TREAT WEALTH LIKE WAGES

A plan to fix our broken tax code, ensure the wealthy pay their fair share, and protect Social Security.

Senate Finance Committee
RANKING MEMBER RON WYDEN (D-ORE.)

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Fixing The Tax System To Save Social Security

Americans who work for a living pay taxes with every paycheck. Meanwhile, those whose income comes from wealth can defer their taxes, often for years. If they pay taxes at all after taking advantage of myriad loopholes, they can pay a lower rate than someone who earns a paycheck.

The average family worth more than $100 million has never paid tax on more than half their wealth (Federal Reserve).

Thanks to a broken tax code that favors income from wealth over income from wages, the average family worth more than $100 million has never paid tax on more than half of its wealth.[1] Working families pay taxes every two weeks. This is a system designed for the fortunate few by professional tax dodgers. It's time we had a new system where everyone pays what they owe and the wealthiest Americans don't get away with paying lower average tax rates than their drivers, nannies, and household workers.

This proposal introduces new anti-deferral accounting rules that would apply to only a fraction of the richest 1 percent of Americans and stop these taxpayers from avoiding taxes year after year. The proposal completely exempts middle-class workers and their families and includes specific exclusions for retirement accounts and family homes and farms.

Finally, every dime raised by these new accounting rules would go toward keeping the Social Security guarantee for future generations. Social Security represents the single greatest source of financial security for middle-class families without an army of accountants at their beck and call. Without additional funding, the program would only be able to pay 80 percent of benefits after 2035.[2] The revenue raised by this proposal will be dedicated to Social Security to help ensure full benefits for generations to come—without raising taxes on middle class families.[3]

1 Robert B. Avery, Daniel Grodzicki, and Kevin B. Moore, "Estate vs. Capital Gains Taxation: An Evaluation of Prospective Policies for Taxing Wealth at the Time of Death," Federal Reserve Board (2013).

2 The 2019 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Fund, April 25, 2019

3 Based on external revenue estimates of related proposals, the Senate Finance Committee estimates that this proposal will raise between $1.5 trillion and $2 trillion within the 10-year budget window, depending on the final details of the proposed legislation. According to the Social Security Administration Actuary, an additional $1.85 trillion each decade starting in 2020 would allow Social Security to pay full benefits until 2095.

Introduction

The preferential tax treatment given to certain types of capital income from investments over ordinary income from wages creates unfairness in the tax code and encourages tax avoidance. The preferences for capital income disproportionately benefit wealthy taxpayers, who receive much of their income from investments. More than half of the wealthiest households' taxable income is taxed at preferential rates, compared to just 2 percent for taxpayers making less than $100,000 annually.[4] According to 2016 data from the Internal Revenue Service (IRS), taxpayers with annual income above $500,000 received about 72 percent of all realized capital gains.[5] The concentration of capital income at the top means that middle-class taxpayers who receive most of their income from wages and salaries can face higher average tax rates than the wealthiest taxpayers.

In 2018, almost 70 percent of all realized capital gains went to the top 1 percent. More than 50 percent of realized gains went to the top 0.1 percent. (Tax Policy Center)[6]

This paper describes the disparate treatment of ordinary and capital income under current law and proposes a policy that would correct this massive tax inequity. The proposed policy would tax all income at the same progressive tax rates and tax wealthy taxpayers' investment income using anti-deferral accounting. Under anti-deferral accounting, tradable assets like stocks would be marked-to-market. Mark-to-market rules would require taxpayers to annually pay tax on any unrealized gain or take a deduction for any unrealized loss from tradable assets. To calculate the tax due on gains from nontradable assets like investment real estate, closely-held businesses, and valuable collectibles, anti-deferral accounting would use a lookback rule upon realization. The resulting lookback charge would tax the gain in a way that diminishes the benefit of deferring tax until sale.

4 Center for American Progress analysis of IRS Statistics of Income data. Alexandra Thornton and Galen Hendricks, "Ending Special Tax Treatment for the Very Wealthy," Center for American Progress, (2019).

5 IRS Statistics of Income, Table 1.4. All Returns: Sources of Income, Adjustments, and Tax Items, by Size of Adjusted Gross Income, Tax Year 2016.

6 Tax Policy Center, Table T18-0231 - Distribution of Long-Term Capital Gains and Qualified Dividends by Expanded Cash Income Percentile, (2018).

The wealthiest 1 percent of Americans own more wealth than the bottom 90 percent. (Center for American Progress)

The middle class would not be affected by these new accounting rules and would not pay more in tax under this proposal than they do under current law. Anti-deferral accounting rules would only apply to individuals with more than $1 million in annual income or more than $10 million in assets, recognizing that wealthy taxpayers employ sophisticated accountants and are best equipped to comply with the system. This proposal would simply change the role of these tax professionals from helping their clients avoid paying tax to helping them pay their fair share.

Senator Wyden is continuing to develop and refine the proposal described below and welcomes comments and feedback on any aspect of proposed policy. In addition, specific questions are highlighted throughout the text of the proposal.

Comments can be submitted to: demcapitalgainsreform@finance.senate.gov.

Taxation Of Ordinary And Capital Income Under Current Law

Classification of Ordinary and Capital Income

Under current law, U.S. citizens and resident aliens are generally subject to U.S. individual income tax on their total gross income less certain exclusions, exemptions, and deductions. Gross income can be divided into ordinary income and capital income. Ordinary income includes wages, salaries, business income, interest, rents, and royalties,[7] and capital income includes income from the sale or exchange of capital assets such as stocks, investment real estate, and business interests.[8]

Tax Rates for Ordinary and Capital Income

Ordinary and capital income are treated differently under the tax code and taxed at vastly different rates. Ordinary income is taxed at marginal rates ranging from 10 to 37 percent. Long-term capital gains and qualified dividends, on the other hand, are taxed at preferential rates that range from 0 to 20 percent, depending on the taxpayer's income.[9] The current tax brackets for ordinary and capital income are summarized in the following table.

7 Certain income from passthrough business entities, such as partnerships, disregarded entities, and S-corporations is considered ordinary income. However, a new deduction created by the 2017 tax law in tax code section 199A effectively provides preferential tax rates for passthrough business income, subject to certain restrictions.

8 While some capital income is taxed at ordinary rates, this proposal uses the term "capital income" to refer to income that is taxed at preferential rates.

9 The 37 percent top rate for ordinary income and the 20 percent top rate for capital income do not include the 3.8 percent Medicare payroll tax on earned income or the 3.8 percent net investment income tax, both of which affect taxpayers with incomes above $200,000 (or $250,000 for married couples). These additional taxes increase top effective rates on wage income and capital income to 40.8 percent and 23.8 percent, respectively.

Federal Income Tax Brackets for Taxpayers Filing a Joint Return, 2019[10]

Taxable Income	Ordinary Income Tax Rate	Long-Term Capital Gains and Qualified Dividends Tax Rate
$0 - $19,400	10%	0%
$19,401 – $78,950	12%	0%; up to $78,750
$78,951 – $168,400	22%	15%; applies above $78,750
$168,401 – $321,450	24%	15%
$321,451 – $408,200	32%	15%
$408,201 – $612,350	35%	15%; up to $488,850
$612,351 and above	37%	20%; applies above $488,850

More than half of the wealthiest households' taxable income is taxed at preferential rates, compared to just 2 percent for taxpayers making less than $100,000 annually. (Center for American Progress)

Opportunities for Avoidance

Wealthy taxpayers who receive their income from long-term capital gains generally face a lower average tax rate than taxpayers who receive the same amount in wages and salaries because rates for capital income are lower than rates for ordinary income. The disparate treatment of ordinary and capital income also creates opportunities for tax avoidance. The strategies described below allow wealthy taxpayers to accumulate wealth by reducing or avoiding taxes on their capital income, while most Americans struggle to save.

First, the tax rate differential encourages taxpayers to receive more of their income as lower-taxed capital income rather than higher-taxed ordinary income. Taxpayers often avoid realizing short-term gains, which are taxed at ordinary rates, and seek to convert capital losses into ordinary losses that can be deducted against higher-taxed wage and business income. Wealthy

10 Effective marginal rates may differ from the statutory rates shown here due to various phase-outs. Also, this table does not reflect the 3.8 percent Medicare payroll tax on earned income or the 3.8 percent net investment income tax.

taxpayers can also restructure their business arrangements such that they receive income in the form of lower-taxed capital gains rather than higher-taxed wages. For example, private equity managers are often compensated for their services with investment income that is taxed at capital rates instead of receiving salaries taxed at ordinary rates.

Second, taxpayers only pay capital gains taxes when they sell an asset. This allows wealthy taxpayers to accrue even more wealth without paying taxes on their capital income. They can also borrow against their wealth so that they continue to spend without sacrificing their savings. Meanwhile, working Americans pay taxes on wage income as they earn it, accumulating wealth at a much slower pace, if they are able to save at all. Data from the Federal Reserve show that 40 percent of Americans do not even have sufficient savings to cover a $400 expense in an emergency.[11]

Third, taxpayers avoid paying any tax on their capital income if they pass assets to their heirs instead of selling them. Taxable gain is generally the difference between an asset's basis (usually its purchase price) and its selling price. However, heirs enjoy a step-up in basis that changes the asset's basis to the fair market value at the time of inheritance. Stepped-up basis eliminates the difference between an asset's purchase price and its current value in the eyes of the tax code, meaning that no tax is paid on any gain accrued prior to inheritance. If heirs later sell these assets, they recognize gain and pay tax only on the difference between the price at sale and the fair market value at inheritance.

Comments are requested on how well the anti-deferral accounting proposal described below would minimize these opportunities for tax avoidance.

11 Report on the Economic Well-Being of U.S. Households in 2017, Federal Reserve, (2018).

Proposal To Reform Capital Income Taxation

This proposal equalizes the treatment of ordinary and capital income by eliminating the rate preference for long-term capital gains and applying new anti-deferral accounting rules for certain taxpayers. The new accounting rules would generally require annual recognition of unrealized gains and losses from tradable assets (such as stocks and bonds) and use a lookback rule to tax gains from the sale of nontradable assets (such as business interests and real estate) upon realization.[12] Anti-deferral accounting could easily assess tax annually on gains from tradable assets because the value of these assets is readily known. In contrast, anti-deferral accounting would not assess tax on gains from nontradable assets until the asset is sold or transferred. The lookback rule used to calculate the tax due on gains from nontradable assets would minimize the benefits of tax deferral.

According to 2016 data, taxpayers with annual income above $500,000 received about 72 percent of all realized capital gains. (IRS)

ELIMINATION OF THE LONG-TERM CAPITAL GAINS RATE PREFERENCE

This proposal would eliminate the current preferential rates for long-term capital gains and dividends so that all income is taxed at applicable ordinary income rates regardless of source. While this rate change would apply to all taxpayers, the middle class would not pay more tax than they do now.

12 Tradable assets are assets for which there is a readily ascertainable value, including actively traded property. For example, tradable assets include personal property traded on an established financial market as defined under Treas. Reg. Sec. 1.1092(d)-1. Generally, all other capital property that is not tradable property is considered nontradable property.

Comments are requested on the elimination of the capital gains rate preference, including:

- **Optimal rates and tax brackets for taxing capital and ordinary income at the same rates.**
- **Whether an exemption for a certain amount of a taxpayer's capital gains would be an appropriate method for ensuring the middle class does not pay more under the new rates.**

NEW ANTI-DEFERRAL ACCOUNTING RULES FOR HIGH-INCOME TAXPAYERS

This proposal would require taxpayers who meet certain income and asset requirements ("applicable taxpayers") to use anti-deferral accounting. Anti-deferral accounting rules include two components:

1. *Mark-to-market taxation of income from tradable property.* Applicable taxpayers would be required to annually pay income taxes on unrealized gains and would be able to take a deduction for unrealized losses from tradable property.
2. *Lookback taxation of income from nontradable property.* A lookback charge would be imposed on gains from nontradable property at realization. The lookback rule would be designed to operate alongside mark-to-market taxation of income from tradable property.

Transfers of property would be considered realization events for applicable taxpayers.[13] Other special rules would govern the treatment of certain assets under anti-deferral accounting and the application of anti-deferral accounting rules to passthrough entities and C corporations. Transition rules would be put in place to smooth the change from current law to anti-deferral accounting.

13 Certain contributions and distributions of property that currently receive tax-preferred treatment (e.g., tax code sections 351 and 721) would not be considered realization events.

Who Would Be Required to Use Anti-Deferral Accounting?

Anti-deferral accounting rules would apply to applicable taxpayers, generally defined as individuals, estates, or trusts that meet certain income or asset requirements.[14] The rules described below are designed to ensure that Americans who work hard and come into money are not immediately affected by anti-deferral accounting when they receive a one-time windfall. The income and asset thresholds are set at levels that only affect a fraction of the wealthiest 1 percent of Americans, and no taxpayer would be required to use anti-deferral accounting until she has met the income or asset threshold for three consecutive years.

How would the income and asset thresholds work?

A taxpayer would be an applicable taxpayer subject to anti-deferral accounting rules if she has met the income or asset threshold for each of the preceding three tax years.[15] The income threshold would be $1 million[16] and the asset threshold would be $10 million of applicable assets.[17] The thresholds would be the same for single and joint filers and would be indexed for inflation.[18]

Example 1: Taxpayer is an individual with the following income and assets:

Year	Income	Applicable Assets
1	**$1,500,000***	$3,000,000
2	**$1,600,000**	$2,000,000
3	**$1,700,000**	$3,000,000

* Bolded figures indicate that the taxpayer meets the relevant threshold in the given year.

The taxpayer is an applicable taxpayer starting in Year 4. Although she did not meet the asset threshold in the previous three tax years, she met the $1 million income threshold in each of the three years.

14 Requiring anti-deferral accounting only for taxpayers above designated income or asset thresholds would increase the progressivity of the tax code while recognizing that wealthy taxpayers already employ sophisticated accountants and are therefore best equipped to comply with the system.

15 Some or all of the preceding three tax years considered for the income and asset tests may be years prior to enactment of the proposal during the first three years after enactment.

16 Unrealized gains would not be counted as income toward the income threshold.

17 Applicable assets are further defined on pages 13 and 14.

18 All examples included in this proposal assume no inflation for the sake of simplicity.

Example 2: Taxpayer is an individual with the following income and assets:

Year	Income	Applicable Assets
1	**$1,100,000***	**$12,000,000**
2	**$1,300,000**	$9,000,000
3	$900,000	**$11,000,000**

* Bolded figures indicate that the taxpayer meets the relevant threshold in the given year.

The taxpayer meets both the asset and income thresholds in Year 1, but only the income threshold in Year 2 and only the asset threshold in Year 3. He is an applicable taxpayer in Year 4, as he met at least one threshold for each of the past three tax years.

The income and asset thresholds are solely used to determine whether a taxpayer is an applicable taxpayer. Once a taxpayer is an applicable taxpayer, she must use anti-deferral accounting for all of her property, subject to phase-in rules and certain exceptions.[19]

Comments are requested on the income and asset thresholds, including:

- **Techniques taxpayers may employ to accumulate significant wealth without meeting the income or asset threshold.**
- **Anti-avoidance provisions that would help prevent gaming near the thresholds.**

When would applicable taxpayer status be terminated?

Once a taxpayer becomes an applicable taxpayer, she would be treated as an applicable taxpayer until she fails to meet the income and asset thresholds for three consecutive tax years, at which point she would have the option to elect not to use anti-deferral accounting.

19 Phase in and transition rules are described on page 16. Special rules exempting certain types of property from anti-deferral accounting are described on pages 17-19.

Example 3: Taxpayer is an individual with the following income and assets:

Year	Income	Applicable Assets
1	**$1,100,000***	**$12,000,000**
2	**$1,300,000**	$9,000,000
3	$900,000	**$11,000,000**
4	$900,000	$8,000,000
5	$900,000	$7,000,000
6	$800,000	$9,000,000

* Bolded figures indicate that the taxpayer meets the relevant threshold in the given year.

The taxpayer becomes an applicable taxpayer in Year 4, after meeting the income or asset threshold for three consecutive years. He remains an applicable taxpayer in Years 5 and 6. In Year 7, he can elect whether or not to remain an applicable taxpayer because he has failed to meet the income or asset threshold in the three previous years. If he had met either threshold in Year 6, he would have automatically remained an applicable taxpayer.

Comments are requested on the termination of applicable taxpayer status, including:

- **Whether taxpayers below the income and asset thresholds should be allowed to elect to use anti-deferral accounting for years in which they would not be required to do so.**

What assets would be counted in determining whether a taxpayer meets the asset threshold?

An applicable asset is any asset counted in determining whether a taxpayer meets the asset threshold. Applicable assets generally include all capital property, such as stocks; partnership interests; bonds or other evidence of indebtedness; futures, options, and other derivatives; intangibles; real property; acquired patents and copyrights; collectibles; and other personal property. Cash would also be considered an applicable asset. Household goods would not generally be considered applicable assets, subject to limits to prevent abuse.

In general, a taxpayer would include all applicable assets in determining whether she is an applicable taxpayer. Special rules (detailed on pages 17 through 19) would apply for personal residences, retirement accounts, and family farms.

Comments are requested on how trusts and beneficial interests in a trust should be considered when determining whether an individual is an applicable taxpayer.

How would assets be valued for the purpose of the asset threshold?

The value of an applicable asset for the purpose of determining whether a taxpayer is an applicable taxpayer is determined on the last day of a taxable year.

The valuation of assets for the purpose of the asset threshold would not require new bureaucracy for valuing assets beyond what is required under current law. For tradable property, the valuation used must be the fair market value of the property as of the last day of the taxable year. In general, to determine the value of nontradable property, a taxpayer must use the greatest of: (1) the taxpayer's unadjusted basis; (2) the value determined at the date of the last transaction establishing value;[20] and (3) for certain ownership interests, the value of a taxpayer's interest reported on, and derived from, the most recent applicable financial statement.

How would debt be treated under this proposal?

How debt is considered when determining whether a taxpayer meets the asset threshold may have a significant effect on whether a taxpayer is an applicable taxpayer. Furthermore, insufficient rules around how debt should be considered could create opportunities for avoidance.

Comments are requested on whether debt should reduce the value of a taxpayer's aggregate applicable assets for the purpose of the asset threshold, including:

- **The likelihood of avoidance if debt may reduce applicable asset values, including the degree to which taxpayers may use debt to maintain living standards while delaying disposition of nontradable assets.**
- **Whether distinctions should be made between recourse and nonrecourse debt or based on what property is securing a debt.**
- **The extent to which guarantees of a third party's debt should be taken into account.**
- **Whether a distinction could be made between personal debt and business debt.**
- **Whether anti-abuse rules are needed for the allocation of debt of a partnership.**

20 For example, while certain contributions of property to a corporation or partnership are treated as non-recognition, carryover-basis transactions under tax code sections 351 and 721, the value of the contributed property determined as of such date should be used as a proxy for fair market value of the stock of the corporation or interest in the partnership.

How Would Income from Tradable Property Be Taxed Under Anti-Deferral Accounting?

For any taxable year that an individual, an estate, or a trust is an applicable taxpayer, the taxpayer would be required to mark all tradable assets to market.[21] This means that the taxpayer must annually recognize and pay tax on the gain (or take a deduction for the loss) from each tradable asset held at the end of the tax year. The annual gain or loss would be equal to the difference between the fair market value of the asset on the final day of the tax year and the fair market value of the asset on the final day of the previous tax year. Losses would be subject to certain limitations to prevent abuse.

Comments are requested on the mark-to-market taxation of tradable property, including:

- **What limitations should be placed on mark-to-market losses.**
- **Whether mark-to-market losses should be deductible against ordinary income.**
- **How to treat assets that change from nontradable to tradable (e.g., an initial public offering).**

How Would Income from Nontradable Property Be Treated Under Anti-Deferral Accounting?

For any tax year that an individual, an estate, or a trust is an applicable taxpayer, the tax due on any gain realized from nontradable property would be calculated upon realization through a lookback rule. The resulting lookback charge would appropriately tax gain and reduce incentives for the taxpayer to defer the sale of the asset. Importantly, because tax on gains from nontradable property is not due until an asset is sold or transferred, anti-deferral accounting would not require taxpayers or the IRS to precisely value assets before their market value and sale price is known.

There are several possible lookback rules that would achieve these goals, such as an interest charge on deferred tax, a yield-based tax designed to eliminate the benefits of deferral, or a surtax based on an asset's holding period. Further discussion of the considerations for designing a lookback rule is included in Appendix I on page 23.

21 Mark-to-market is far from a novel concept. Taxpayers who own futures contracts have been required (under tax code section 1256) to mark these contracts to market since 1981. Similarly, taxpayers who are securities dealers have been required (under tax code section 475) to mark their securities and derivatives not held for inventory to market and pay ordinary tax rates on gains (while deducting losses) since 1993.

Comments are requested on designing an appropriate lookback rule for taxing the gain from nontradable assets.

What Phase-In and Transition Rules Would Be Put in Place?

Anti-deferral accounting requirements would begin to phase in once a taxpayer becomes an applicable taxpayer. Once a taxpayer's income or asset level exceeds the end of the phase-in range, all tax due on gains from tradable and nontradable property would be determined using anti-deferral accounting rules.

Additionally, a taxpayer's built-in gains accrued prior to becoming an applicable taxpayer (including gains accrued prior to enactment of this proposal) would be taxed under transition rules. These rules would ensure that taxpayers are not required to pay the full amount of the tax due on their unrealized built-in gains in the first year that they are an applicable taxpayer. Transition rules would also be designed to prevent abuse.

Comments are requested on smoothing the transition between current law and anti-deferral accounting, including:

- **Whether phasing in anti-deferral accounting requirements would prevent gaming near the threshold.**
- **An appropriate range for phasing in anti-deferral accounting rules, and how to partially apply anti-deferral accounting rules for taxpayers within the phase-in range.**
- **Appropriate treatment of built-in gains accrued before a taxpayer becomes an applicable taxpayer, including both pre-enactment gains and gains accrued post-enactment but before a taxpayer becomes an applicable taxpayer.**
- **Whether mark-to-market losses should be available to offset gains accrued prior to becoming an applicable taxpayer.**
- **Appropriate method of calculating a lookback charge for built-in gains, including a method for calculating a lookback charge upon disposition of a nontradable asset for which the seller was only an applicable taxpayer for part of the holding period.**

How Would this Proposal Exempt the Personal Residences, Family Farms, and Retirement Accounts of Middle-Class Families?

Special rules would apply to certain assets when determining whether they are applicable assets and whether they are subject to anti-deferral accounting for applicable taxpayers. These rules will ensure that the personal residences, family farms, and tax-preferred savings accounts of middle class families are unaffected by anti-deferral accounting.

Personal Residences

The first $2 million of combined value of a taxpayer's primary and secondary personal residences would not be considered an applicable asset for the purpose of determining whether a taxpayer is an applicable taxpayer. If the value of the property exceeds $2 million, only the amount in excess of $2 million is considered an applicable asset. The $2 million threshold would be indexed for inflation.

> *Example 4: An individual taxpayer owns a home worth $5,000,000. Only $3,000,000 is considered an applicable asset for the purpose of determining whether the taxpayer is an applicable taxpayer.*
>
> *Example 5: An individual taxpayer owns two homes worth $500,000 each (for a total combined value of $1,000,000). Neither home is considered an applicable asset for the purpose of determining whether the taxpayer is an applicable taxpayer, because the total combined value of the homes does not exceed $2,000,000.*
>
> *Example 6: An individual taxpayer owns two homes worth $1,500,000 each (for a total combined value of $3,000,000). Only $1,000,000 of home value is considered an applicable asset for the purpose of determining whether the taxpayer is an applicable taxpayer.*

For applicable taxpayers, any gain in property value of primary and secondary personal residences would be taxed upon realization in the same way as under current law until the combined property value of the residences reaches $2 million.[22] Once the combined property value of an applicable taxpayer's primary and secondary personal residences reaches $2 million, any additional gain would be subject to the lookback rule for nontradable assets upon realization.

22 Current tax code section 121 rules that allow taxpayers who sell a principal residence to exclude up to $250,000 of gain if filing single (or $500,000 if filing a joint return) would remain in effect.

Example 7: An applicable taxpayer purchases a $2,000,000 home that rises in value to $3,000,000. The full $1,000,000 of gain is subject to the lookback rule for nontradable assets.

Example 8: An applicable taxpayer purchases a $1,000,000 home that rises in value to $3,000,000. The first $1,000,000 of gain is taxed under current realization rules, and the remaining $1,000,000 of gain is subject to the lookback rule for nontradable assets upon realization.

Example 9: An applicable taxpayer owns two homes worth $1,500,000 each. Any gain on either home is subject to the lookback rule for nontradable assets, as the total value of the two personal residences is above the $2,000,000 threshold.

Rules for special treatment of primary and secondary personal residences would not apply to properties held primarily as income-producing properties.

Family Farms

The first $5 million of total combined value of a taxpayer's operating family farms would not be considered an applicable asset for the purpose of determining whether a taxpayer is an applicable taxpayer. For applicable taxpayers, gain in value of operating family farms would be taxed upon realization in the same way as under current law until the total combined value of the farms reaches $5 million. Once the total property value of an applicable taxpayer's family farms reaches $5 million, any additional gain would be subject to the lookback rule for nontradable assets. The $5 million threshold would be indexed for inflation. Certain material participation rules would apply in determining whether the property meets the definition of a family farm.

Retirement and Other Tax-Preferred Savings Accounts

Tax-preferred savings accounts would not be considered applicable assets for the purpose of determining whether a taxpayer is an applicable taxpayer, provided that their total combined value does not exceed $3 million (indexed for inflation). Tax-preferred savings accounts that would not be considered applicable assets include tax-qualified retirement plans (like a pension or 401(k) plan), 403(b) plans, 457 plans, SIMPLE IRAs, SEPs, IRAs (traditional or Roth), HSAs, Archer MSAs, 529 plans, or Coverdell accounts.

Tax-preferred savings in excess of $3 million would be treated as applicable assets for the purpose of determining whether the taxpayer is an applicable taxpayer. However, assets held in tax-preferred savings accounts would not be subject to anti-deferral accounting rules and would be taxed in the same manner as under current law, even if a taxpayer is an applicable taxpayer.

> *Example 10: An individual taxpayer has $4,000,000 in tax-preferred savings accounts. Only $1,000,000 is counted toward the asset threshold for the purpose of determining whether a taxpayer is an applicable taxpayer, but no amount of the savings in such accounts is ever subject to anti-deferral accounting.*

Flexible spending arrangements, health reimbursement arrangements, and the right to a benefit from a defined-benefit pension plan would not be considered applicable assets.

The proposal would not change current tax rules that permit a business owner to defer recognition of gain from the sale of stock in the business to an employee stock ownership plan.

How Would Anti-Deferral Accounting Apply to Passthrough Entities?

Unless an exception applies, anti-deferral accounting rules would be applied at the partner or shareholder level, and an interest in a partnership or an S corporation is treated as a nontradable asset. Rules for how anti-deferral accounting applies for passthrough entities are further detailed in Appendix II on page 25.

Comments are requested on the application of anti-deferral accounting to passthrough entities.

How Would Anti-Deferral Accounting Apply to C Corporations?

Publicly-traded C corporations would generally not be required to use anti-deferral accounting for assets they hold. However, there is significant concern that C corporations could become devices for taxpayers to avoid anti-deferral accounting. For this reason, anti-abuse rules would be used to ensure taxpayers cannot use C corporations for such avoidance.[23]

Comments are requested on the application of anti-deferral accounting to C corporations, including:

- **Whether C corporations should ever be required to use anti-deferral accounting for assets they hold.**
- **Whether publicly-traded C corporations (the stock of which is generally a tradable asset) and privately-held C corporations (the stock of which is generally a nontradable asset) should be treated differently for purpose of anti-deferral accounting.**
- **What types of transactions C corporations may use become devices for taxpayers to avoid anti-deferral accounting.**
- **What anti-avoidance rules should apply to prevent the use of a C corporation as a device to avoid anti-deferral accounting, such as rules that would treat a C corporation as an applicable taxpayer subject to anti-deferral accounting or look-through rules that would attribute the C corporation's gains to the shareholder and apply anti-deferral accounting to those gains.**

23 This concern may be more prevalent for privately-held C corporations. For example, a closely-held C corporation could own a business for many years, sell that business at a significant gain, and pay the corporate tax on the gain but never face a mark-to-market tax or lookback charge on that sale. Had the same business been held directly by an individual applicable taxpayer, the sale of the business would have been subject to anti-deferral accounting rules.

How Would Anti-Deferral Accounting Interact with Current Law?

The introduction of anti-deferral accounting would affect how some existing provisions of the tax code work, and changes to such provisions may be necessary to implement this proposal.

Comments are requested on how anti-deferral accounting may interact with existing provisions of the tax code, including:

- nonqualified deferred compensation
- non-term life insurance and annuities
- property transferred in connection with performance of services
- property transferred as a gift
- Opportunity Zones
- collectibles
- exclusion of gain on small business stock
- like-kind exchanges

What New Information Reporting Requirements Would Be Necessary to Implement Anti-Deferral Accounting?

The IRS would need additional information beyond what it collects under current law to enforce anti-deferral accounting rules. For example, Form 1099 reporting requirements may need to be modified to include beginning and ending values of tradable assets for each year.

Comments are requested on information reporting issues under an anti-deferral accounting system, including:

- How to leverage existing information reporting requirements to implement this proposal.
- How to collect information necessary for enforcing anti-deferral accounting rules that is not collected under current law, including information on the value or basis of a taxpayer's nontradable assets.

How Would the Revenue Raised Through Anti-Deferral Accounting Be Used?

The revenue raised from this proposal would be dedicated to Social Security. Social Security represents the single greatest source of financial security for middle-class families, but without additional funding, the program is projected to pay 80 percent of benefits after 2035.[24]

This proposal to tax non-wage income to fund Social Security is a departure from past financing for the program, which is currently funded through payroll taxes. However, such a departure is appropriate in order to pay for the benefits received by early Social Security beneficiaries, who received far more in benefits over their lifetimes than they paid in payroll taxes.[25] Since the revenue from this policy would pay for the benefits of the first Social Security beneficiaries, individuals who are subject to anti-deferral accounting would not receive additional Social Security benefits beyond what they are promised under current law. Instead, revenue raised through this proposal would help ensure that all Social Security beneficiaries receive their promised benefits.

24 The 2019 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Fund, (April 25, 2019).

25 Ida May Fuller, the first monthly Social Security beneficiary, worked for about three years under Social Security and paid $24.75 in payroll taxes. Her first Social Security check in January 1940 was for $22.54, a benefit almost equal to her entire taxes. Fuller lived to be 100 years old and collected more than $22,000 in benefits.

APPENDIX I: LOOKBACK TAXATION OF NONTRADABLE PROPERTY

If tradable assets were marked to market and nontradable assets (such as investment real estate, business interests or collectibles) remained taxed under the current realization system, taxpayers may have an incentive to shift investments to nontradable assets to benefit from deferral. However, marking nontradable assets to market annually could be administratively challenging, as it would require applicable taxpayers to value their nontradable assets each year. Some nontradable assets can be difficult to value before they are sold, and requiring an annual valuation for all nontradable assets could also introduce administrative challenges for the IRS.[26]

Instead, the proposed lookback rule would calculate the total tax due upon sale of a nontradable asset in a way that appropriately taxes any gain and minimizes the advantages of deferral. While any lookback charge would be an imperfect approximation of annual taxation over the holding period, the imperfections of a lookback approach are preferable to those associated with requiring annual valuations of nontradable property. Such lookback rules are not unprecedented in the tax code. Under current law, distributions from investments in passive foreign investment companies (PFICs) are subject to interest charges on deferred tax in certain cases. Under these rules, PFIC gains are assumed to have accrued pro rata over the holding period, and the tax that would have been due each year is calculated retrospectively and subject to an interest charge.

There are many existing proposals for lookback rules that retrospectively tax the gain on nontradable assets and disincentivize deferral.[27] Some of these proposals have characterized deferred tax as an interest-free loan from the

26 This proposal does require approximations of the value of nontradable property for the purpose of determining whether a taxpayer meets the asset threshold (described on page 14). While these approximate valuations are sufficient for determining whether a taxpayer meets the asset threshold, in many cases, they might not be precise enough to calculate tax due annually.

27 For select examples of lookback taxation methods, see: Alan J. Auerbach, "Retrospective Capital Gains Taxation," National Bureau of Economic Research (1988); Cynthia Blum, "New Role for the Treasury: Charging Interest on Tax Deferral Loans," Harvard Journal on Legislation (1998); Ari Glogower, "Taxing Capital Appreciation," Tax Law Review (2016); David S. Miller, "A Comprehensive Mark-to-Market Tax for the 0.1% Wealthiest and Highest Earning Taxpayers," (2017); David J. Shakow, "Taxation Without Realization: A Proposal for Accrual Taxation," University of Pennsylvania Law Review (1986).

government and have designed lookback formulas that approximate the interest the taxpayer should have paid on that loan. Others have proposed lookback rules based on the asset's yield, designing the charge to leave the taxpayer with what she would have been left with if she had sold a portion of the asset to pay the tax due each year. Any lookback rule that retrospectively calculates the tax that would have been due annually during the holding period would require an assumption about the pattern of accrual. Most previous proposals have assumed that gains either accrued pro rata or constantly over the holding period. Alternatively, simply assessing a surtax on gain for assets with longer holding periods would reduce incentives for deferral, but this approach would less precisely counteract the benefits of deferral than the other methods described.

Comments are requested on designing an appropriate lookback rule for nontradable assets, including:

- **Appropriate methods for calculating a lookback charge.**
- **How to treat losses under the lookback rule.**
- **Ways taxpayers may try to avoid a lookback charge.**
- **Whether a special lookback rule is needed to appropriately calculate tax due on the gain from long-held assets or assets with low basis and substantial gain.**
- **Method for taxing assets for which gain primarily accrues late in the holding period.**
- **The possibility of designing a system through which applicable taxpayers can voluntarily prepay tax on nontradable assets.**
- **Whether a taxpayer should be allowed to elect to treat a nontradable asset as a tradable asset and mark it to market annually.**
- **How to apply the rule for taxpayers who were only applicable taxpayers for part of an asset's holding period.**

APPENDIX II: APPLICATION TO PASSTHROUGH ENTITIES

Partnerships

Application of the Asset Threshold

Unless an exception applies, the highest of: (1) a taxpayer's basis; (2) a taxpayer's 704(b) capital; and (3) the value of a taxpayer's interest reported on, and derived from, the most recent applicable financial statement would be used as a proxy for the value of the partnership interest for purpose of determining whether the taxpayer is an applicable taxpayer.

Stock of a publicly-traded partnership would be considered a tradable asset. The fair market value as of the end of the taxpayer's tax year would be used in applying the asset threshold and in determining an applicable taxpayer's mark-to-market gain or loss.

A special rule would apply for any partnership in which at least 50 percent of the value of partnership assets is represented by tradable assets. For such partnerships, the highest of the following measures would be used for the purpose of determining whether a taxpayer is an applicable taxpayer: (1) a taxpayer's basis adjusted to account for the partner's share of built-in gain in tradable property; (2) a taxpayer's 704(b) capital; and (3) the value of a taxpayer's interest reported on, and derived from, the most recent applicable financial statement.

Application of Anti-Deferral Accounting Rules

Separate rules would apply for partnership tradable and nontradable assets. Rules similar to existing partnership tax law would apply to prevent the double counting of mark-to-market gain or loss and the lookback charge. Such rules would also prevent the shifting of tax among partners.

For tradable assets, a partnership would calculate and report to each partner the partner's share of any realized gain or loss as well as each partner's share of annual mark-to-market gain or loss. A partner that is an applicable taxpayer would be required to include the mark-to-market gain or loss from partnership tradable assets in her income.

*Example 11: Partnership with Tradable Assets. Partner A and Partner B each own a 50% interest in Partnership AB. Partner A is an applicable taxpayer. Partner B is not an applicable taxpayer. Partnership AB holds publicly-traded stock of Company 1. The fair market value of the shares of Company 1 owned by Partnership AB at the beginning of Tax Year 1 was $1,000,000. The fair market value of the same shares at the end of Tax Year 1 was $1,005,000. Partnership AB reports to both Partner A and Partner B their share of mark-to-market gain of $2,500 ($5,000 * 50%). Partner A is an applicable taxpayer and therefore includes the $2,500 mark-to-market gain in income for Tax Year 1 and has a corresponding basis adjustment in equal amount. Partner B has no income inclusion for Tax Year 1 because Partner B is not an applicable taxpayer.*

*In Tax Year 2, Partnership AB sells the shares of Company 1 for $1,010,000. Partnership AB reports to both Partner A and Partner B their share of realized gain of $5,000 (($1,010,000 - $1,000,000) * 50%). Partner A recognized $2,500 of the gain in Year 1 and has a corresponding basis adjustment reducing Partner A's gain included in Year 2 income to $2,500 ($5,000 realized gain reported to Partner A from Partnership AB less the $2,500 basis adjustment related to Partner A's mark-to-market gain recognized in Year 1). Partner B did not recognize the mark-to-market gain in Year 1 and includes the full share of realized gain of $5,000 in income in Year 2.*

Partnership assets that are nontradable would be subject to the lookback rule. Upon disposition of a partnership asset or a group of related assets, the partnership would be required to calculate each partner's share of realized gain or loss as well as each partner's share of the lookback charge and report both to each partner.

Example 12: Partnership with Nontradable Assets. Partners C and D each hold an interest in Partnership CD. Partner C is an applicable taxpayer. Partner D is not an applicable taxpayer. Partnership CD owns 10% of Private Company 2, a nontradable asset. In Tax Year 7, Partnership CD sells its interest in Private Company 2. Partnership CD calculates each partner's share of realized gain as well as each partner's share of lookback charge by applying the lookback rule. Partner C includes Partner C's share of realized gain in Year 7 income and pays the lookback charge. Partner D includes Partner D's share of realized gain in Year 7 income but is not required to pay the lookback charge.

A partnership must calculate the lookback charge with respect to each nontradable asset upon contribution or distribution of such nontradable asset to a partnership. In addition, the lookback charge must be calculated at each revaluation event. The portion of tax attributable to the lookback charge is due from an applicable taxpayer in the tax year that includes the revaluation event. The time period for lookback charge accrual for partnership assets restarts after each revaluation event.

> *Example 13: Partner E and Partner F are applicable taxpayers and each holds a 50% interest in Partnership EF. Partner E and F each have a basis of $500,000 in their interests and each interest has a value of $1,000,000. Partnership EF has an accrued gain of $1,000,000 in Nontradable Asset 1. Partner G contributes $1,000,000 to Partnership EF in exchange for a one-third interest during Tax Year 3. Partner E's and Partner F's share of the lookback charge related to Nontradable Asset 1 is calculated immediately prior to the contribution by Partner G. Partner E and Partner F pay the portion of tax attributable to the lookback charge with their Tax Year 3 tax return.*

When a partner that is an applicable taxpayer sells a partnership interest, the lookback charge must be calculated and paid using the lookback rule. The purchaser receives a lookback charge credit with respect to partnership nontradable assets which can be used to offset future lookback charges reported to the partner by the partnership.

Unless a partnership-level mark-to-market election (described below) is in place, a partner that is not an applicable taxpayer would disregard mark-to-market gain or loss and disregard any lookback charge reported to the partner by the partnership. The partner would not be required to complete the lookback calculation at the sale of the partnership interest and would include in income only realized gain or loss (as required under current law).

A partnership in which at least 90 percent of the value of non-cash assets is represented by tradable assets may elect mark-to-market realization at the partnership level. The mark-to-market partnership would be required to supply each partner with the partner's share of the partnership's mark-to-market gains and losses, and each partner would be required to recognize the partner's distributive share of mark-to-market gains and losses each year regardless of whether they would otherwise be an applicable taxpayer for the purpose of the proposal. A partner holding an interest in a partnership making the mark-to-market election would not be required to complete the lookback calculation at disposition of her interest. Once made, an election would be irrevocable except as otherwise permitted under Treasury regulations.

S Corporations

An interest in an S corporation would be treated as a nontradable asset. The highest of: (1) a taxpayer's stock basis; (2) the value of the stock determined at the date of the last transaction establishing value; and (3) the value of a taxpayer's stock reported on, and derived from, the most recent applicable financial statement would be used as a proxy for the value of the S corporation shares for the purpose of determining whether the taxpayer is an applicable taxpayer.

Upon disposition of a significant asset, or group of related assets, an S corporation would be required to calculate each shareholder's realized gain or loss as well as each shareholder's lookback charge and report both to each shareholder. A shareholder that is an applicable taxpayer would be required to pay the lookback charge. A shareholder that is not an applicable taxpayer would disregard the lookback charge.

A shareholder that is an applicable taxpayer must apply the lookback calculation at realization of the S corporation shares to determine her lookback charge.

Exemption for Certain Partnerships and S Corporations

If a partnership or S corporation receives statements from all partners or shareholders certifying that each partner or shareholder is below the asset and income thresholds and is not subject to anti-deferral accounting, the partnership or S corporation would not be required to calculate or report mark-to-market gains and losses or lookback charges. Statements must be included with the partnership or S corporation annual return.

Other Passthrough Entities

Stock of publicly-traded real estate investment trusts (REITs) and regulated investment companies (RICs) is considered a tradable asset, and the fair market value as of the end of the taxpayer's tax year would be used in applying the asset threshold and in determining an applicable taxpayer's mark-to-market gain or loss.

Comments are requested on how anti-deferral accounting should apply to passthrough entities, including:

- **Whether rules are needed to allow or require the grouping of passthrough entity assets in application of the lookback rule.**
- **Whether a de minimis rule is needed to exempt certain sales of capital assets at the passthrough level from the lookback rule.**
- **Method for determining a transferee's lookback charge credit upon transfer of an interest.**

APPENDIX III: REQUEST FOR COMMENTS

Comments are welcome on any aspect of this proposal, including on the specific issues noted throughout the proposal and summarized below.

Comments can be submitted to: demcapitalgainsreform@finance.senate.gov.

Income and Asset Thresholds

- Techniques taxpayers may employ to accumulate significant wealth without meeting the income or asset threshold.
- Anti-avoidance provisions that would help prevent gaming near the thresholds.

Termination of Applicable Taxpayer Status

- Whether taxpayers below the income and asset thresholds should be allowed to elect to use anti-deferral accounting for years in which they would not be required to do so.

Applicable Assets

- How trusts and beneficial interests in a trust should be considered when determining whether an individual is an applicable taxpayer.

Valuation of Assets for the Purpose of the Asset Threshold

- Accurate methods of valuation that minimize the burden on taxpayers.
- The feasibility of using state and local tax valuations to determine the value of real property.
- Whether the value of a tradable asset used for the purpose of the asset threshold should be an average value, such as the average value over the year or over the last month of the year, rather than the value on the last day of the year.
- How taxpayers should be required to report the value of their applicable assets.

Debt

- The likelihood of avoidance if debt may reduce applicable asset values, including the degree to which taxpayers may use debt to maintain living standards while delaying disposition of nontradable assets.
- Whether distinctions should be made between recourse and nonrecourse debt or based on what property is securing a debt.
- The extent to which guarantees of a third party's debt should be taken into account.
- Whether a distinction could be made between personal debt and business debt.
- Whether anti-abuse rules are needed for the allocation of debt of a partnership.

Mark-to-Market Taxation of Income from Tradable Property

- What limitations should be placed on mark-to-market losses.
- Whether mark-to-market losses should be deductible against ordinary income.
- How to treat assets that change from nontradable to tradable (e.g., an initial public offering).

Lookback Taxation of Income from Nontradable Property

- Appropriate methods for calculating a lookback charge.
- How to treat losses under the lookback rule.
- Ways taxpayers may try to avoid a lookback charge.
- Whether a special lookback rule is needed to appropriately calculate tax due on the gain from long-held assets or assets with low basis and substantial gain.
- Method for taxing assets for which gain primarily accrues late in the holding period.
- The possibility of designing a system through which applicable taxpayers can voluntarily prepay tax on nontradable assets.
- Whether a taxpayer should be allowed to elect to treat a nontradable asset as a tradable asset and mark it to market annually.
- How to apply the rule for taxpayers who were only applicable taxpayers for part of an asset's holding period.

Phase-In and Transition Rules

- Whether phasing in anti-deferral accounting requirements would prevent gaming near the threshold.
- An appropriate range for phasing in anti-deferral accounting rules, and how to partially apply anti-deferral accounting rules for taxpayers within the phase-in range.
- Appropriate treatment of built-in gains accrued before a taxpayer becomes an applicable taxpayer, including both pre-enactment gains and gains accrued post-enactment but before a taxpayer becomes an applicable taxpayer.
- Whether mark-to-market losses should be available to offset gains accrued prior to becoming an applicable taxpayer.
- Appropriate method of calculating a lookback charge for built-in gains, including a method for calculating a lookback charge upon disposition of a nontradable asset for which the seller was only an applicable taxpayer for part of the holding period.

Special Treatment of Certain Assets

- Personal Residences
- Family Farms
- Retirement and Other Tax-Preferred Savings Accounts

Application to Passthrough Entities

- Whether rules are needed to allow or require the grouping of passthrough entity assets in application of the lookback rule.
- Whether a de minimis rule is needed to exempt certain sales of capital assets at the passthrough level from the lookback rule.
- Method for determining a transferee's lookback charge credit upon transfer of an interest.

Application to C Corporations

- Whether C corporations should ever be required to use anti-deferral accounting for assets they hold.
- Whether publicly-traded C corporations (the stock of which is generally a tradable asset) and privately-held C corporations (the stock of which is generally a nontradable asset) should be treated differently for purpose of anti-deferral accounting.
- What types of transactions C corporations may use become devices for taxpayers to avoid anti-deferral accounting.
- What anti-avoidance rules should apply to prevent the use of a C corporation as a device to avoid anti-deferral accounting, such as rules that would treat a C corporation as an applicable taxpayer subject to anti-deferral accounting or look-through rules that would attribute the C corporation's gains to the shareholder and apply anti-deferral accounting to those gains.

Policy Coordination Issues

- nonqualified deferred compensation
- non-term life insurance and annuities
- property transferred in connection with performance of services
- property transferred as a gift
- Opportunity Zones
- collectibles
- exclusion of gain on small business stock
- like-kind exchanges

Information Reporting

- How to leverage existing information reporting requirements to implement this proposal.
- How to collect information necessary for enforcing anti-deferral accounting rules that is not collected under current law, including information on the value or basis of a taxpayer's nontradable assets.