Case Study of Taxation of Appreciated Assets in the Biden 2023 Budget

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ABSTRACT

This research project requires students to research and analyze a proposal in the 2023 Federal Budget that would significantly alter the traditional tax treatment of unrealized gains on appreciated assets for high-net-worth individuals. Historically, unrealized gains on assets have not been taxed until there has been a sale or other disposition of an asset by a taxpayer. The rationale for such an approach has been no tax should be imposed until the taxpayer has "the wherewithal to pay" the tax. (Eisner v Macomber, 252 U.S. 159 (1920)). The case examines the proposed 2023 Federal Budget treatment of taxing unrealized gains for taxpayers with net worth's exceeding $100 million dollars. The case deals with the hypothetical impact of this proposal on Bill Gates, requiring the students to calculate the Federal tax due in 2023.

Keywords: appreciated assets, unrealized gain, realized gain, minimum tax, regular tax

INTRODUCTION

Background

Since the Internal Revenue Code's inception, Federal tax law has only taxed realized gains from sales or exchanges of assets. Mere appreciation of assets has never been taxed, primarily because taxpayers lack the ability to pay the tax. If there has been no bargained for exchange, taxpayers have no cash or other liquid assets which could be used to pay the tax.

In part, due to revenue shortfalls and the concern the deferral of tax on unrealized gains gives high net worth taxpayers an advantage that modest income taxpayers do not have, the Treasury Department has proposed the creation of a new minimum tax on unrealized gains which would apply to taxpayers with net worth's exceeding 100 million dollars in 2023.

Bill Gates, the former Microsoft executive, is introduced to students as the specimen for application of the minimum tax. Appreciation of certain of his assets are used to illustrate the potential impact of this revolutionary tax on high-net-worth individuals.

TEACHING NOTES

Student Outcomes and Proposed Use

The goal of this project is to understand the impact of taxing unrealized gains on high-net-worth individuals by researching and applying the principles contained in the Treasury Department's March 2022, General Explanations of the Administration's Fiscal Year 2023 Revenue Proposals, hereinafter referred to as the "Green Book." This proposed tax is unique under the Federal tax law. Researching and analyzing the impact of a Treasury Department proposal, as opposed to existing statutes or case law, will expand student's repertoire of skills for solving novel tax issues.

The desired student academic outcomes of the case are to:

1. understand the differences between realized and unrealized gains;
2. calculate the Federal income tax on realized and unrealized gains;
3. understand and calculate the minimum tax concept incorporated into the Biden Administration's 2023 proposal.

Course and Audience

This case should be suitable for advanced undergraduate and graduate accounting students. Extensive knowledge of Federal tax research is not necessary as these proposed tax concepts have not been introduced as legislation, nor codified yet. It is only necessary that students can access, read, and comprehend the Biden Administration's 2023 Budget.

Student's analysis can be presented in person in a classroom or virtual setting. The project may be used as homework with solutions presented in class incorporating tax analysis and study of the proposed 2023 Federal Budget.

Other options for the case's use include: assignment and completion of the case during one class period, either online or in person; or assignment for students to work individually or in groups outside of class, asking them to bring their research and analysis back to class for discussion; or the case could be used as a separately graded turned in assignment, either completed individually or in groups, depending upon the level of the course.

Student's interest in this subject matter should be high, as it involves a hypothetical situation with Bill Gates, one of the world's wealthiest individuals. In addition, this case should generate significant student interest because this proposed tax would bring a fundamental change in how our taxing system has worked since its inception in 1913.

THE CASE PRESENTED TO STUDENTS

The Case Situation

Bill Gates is one of the wealthiest individuals in the United States, with a current net worth estimated to be 121 billion dollars. (Hayes, 2022). The majority of his net worth was derived from his ownership in Microsoft Corporation. He owns approximately 1.3 percent of its shares currently valued at 20 billion dollars. Since his departure from Microsoft management in 2014, he has diversified his investments to include other investments in other companies, real estate holdings and collectables, among other things. (Hayes, 2022).

Much of Bill Gates' stockholdings are held in Cascade Investments, LLC, a wholly owned investment company. Its estimated current value is 35 billion dollars. (Hayes, 2022).

He also has significant real estate holdings, including his Xanadu home in the Seattle area valued at 131 million dollars, a Wellington Florida horse ranch valued at 8.7 million dollars, and the Grand Bogue Caye Island near Belize, valued at 25 million dollars. (Hayes, 2022).

Mr. Gates has invested in collectables, too, such as a Leonardo Davinci manuscript called Codex Leicester, valued at 31 million dollars and several paintings, including Andrew Wyeth's "Distant Thunder" valued at 7 million dollars and Frederick Childe Hassam's "Room of Flowers" worth 20 million dollars. (Hayes, 2022).

Assume Mr. Gates' portfolio of investments experiences the following results in 2023:

- His tradeable Microsoft stock appreciates by 10 percent from its 2022 tax basis and value of 20 billion dollars, based upon 2023-year end New York Stock exchange values.
- The non-tradeable Davinci manuscript has not been revalued since 2022, when it carried a 31-million-dollar tax basis and value. However, under the Green Book's guidelines, page 35, it will be revalued using the five-year Treasury interest rate plus two percent. The current five-year Treasury rate is 3.26, resulting in an appreciation rate of 5.26 percent.
- Mr. Gates' 2023 regular tax liability is $240,000,000 (based on a 40% tax rate given 600 million dollars of regular taxable income).

THE CASE DISCUSSION QUESTIONS

President Biden's proposed 2023 Federal Budget included a revolutionary tax proposal: to tax unrealized gains on appreciated assets prior to their sale or exchange. Research this proposal and answer the following questions.

1. What will the proposed tax on unrealized gains apply to?
2. How is the proposed tax on unrealized gains calculated?

3. Assuming Bill Gates' Microsoft stock increases by 10 percent and his Davinci manuscript increases by 5.26 percent in 2023, will he be liable for the unrealized gain tax? If so, how much?

Proposed Student Answer to Discussion Question 1

"What will the proposed tax on unrealized gains apply to?"

Under current Federal tax law, only realized gains from the sale or exchange of assets are subject to Federal income tax. See IRC 1001. The rationale for such an approach is Federal income tax should only apply when the taxpayer has the wherewithal to pay the tax. Eisner v Macomber, 252 U.S. 159 (1920). Consequently, the imposition of taxes on the appreciation of assets has been deferred to their sale. According to the Treasury Department, this results in incentives for high-net-worth individuals to hold portfolios to avoid capital gains taxes at preferable long term capital gain rates of 15 or 20 percent on most capital assets. This is particularly true when high- net- worth taxpayers retain appreciated assets to death, resulting in a step up in basis equal to the asset's fair market value. See IRC 1014. This effectively eliminates any gain on sale (Green Book, page 34). This proposal will also reduce the tax disparities between taxpayers and produce more tax revenue, estimated to be 360 billion dollars over ten years.

To combat such deficiencies under current Federal tax law, the Treasury Department proposes to assess a minimum tax on total income, including unrealized gains, for taxpayers with net worth's exceeding 100 million dollars (Green Book, page 34). The minimum tax will be phased in for taxpayers with net worth's between 100 and 200 million dollars (Green Book, page 35).

Proposed Student Answer to Discussion Question 2

"How is the proposed tax on unrealized gains calculated?

Each taxpayer affected by the minimum tax is required to make two tax calculations. First, each taxpayer calculates his/her regular tax liability under existing Federal tax law. Second, each taxpayer must calculate his/her minimum tax under the Treasury Department's proposal (Green Book, page 34). The taxpayer must pay the greater of the two. The minimum tax calculation can be summarized as: 20 percent minimum tax rate times total income, including unrealized capital gains, less the sum of unrefunded and uncredited prepayments of tax and regular tax liability. (Green Book, page 34). If minimum tax results from such calculation, the minimum tax payments are treated as prepayments of tax to be credited against subsequent taxes imposed when the asset is sold and the gain realized. This prepayment treatment avoids double taxation on disposition of the asset. (Green Book, page 34).

If this is the first time the taxpayer is subject to the minimum tax, it can be paid in nine equal annual installments. Minimum tax arising in subsequent years can be paid over five years, in equal annual installments. (Green Book, page 34).

The question how to value different types of assets obviously arises when considering the application of a tax based on unrealized appreciation. The Treasury Department proposes the following classification for asset groups.

1. Tradeable Assets: for example, publicly traded stock, are valued at year end market prices (Green Book, page 35).
2. Non-tradeable Assets: are valued as follows:
    a. At the greater of cost or adjusted basis; or
    b. The last valuation event from investment; or
    c. The last valuation event from borrowing; or
    d. Financial statements; or
    e. Other method approved by the Internal Revenue Service. (Green Book, page 34).

If cost or adjusted basis is used, it will be deemed to increase in value at the rate of the five-year Treasury rate plus 2 percent, annually. (Green Book, page 34).

Proposed Student Answer to Discussion Question 3

"Assuming Bill Gates' Microsoft stock increases by 10 percent and his Davinci manuscript increases by 5.26 percent in 2023, will he be liable for the unrealized gain tax? If so, how much?"

Yes, Bill Gates would be liable for the unrealized gain tax due to having a higher tentative minimum tax under this proposed legislation than his regular tax liability would be without this proposed tax. The additional unrealized gain tax would amount to $280,326,120. That would be paid in addition to his regular tax liability of $240,000,000. His total tax paid under the new proposal would be $520,326,120. Calculations follow.

A ten percent appreciation of the Microsoft stock would increase its 2022 value of 20 billion dollars to 22 billion dollars, a 2-billion-dollar increase. Gates' Davinci manuscript would increase from its 2022 value of 31 million dollars by $1,630,600, a 5.26 percent increase.

Assume Gates' regular taxable income is 600 million dollars for 2023. His minimum tax calculation is:

Total Income:	
Regular Taxable Income	$600,000,000
Unrealized Gains: Microsoft	$2,000,000,000
Unrealized Gains: Davinci Manuscript	$1,630,600
Minimum Taxable Income	$2,601,630,600
Minimum Tax Rate	X .20
Tentative Minimum Tax	$520,326,120
Less: Regular Tax Liability @ .40	($240,000,000)
2023 Minimum Tax Liability	$280,326,120
Paid in Nine Annual Installments of	$31,147,346

CONCLUSION

U. S. Federal deficits have exploded since Public Law 115-97, adopted December 22, 2017, topping 3.1 trillion dollars in 2020 and 2.8 trillion dollars in 2021 (U.S. Government Accountability Office, May 5, 2022). The Treasury Department is seeking ways to tap new revenue streams to combat and reduce these burgeoning deficits. The concept of applying a minimum tax of 20 percent, to unrealized gains of taxpayers with net worth's exceeding 100 million dollars, is one novel way to approach the deficit problem. The minimum tax would apply to very few taxpayers, estimated at one tenth of one percent of all U.S. households. But it is also estimated it will produce 360 billion dollars in Federal tax revenues over a decade. (Rappeport, 2022).

Whether this proposal has any traction in Congress remains to be seen. Since it is such a fundamental change in tax policy, it is difficult to predict its adoption. In fact, Senator Joe Manchin rejected the concept, calling it "a tough one. You can't be taxed on things you don't have. You might have it on paper. There are other ways for people to pay their fair share, and I think everyone should pay." (Ross, 2022).

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