years later.

For much of its long history, the tax-free step up in basis has been attacked by some as conceptual error in need of revision.[12] Even so, efforts to change the deep-seated rule have met great opposition. A 1976 law[13]—which would have changed the step-up-in-basis to a carryover basis rule (similar to the current rule for lifetime gifts)—was later repealed *retroactively* without effect.[14] Opponents argued that a carryover basis rule at death would be unwieldy and unfair. Common concerns included the difficulty of obtaining basis records from the deceased and the burden of tracking historical basis across generations. Without these records, opponents argued that beneficiaries later selling assets would be subject to unfair tax burdens because rules would require them to treat an undocumented basis as zero.

Another alternative to the step-up in basis—on-occasion proposed, but to this point never gaining traction in Congress—is that of treating death and gift as income realization events. In other words, as in some form now proposed by the American Families Plan, unrealized gain at death would be taxed to the decedent as though the property had been sold. Likewise, donors would be taxed on unrealized gain at the time of making a gift. These proposals, when raised in the past, have met with even more resistance than the carryover basis. Although some believe this approach would be the most logical and would promote income equality, others argue the rule would be fraught with unworkable administrative challenges and unfair burdens. The difficulties would be similar to

those inherent in the carryover basis rule, but magnified by the immediate imposition of tax liability in the absence of income to fulfill the obligation. In particular, the fate of small businesses and family farms faced with large tax bills at transfer and the difficulty inherent in carving out equitable and workable exceptions has prevented this approach from gaining much acceptance in the past.

Current Law Example

Assume for simplicity that all of the assets discussed in the previous example were owned by Harris alone (pretend Harriet never existed) and that Harris died in 2021. When Harris' daughter Jordan inherits these assets, her basis is adjusted to be equal to the value of the assets on the date of Harris' death.

- Land – 1,000 acres at $7,200 / acre basis
- Machinery – $675,000 basis
- Corn - $500,000 basis

If Jordan immediately sold the assets after inheriting them, she would owe no tax.

Impact of the American Families Plan?

The American Families Plan would treat the transfer of Harris' farmland at death as a sale of the property. If Jordan is not actively farming, this would trigger the taxation of $5,525,000 gain ($6,525,000 total capital gain minus $1,000,000 exemption), resulting in a tax bill of approximately **$2.19 million** (or **30 percent of the sales price**). The basis in the farmland would step up to $7,200,0000 (because of the $1 million exemption and the payment of the tax). Jordan may have to sell a portion of the land to pay the tax.

If Jordan is actively farming, the family may receive an exemption to defer the tax liability on the previously unrealized gain. The tax would presumably become due at any point where the land was no longer actively farmed by a family member, perhaps with interest. If Jordan takes advantage of the active farming deferral, the basis in the farmland would step up by $1,000,000 (pursuant to the $1 million exemption), but no further basis adjustment would be made.

It is unclear how the American Families Plan would treat the machinery and grain at death since it speaks only of "capital gain."[15] Would the transfer of these assets receive a step-up in basis outside of the $1 million exemption? These are key details the high-level proposal does not discuss.

Lifetime Gift – All Assets

Property transferred by gift is treated differently. The gift does not trigger income tax liability, but the recipient of the gift takes the property with the same basis the property had in the hands of the donor. This "carryover basis"

rule has been in place under IRC § 1015 since 1921. Before that time, owners of appreciated property could escape the capital gains tax by transferring the property to someone else because the basis of gifted property was set at fair market value in the hands of the donee. The gift tax was introduced in 1924.

Current Law Example

If Harris gifted all of his assets to his adult daughter Jordan in 2021, Jordan's basis in the assets would be the same as that of Harris:

- Land – 500 acres at $550/acre and 500 acres at $800/acre
- Machinery – 0 Basis
- Corn – 0 Basis

If Jordan were to sell the assets received from Harris, she would be liable to pay tax on the gain. As a recipient of gifted depreciated property (the machinery), she would be liable to pay the recapture tax. If Jordan is not a farmer, however, the grain would be a capital asset in Jordan's hands, instead of inventory. As such, if Jordan held the grain for more than one year (including the time it was held by her parents), the gain from the sale of the corn would be subject to the preferential long-term capital gains tax rate and no self-employment tax. Gain from the sale of the land would be subject to the long-term capital gains tax rates whether the land is held by Jordan as a business asset or a capital asset.

Impact of the American Families Plan?

It is unclear how the American Families Plan would treat the gifting of assets. It is likely, however, that it would be subject to the income realization rules proposed for death transfers. Without this consistency, taxpayers would be incentivized to transfer property during their lifetimes to much younger relatives instead of passing it to beneficiaries at death.

The more detailed Step Act proposal ,[16] would treat property transferred by gift as sold for purposes of realizing gain. The Step Act has proposed only a $100,000 gain exemption for lifetime gifts. The $100,000 exemption would offset a higher $1,000,000 exemption for unrealized gain transferred at death. Under this approach, it appears basis would step up at transfer since the tax would be paid. If this is the approach taken by the American Families Plan, the transfer to Jordan would presumably be taxed in a similar way to that of the sale detailed above. It is unclear whether the active farming exemption would apply to defer the tax due upon a gift transaction.

Lifetime Exchange – Real Property

Under current law, gain or loss on the exchange of *real* property held for productive use in a trade or business or

for investment is *deferred*, as long as that property is exchanged for like-kind real property also used in a business or held for investment. IRC § 1031(a). This means that appreciated real property, such as a farm field or an office building, can be exchanged for other real property of equal or greater value without incurring any tax liability. The basis of the relinquished property is carried over to the replacement property, and the gain is not recognized until a later sale. The policy behind the like-kind exchange—which has, in some form, been part of the tax law for more than 100 years—is that owners who exchange property for similar property haven't changed their economic position. Without this deferral, the tax obligation would reduce the money available to invest in their replacement property, reduce the ability of real property owners to improve property, and disrupt property markets. Farmers frequently use this tool to make their operations more efficient. It allows them, for example, to acquire contiguous, more geographically efficient parcels as they become available or to reshuffle ownership of multiple parcels owned with others as tenants in common. Critics argue that the impact of section 1031, coupled with the step up in basis rules described above, forever forgives billions of dollars of gain and leads to greater wealth inequality.

Although the Tax Cuts and Jobs Act eliminated like-kind deferral treatment for the exchange of personal property (farmers, for example, must now recognize gain on the trade-in value of a tractor), section 1031 for real property survived.

> *Current Law Example*
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> Martin, who farms in western Iowa wants to move to eastern Iowa to be closer to family. His 500-acre farm, a lifetime gift from his grandfather, has a basis of $600/acre. Martin has found a farm in eastern Iowa of equal value. Using a section 1031 exchange, current law allows Martin to sell his farm in western Iowa and reinvest the proceeds into the farm in eastern Iowa without incurring tax liability. Martin's basis in his new 500-acre farm (worth the same for simplicity), is $600/acre.
>
> Assuming land now worth $7,500/acre, if Martin sold his farm in western Iowa without using § 1031, he would incur approximately $690,000 in tax liability, limiting his ability to reinvest in a similar property.
>
> *Impact of the American Families Plan?*
>
> The American Families Plan would significantly restrict Martin's options. The Plan would allow him to defer only $500,000 in gain under IRC § 1031. As such, he would be required to realize $2,950,000 in gain upon the exchange. Furthermore, $1,950,000 of this gain would be subject to ordinary income tax rates ($772,200) and $2,550,000 would be subject to the Medicare tax ($96,900). In total, Martin would owe an estimated $1,065,100 in tax on the $3,750,000 "exchange" (or 28.4 percent of the sales price).

Review of Estate and Gift Tax under Current Law

In addition to triggering income tax consequences, some asset transfers are subject to estate and gift tax consequences. In 2021, however, these latter taxes impact very few Americans. Under current law, a tax is imposed on the value of property transferred at death and via lifetime gift.[17] IRC §§ 2001, 2501. A unified credit, however, provides that no tax liability will be imposed unless the sum of lifetime taxable gifts and property transferred at death exceeds the "basic exclusion amount." In 2021, this basic exclusion amount is $11.7 million per person. Married couples may receive the benefit of a double exclusion because at the death of the first spouse, "portability" grants the surviving spouse the option to preserve the deceased spouse's unused exclusion as well. IRC § 2010(c)(4). Although estate and gift tax rates are graduated, transfers in excess of the exemption are currently taxed at 40 percent because the present exemption exceeds the top rate threshold, which is $1 million.[18] In other words, for estates subject to the estate and gift tax, the tax rate is steep.

In addition to the lifetime exclusion amount, current law allows an annual exclusion for lifetime gifts of $15,000 per year. This means that a person can gift up to $15,000 per year to as many people as they wish without incurring a gift tax obligation. IRC § 2503(b)(1). Gifts over $15,000 to a single recipient in any year require the donor to file a Form 709, Gift Tax Return. Gift tax is only due, however, if the giver has exceeded their basic exclusion amount with the sum of their lifetime gifts.

The estate tax basic exclusion amount[19] has increased dramatically during the past several decades:

- 2005 $1.5 million
- 2005 $1.5 million
- 2006 $2 million
- 2007 $2 million
- 2008 $2 million
- 2009 $3.5 million
- 2010 $5 million (or no estate tax with carryover basis)
- 2011 $5 million
- 2012 $5.12 million
- 2013 $5.25 million
- 2014 $5.34 million
- 2015 $5.43 million
- 2016 $5.45 million
- 2017 $5.49 million
- 2018 $11.18 million
- 2019 $11.4 million
- 2020 $11.58 million
- 2021 $11.7 million

At current exemption levels, very few estates owe estate tax. The Tax Policy Center has estimated that only .1 percent of the 2.8 million people expected to have died in 2020 will owe any estate tax.[20] USDA-ERS recently

estimated that of the approximately 31,000 principal farm operators expected to have died in 2020, 189 (0.6 percent) will be required to file an estate tax return, and only 50 (0.16 percent) will owe Federal estate taxes.[21] Absent intervention from Congress, the basic exclusion is set to go back to $5 million, indexed for inflation, in 2026.

> *Current Law Example*
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> If Jordan from the last example died in 2021 with an estate valued at $8,375,000, no estate tax would be due because her basic exclusion amount exceeds the value of her estate. If, however, Jordan had been allowed only a $3.5 million exemption (as was in place in 2009), her estate would be subject to $1.95 million in estate tax.
>
> *Impact of the American Families Plan?*
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> The American Families Plan does not propose to change the current estate and gift tax exemptions or tax rates. On March 25, 2021, Senator Bernie Sanders introduced the "99.5 Percent Act." This proposal would lower the basic exclusion to $3.5 million ($1 million for lifetime gifts) and increase the highest estate tax rate from 40 percent to 65 percent.

What's Ahead?

It is difficult to predict the likelihood that significant changes such as those proposed by the American Families Plan[22] will become law. It is also unclear when these proposals would go into effect. Such legislation, however, could potentially be effective from the date of passage or even retroactive to the beginning of the current tax year to prevent last-minute planning in anticipation of changes. The Senate parliamentarian has paved the way for further use of budget reconciliation during this session. This means that a final vote of 51-50 (with Vice President Harris casting a deciding vote) would likely be sufficient for passage. There appears to be much impetus to enact substantial tax reform before the 2022 election. The outcome will likely depend greatly upon the will of several moderate Democratic Senators. We will be watching developments closely.

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[1] 'Sensible Taxation and Equity Promotion Act of 2021".

[2] For example, the Step Act does not include a special exemption for family owned businesses and farms.

[3] It is not clear if this oft-cited $400,000 threshold is a shortcut for the highest single tax bracket or whether

there would be a new threshold for some of these rules (as there has been for the net investment income tax).

[4] See IRC § 1411.

[5] See IRC § 121 (rule requires taxpayers to have lived in the home 2 out of the last 5 years)

[6] The farmland would be property used in a trade or business under IRC § 1231.

[7] Iowa Admin. Code 701-40.38(1).

[8] The sale of IRC § 1250 property is subject to different rules.

[9] IRC § 1014(a).

[10] Some business and farm assets are subject to optional special use valuation rules under IRC §2032A.

[11] Revenue Act of 1921, Pub. L. No. 67-98.

[12] For a detailed history of this provision, *see* Lawrence Zelenak, *Figuring Out the Tax: Congress, Treasury, and the Design of the Early Modern Income Tax*, Cambridge University press, 2017/2018.

[13] *See* Tax Reform Act of 1976, Pub. L. No. 94-455.

[14] *See* Pub. L. No. 96-223 (1980).

[15] The Step Act proposal explicitly excludes tangible personal property used in a business from the “sale on death” rule.

[16] This legislative proposal was released by Senators Chris Van Hollen, Cory Booker, Bernie Sanders, Sheldon Whitehouse, and Elizabeth Warren on March 29, 2021.

[17] This article does not discuss the general skipping tax, which is beyond the scope of this discussion.

[18] The executor of an estate required to pay estate tax must file a Form 706 and pay the tax due within nine months of the date of death. An executor must also file a Form 706 if they wish to elect portability on behalf of the surviving spouse.

[19] The gift tax and estate tax did not share an exclusion until 2011.

[20]*See* https://www.taxpolicycenter.org/briefing-book/how-many-people-pay-estate-tax

[21] *See* https://www.taxpolicycenter.org/briefing-book/how-many-people-pay-estate-tax

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"Green Book" Details President's Tax Reform Proposals

June 2, 2021 | Kristine A. Tidgren

On May 28, 2021, the Treasury Department released the "Green Book," a description of revenue proposals within President Biden's fiscal year 2022 budget. This document includes a wish list of tax changes the Administration says would "raise revenue, improve tax administration, and make the tax system more equitable and efficient." The proposals are an opening bid for potential tax reform in the months to come, providing a bit more detail on the President's Build Back Better agenda, namely the American Jobs Plan and the American Families Plan. We discussed the potential impact of the American Families Plan in a previous post (including some basic examples). Here we review key provisions detailed in the Green Book, recognizing that any final legislation will likely look quite different from the proposed provisions.

General Explanations
of the
Administration's Fiscal Year 2022
Revenue Proposals

Increase the Top Individual Tax Rate

For tax years **beginning in 2022**, the proposal would restore the 39.6 percent individual tax rate that was in effect before the Tax Cuts and Jobs Act (TCJA) and lower the income thresholds to which it applies. For tax years beginning in 2018 through 2025, the TCJA lowered the top tax rate from 39.6 percent to 37 percent. It also raised the income thresholds at which the highest rate was triggered. The Green Book explains that "this change would

raise revenue while increasing the progressivity of the tax system."

Under the proposal, joint filers would reach the 39.6 percent top tax rate in 2022 with $509,301 of income. Under current law, joint filers reach the highest tax rate of 37 percent with $628,301 of income. This chart shows how the top rate would change in 2022 under the President's proposal.

Top Tax Rate Increase

	2021 (37 percent)	2022 (39.6 percent)
MFJ	$628,301	$509,301
Single	$523,601	$452,701
HOH	$523,601	$481,001
MFS	$314,151	$254,651

Eliminate the Preferential Capital Gain Tax Rates for Taxpayers with > $1 million in Income

***After the date of the announcement* (which was April 28, 2021)**, the proposal would subject long-term capital gain to **ordinary income tax rates** where overall income (including gain) exceeds $1 million. The highest tax rate would apply to all income (including capital gain) that exceeds $1 million ($500,000 for married filing separately), indexed for inflation after 2022. The Green Book explains, "Reforms to the taxation of capital gains and qualified dividends will reduce economic disparities among Americans and raise needed revenue."

Currently, long-term capital gain is taxed at the highest rate of 20 percent. Gain subject to the net investment income tax (NIIT) (see below) is taxed at a top federal rate of 23.8 percent. This rate is only reached for joint filers with income of $501,601 or more. Most long-term capital gain is taxed at a 15 percent rate. Under the proposal, all income above a new income cutoff of $1,000,000 would be taxed at the highest rate of 37 percent in 2021 and 39.6 percent in 2022 and beyond.

Tax Rates - 2021

Ordinary Income Tax Rates					Long-Term Gain			New Proposal
Single		MFJ			Single	MFJ		
0	9950	0	19,900	**10%**	0	0		
9951	40,525	19,901	81,050	**12%**	40,400	80,800	**0%**	**0%**
40,526	86,375	81,051	172,750	**22%**	40,401	80,801		
86,376	164,925	172,751	329,850	**24%**				
164,926	209,425	329,851	418,850	**32%**				
209,426	523,600	418,851	628,300	**35%**	445,850	501,600	**15%**	**15%**
523601+		628,301+		**37%**	445,851	501,601	**20%**	**20%**
					1,000,000	1,000,000		**37%***

*In 2022, this rate would jump to 39.6.

The Green Book provides the following 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.

As explained below, the proposal would also impose a 3.8 percent NIIT on this gain, increasing the top 2022 tax rate for long-term capital gain to 43.4 percent.

Extend the Application of the Net Investment Income Tax and SECA

Current Law

Presently, the 3.8 percent NIIT, which was implemented with the Affordable Care Act, applies to net investment income higher than $200,000 for singles and $250,000 for MFJ. Net investment income includes:

- Most interest, dividends, rents, annuities, and royalties
- Income derived from a trade or business in which the taxpayer does not materially participate
- Income from a business of trading in financial instruments or commodities
- Net gain from the disposition of property other than property held in a trade or business in which the taxpayer materially participates

Although called the “Medicare tax,” money generated from the NIIT is paid into the general fund.

Wages and self-employment earnings are subject to employment taxes under either the Federal Insurance

Contributions Act (FICA) or the Self-Employment Contributions Act (SECA). FICA and SECA tax applies at a rate of 12.4 percent for social security (capped at $142,800 in 2021) and at a rate of 2.9 percent for Medicare on all employment earnings (no cap). The Affordable Care Act imposed an additional 0.9 percent Medicare tax on self-employment earnings and wages of high-income taxpayers, above the same NIIT thresholds of $200,000 for single and head of household filers and $250,000 for joint filers. This ensures that a 3.8 percent Medicare tax applies to earnings as well.

The Green Book explains that while general partners and sole proprietors pay SECA tax on earnings from their businesses, S corporation owner-employees pay employment tax only on their "reasonable compensation" and limited partners pay employment tax only on any employee earnings. LLC members often pay little or no SECA tax at all. The Green Book urges that "different treatment is unfair, inefficient, distorts choice of organizational form, and provides tax planning opportunities for business owners, particularly those with high incomes, to avoid paying their fair share of taxes."

Proposal

The proposal would seek to ensure that anyone earning more than $400,000 would be subject to the 3.8 percent Medicare tax. The $400,000 income limit is a threshold the President has used to define "wealthy." The imposition of this new tax would be accomplished in several ways.

- Making the application of SECA to partnership and LLC income more consistent for high-income taxpayers
- Applying SECA to the ordinary business income of high-income non-passive S corporation owners
- Ensuring that all trade or business income of high-income taxpayers is subject to the 3.8 percent Medicare tax, either the NIIT or SECA tax
- Redirecting NIIT funds to the Hospital Insurance Trust Fund

Making the application of SECA to partnership and LLC income more consistent for high-income taxpayers

The proposal suggests that limited partners and LLC members who *materially participate or provide service* to their businesses would be subject to SECA tax on their distributive shares of partnership or LLC income to the extent that their overall business and employee income exceeds $400,000. Material participation standards would apply consistently to these limited partners and LLC members. Exemptions from SECA tax for rents, dividends, capital gains, and certain retired partner income would continue to apply.

Applying SECA to the ordinary business income of high-income non-passive S corporation owners

Likewise, the proposal states that S corporation owners who materially participate in the trade or business would be subject to SECA taxes on their distributive shares of the business's income to the extent that their overall business and employee income exceeds $400,000. Current exemptions from SECA tax for rents, dividends, and capital gains would continue to apply.

Ensuring that all trade or business income of high-income taxpayers is subject to the 3.8 percent Medicare tax, either the NIIT or SECA tax

For taxpayers with more than $400,000 in adjusted gross income, the proposal would change the definition of net investment income to include "gross income and gain from any trades or businesses that is not otherwise subject to employment taxes." This would, for example, apply the 3.8 percent Medicare tax to any high earner income missed by the above SECA expansion. This would appear to include IRC § 1231 gain and self-rental income. The 3.8 percent tax would appear to apply to IRC §§ 1245 and 1250 gain as well, whether through a SECA enhancement or a NIIT expansion.

Redirect NIIT funds to the Hospital Insurance Trust Fund

The proposal would redirect the "Medicare tax" from the general fund, as directed by the Affordable Care Act, to the Hospital Insurance Trust Fund, where the SECA and FICA Medicare tax is paid.

Treat Property Transfers at Death or Gift as Realization Events

Beginning in 2022, the AFP would treat the **transfer of appreciated property at death or by gift as a sale**, meaning that unrealized capital gain would be taxed at the time of death or gift. This would be a new tax, never before imposed in the U.S. As described in the Green Book, dying with or gifting appreciated property would trigger taxable income to the decedent on the federal gift or estate tax return or on a separate capital gains return.

> **Note**: This proposal is in conjunction with provisions that would **increase the top tax rate**, subject gains to **ordinary income tax rates where income is more than $1 million**, and **apply the NIIT to gain from the sale of business assets, like farmland, if overall adjusted gross income is more than $400,000**.

Transfers to Spouses and Charities

Although transfers to a spouse or charity would be exempt from the new tax recognition rules, the proposal states that these transfers would be completed with a *carryover basis***.** Thus, capital gain would be recognized when the surviving spouse disposes of the asset or dies, and appreciated property transferred to charity would no longer result in a charitable deduction based upon fair market value. Likewise, the transfer of appreciated assets to a split-interest trust would generate a taxable capital gain, with an exclusion allowed only for the charity's share of the gain based on the **charity's share of the value**. This means that transfers of appreciated property to charitable remainder trusts would be largely taxable.

Transfers of Tangible Personal Property

The proposal states that it would exclude from recognition any gain on “tangible personal property such as household furnishings and personal effects (excluding collectibles).” It is unclear from this statement whether all tangible personal property, such as depreciated business equipment, would be covered by this exclusion.

Exemptions

Each person would be allowed to exclude **up to $1 million (indexed for inflation) in gain from recognition at death or at the time of gift**. Spouses would each get their own exemption, which would be **portable**, meaning that a couple could exempt $2 million in gain from tax. Additionally, the proposal would exempt $250,000 in gain from the sale of a personal residence ($500,000 for married filing jointly). The current exclusion for capital gain on certain small business stock would also apply.

Basis

The proposal states that if property is transferred at death, the recipient’s basis in the property would be the FMV of that property at the decedent’s death.

> **Example**: Decedent transfers a $5 million parcel of land with $3 million in appreciation ($2 million basis) at death. The heir receives the land with a $5 million basis. Tax is due on $2 million of gain after the $1 million exemption.

If property is transferred by gift, the recipient would receive a *carryover basis*, to the extent that the $1 million exclusion applies. In other words, if a gift triggers a transfer tax, the basis would adjust to FMV only for that portion of the property subject to the tax.

> **Example**: Donor gift a $5 million parcel of land with $3 million in appreciation ($2 million basis). Here the donee receives the land with a $4 million basis. Tax is due on $2 million of gain.

Interaction with the Estate Tax

Note that this tax is not an estate tax based upon the value of the estate. It is a tax on unrealized gain. The current estate tax would continue to apply if the value of the estate exceeds the basic exclusion amount (currently $11.7 million). The proposal states, however, that the new tax would be deductible from the estate value. The Green Book does not contain any estate tax proposals, but current law would reduce the current basic exclusion by 50 percent in 2026.

Special Provisions for Trusts, Partnerships and Other Non-Corporate Entities

The proposal also states that gain on unrealized appreciation would be recognized by a trust, partnership, or other non-corporate entity (presumably an LLC) 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. Under this proposal, the first possible recognition event for any taxpayer would be **December 31, 2030** (90 years from January 1, 1940).

No Valuation Discounts for Minority Interests

The proposal states that transfers would be defined under the gift and estate tax provisions and would be valued using the methodologies used for gift or estate tax purposes. A transferred partial interest would be its proportional share of the fair market value of the entire property. This means that the proposal would disallow valuation discounts for minority interests.

Transfers into and out of Trusts, Partnerships, and Non-Corporate Entities Would Be Recognition Events

The proposal states that transferring property into and receiving distributions in kind from, a trust, partnership, or other non-corporate entity (LLC)—other than a grantor trust that is deemed to be wholly owned and revocable by the donor—would be recognition events. While this provision is likely intended to prevent recognition avoidance schemes, this proposal would fundamentally transform partnership taxation.

Deferral of Tax for Family-Owned and Operated Businesses

The proposal states that 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**. No further details are provided on this key, yet difficult, exception. It is likely that in conjunction with deferral liens would be imposed on the property to secure the unpaid tax.

15-Year Payment Plan

The proposal provides a 15-year fixed-rate *payment plan* for the tax on appreciated assets transferred at death, except for liquid assets, such as publicly traded stock, and family owned and operated businesses that elect a tax deferral.

Other Provisions

The proposal includes several other details:

- The full cost of appraisals of appreciated assets would be deductible.
- Liens could be imposed for unpaid tax.

- Underpayment of an estimated tax penalty would be waived if underpayment is due to death.
- New rules would seek consistency in valuation for transfer and income tax purposes.
- New rules and safe harbors for determining the basis of assets in cases where complete records are unavailable would be created.
- New reporting requirements for all transfers of appreciated property including value and basis information would be imposed.

Limit the Section 1031 Exchange

The proposal would limit the IRC § 1031 like-kind exchange deferral to $500,000 in gain ($1 million for a married couple) ***per year***. The Green Book states that this proposal would raise revenue while increasing the progressivity of the tax system. This provision would apply to exchanges ***completed*** after the 2021 tax year.

Increase the Corporate Tax Rate

The proposal would raise the corporate tax rate from 21 percent to 28 percent, for tax years beginning in 2022. Before 2018, the corporate tax rate was 35 percent. It is not clear whether any increased corporate tax rate would be graduated (like the pre-2018 rate).

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