Taxing Unrealized Capital Gains & 2024 VT HB 827

PRESENTED BY

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Our Mission

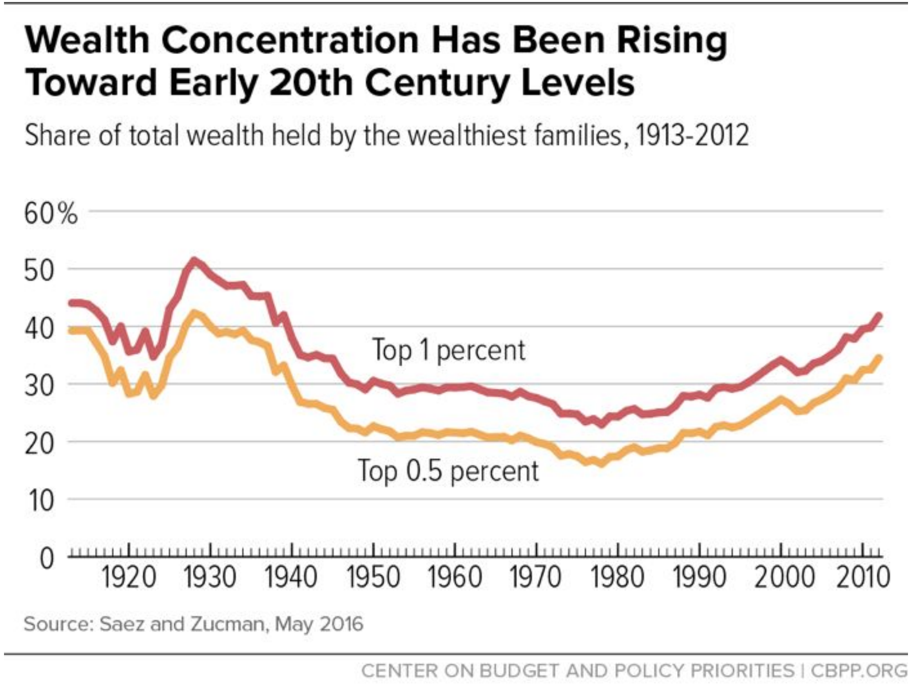
We empower, embolden and equip state legislators to build and wield community governing power by/with/for the people they represent.

We do this by providing legislators with the tools needed to shape impactful public policy and building their capacity to lead with their constituents. We foster long-term collaboration between legislators—across chambers, across regions, and across state lines–and with grassroots movements for progress.

Problems

- **Massive wealth inequality is growing**

- **Extreme wealthy do not pay their fair share**

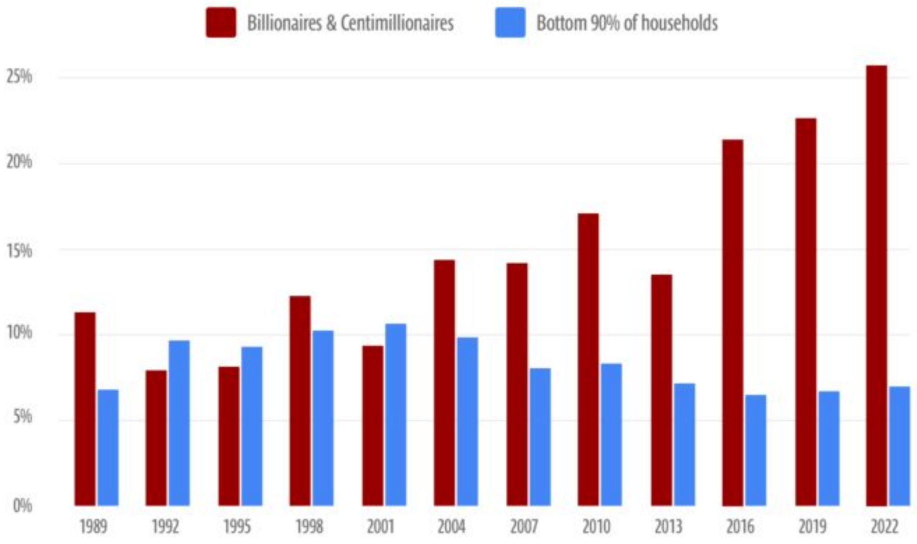


Problems

- **Reliance on realized capital gains**

- **“Buy, Borrow, Die” tax loophole**
  - **Stepped up cost basis**

Share of Nation’s Unrealized Gains



Source: Americans for Tax Fairness (excludes value of primary residence)

One Solution: Wealth Tax

- **European examples**
  - **Belgium**
  - **France**
  - **Italy**
  - **Liechtenstein**
  - **Luxembourg**
  - **Norway**
  - **Spain**
  - **Switzerland**

One Solution: Wealth Tax

- U.S. examples
  - Property Tax
  - State Franchise Tax
  - Expatriation Tax

Wealth Tax: Types of Assets

Broad asset classes including financial and nonfinancial assets

- Former French wealth tax

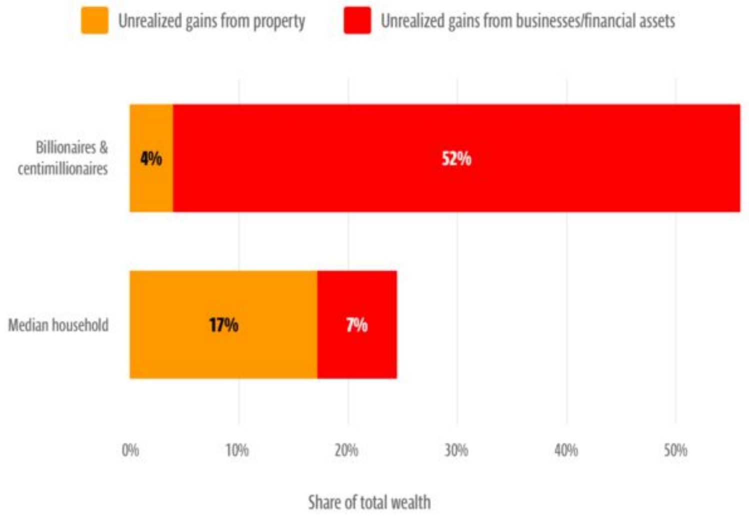
Narrower application

- Net wealth from real estate
- Unrealized capital gains

Wealth Tax: Unrealized Capital Gains Tax

- **Unrealized capital gains make up the majority of extreme wealth**
- **Least complicated and likely most politically feasible**

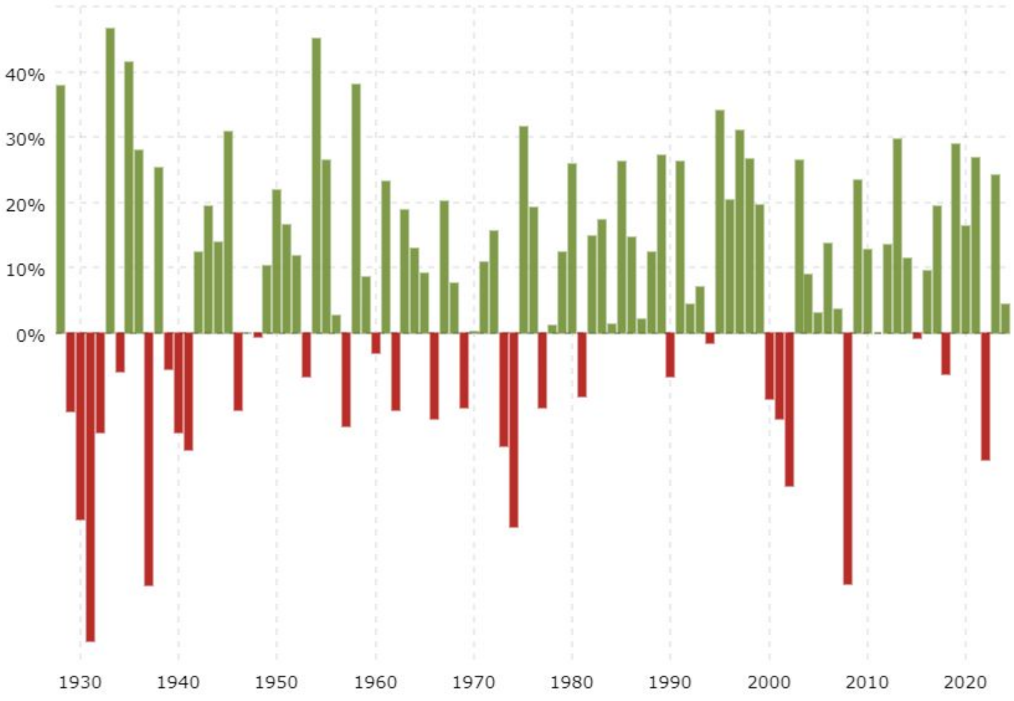
Share of Unrealized Gains Financial vs. Property



Source: Americans for Tax Fairness

Wealth Tax: Unrealized Capital Gains Tax

S&P 500 Historical Annual Returns



(Source: Macrotrends, LLC)

- **Issues with Mark-to-Market Tax**
  - **Price volatility**
  - **Uncertain valuation of illiquid assets**

Note on Unrealized Capital Gains Tax Terminology

"Exemption Threshold" is the amount of net wealth exempted from taxation (e.g., the first $10 million), and therefore, who the tax applies to.

"Cost basis" is the original price that the asset was purchased for.

"**Deemed realized gains"** are unrealized gains that are treated as realized for tax purposes.

"Realized capital gains" are the profits from the sale of an asset calculated as sales price minus cost basis.

"Recognized gains" are the amount of realized or deemed realized gains that are subject to taxation (e.g. after subtracting deferred gains).

"Tax Limit" is the maximum amount of assets that are subject to taxation; also a referred to as a cap.

Unrealized Capital Gains Tax: Policy Options

- **Phased Mark-to-Market**
- **Withholding Tax**
- **Unliquidated Tax Reserve Account (ULTRA)**

Unrealized Capital Gains Tax: Withholding Tax

Withholding Tax Example: Jeff Bezos

"Suppose [Jeff Bezos'] unrealized capital gains are $200B on December 31, 2021. Then for tax year 2021, Jeff Bezos would pay 3.96% of $200B, i.e. $7.92B in withholding tax [assuming a 39.6% tax rate]. If Amazon's stock price stays flat, Bezos would continue to pay $7.92B per year through 2029, at which point he will have prepaid 90% of his nearly $79B in capital gains taxes. . . When Bezos eventually sells his Amazon stock, he will owe little: the $79B in his withholding account will be credited back to him and largely cover his capital gains tax due.

However, if Bezos never realizes his gains in his lifetime and passes on the stock to his heirs, then the withholding tax is never refunded, ensuring that Bezos will have paid a tax commensurate to his income . . ." (Saez et al., 2021).

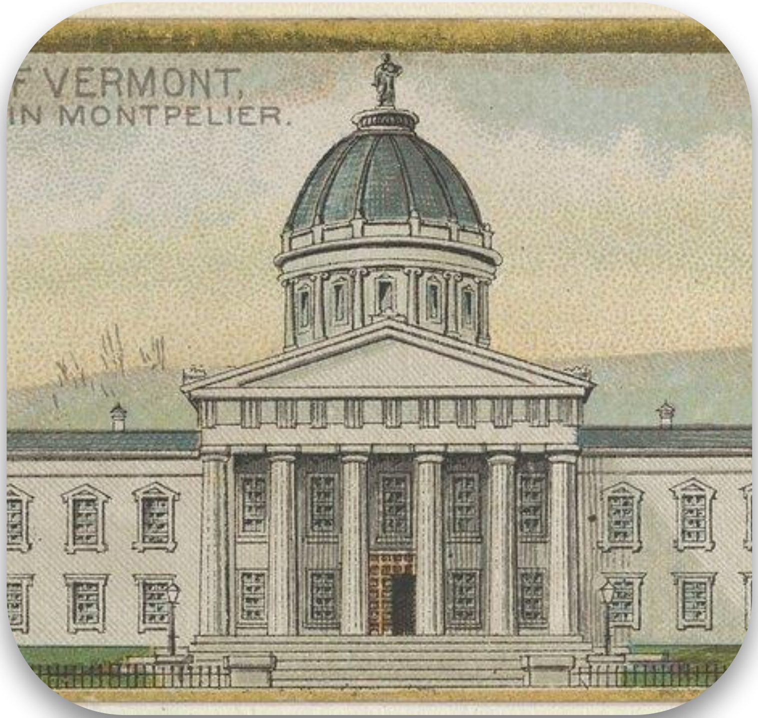
Unrealized Capital Gains Tax: ULTRA

ULTRA Example

For example, for a 2% wealth tax on $100 million worth of a private stock, the taxpayer could instead provide the government with 2% "ownership" of these assets. If the taxpayer holds on to these stocks, in the second tax year the taxpayer begins with 98% ownership of the private stock (since the first tax year they chose to grant the government 2% notional equity interest in lieu of a tax payment), and therefore the government would receive an additional 1.96% equity interest (i.e. 2% of 98%) for a total of 3.96%.

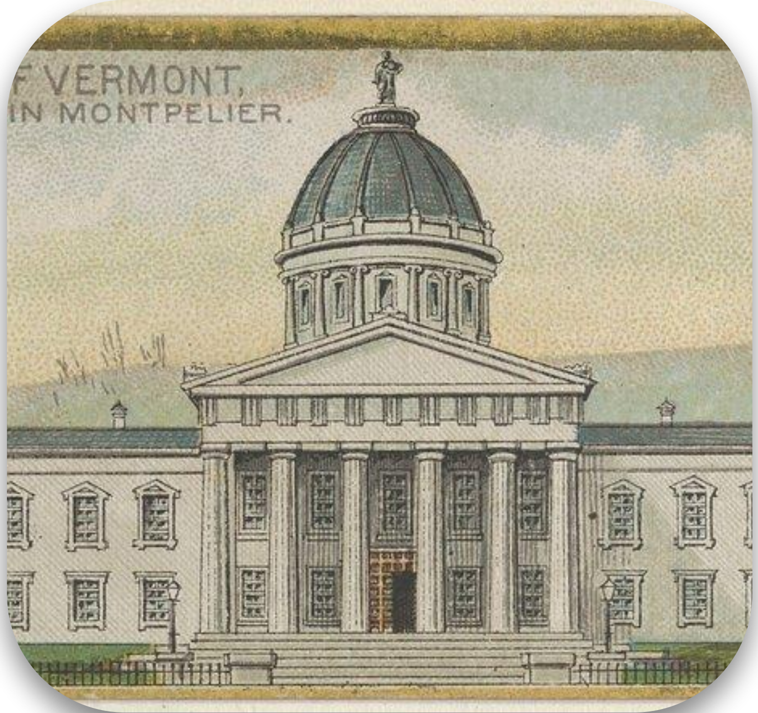
Unrealized Capital Gains Tax: 2024 VT HB 827

- **Phased mark-to-market capital gains tax**
- **Exemption threshold:** applies to individuals with greater than $10 million in net assets
- **Exclusion amounts:** $1 million for specific asset classes, such as real estate, non-distributed interest in a trust, and personal property like vehicles or art/collectibles are excluded from net asset calculation
- **Deemed capital gains:** 50% of unrealized capital gains are treated as realized gains
- **Tax limit:** 10% of net assets over $10 million is the maximum amount of taxable income added from this unrealized capital gains tax
- **Tax rate:** individual income tax rate
- **Other:** apportionment based on years of residence (up to 4 years)



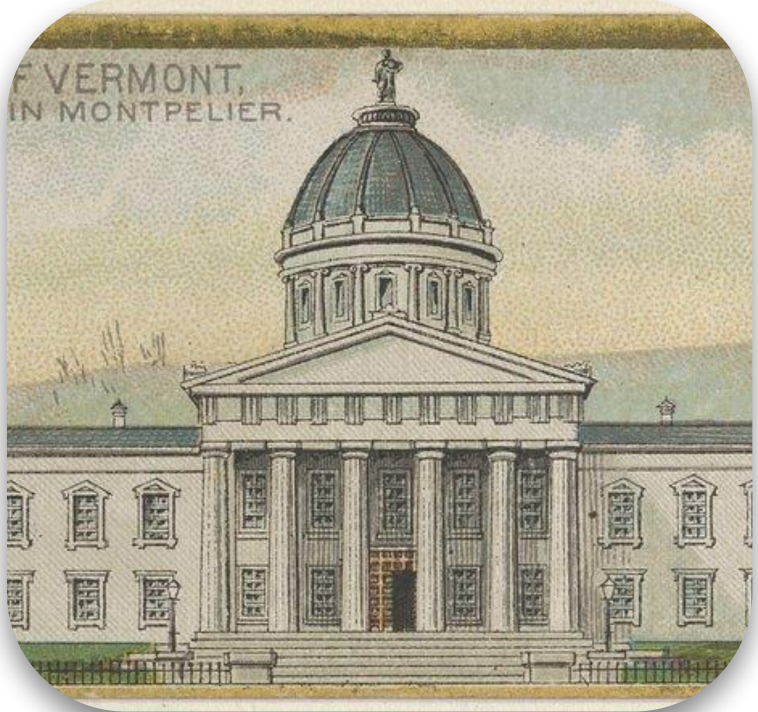
Unrealized Capital Gains Tax: 2024 VT HB 827

- **Addressing double taxation:** recognizing deemed gains and losses (unrealized capital gains and losses that are treated as realized) results in adjustment of each assets' cost basis (the original purchase price, which is used to calculate gains and losses).
  - For assets with deemed capital gains, the lesser of 50% of total gains or 100% of the tax cap amount are added to the cost basis of these assets based on their share of gains .
  - Additional increase in the cost basis of assets with deemed capital gains to account for the portion unrecognized due to the tax cap and deemed losses.
  - For assets with deemed losses , their basis will be decreased by 50% of the deemed losses.



Unrealized Capital Gains Tax: 2024 VT HB 827

- **Optional deferral accounts (ODA)**
  - Unliquidated tax reserve account
  - Defers tax until an asset is sold or leveraged
  - Assets accumulate an interest charge based on ODA withholding percentage (i.e., estimated economy-wide normal rate of return for prior year x highest marginal income tax rate)
  - Contract where taxpayer agrees to:
    - file annual informational returns
    - pay tax liabilities arising from the ODA
    - be subject to these state laws even if no longer a state resident.



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Income deemed realized and recognized:

- Taxpayer holds Stock X with fair market value of $25 million and cost basis of $15 million ($10 million deemed realized gain), and Stock Y with fair market value of $25 million and cost basis of $30 million ($5 million deemed realized loss).
- Total deemed realized gains of $5 million from Stock X and Stock Y ($10M-$5M).
- 50% of deemed realized gains are recognized = $2.5 million.

Tax limit/phase-in cap amount:

- Assuming Stock X and Stock Y are total assets, the taxpayer has $50 million in assets.
- Taxpayer has personal debts of $20 million, and therefore $30 million in net assets.
- Cap is 10% of net assets beyond $10 million, or 10% x ($30 million - $10 million) = 10% x $20 million = $2 million.

Lesser of these two calculations, $2 millon, is added to individual taxable income.

Basis adjustment:

- $2.5M($2M cap amount + $500K offset) is added to the cost basis of Stock X (increasing the basis to $17.5M).
- $2.5M (50% of deemed losses) is subtracted from the cost basis of Stock Y (decreasing it to $27.5M).

Unrealized Capital Gains Tax: 2024 VT HB 827

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- Total deemed realized gains of $5 million from Stock X and Stock Y ($10M-$5M).
- 50% of deemed realized gains are recognized = $2.5 million.
- Apportionment factor of ¾ x $2.5 million = $1.875 million

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- Taxpayer has personal debts of $20 million, and therefore $30 million in net assets.
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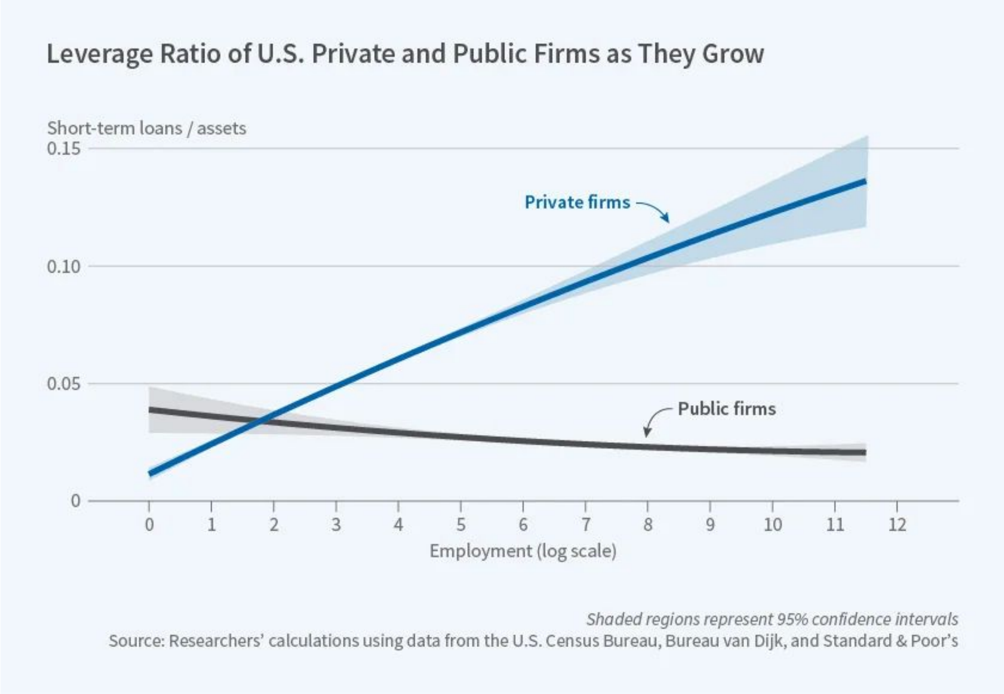
Basis adjustment:

- $2M ($2M cap amount) is added to the cost basis of Stock X (increasing the basis to $17M).
- $2.5M (50% of deemed losses) is subtracted from the cost basis of Stock Y (decreasing it to $27.5M).

Unrealized Capital Gains Tax: Valuing Private Businesses



- **Shares of private firms are more difficult to value, but estimating the value of nonmarketable assets is done as a regular practice.**
- **Private firms may operate differently than public firms, but they are still businesses.**
- **Valuation formulas do exist based on:**
  - **Book value**
  - **Sales**
  - **Profits**

Unrealized Capital Gains Tax: Valuing Private Businesses

Swiss Private Business Valuation Formula "The Practitioner's Model"

The Swiss valuation of private businesses is done by calculating a three year average of both current net asset values and a three-year average double weighted and capitalized earnings-based value. This sounds more complicated than it is; the formula is:

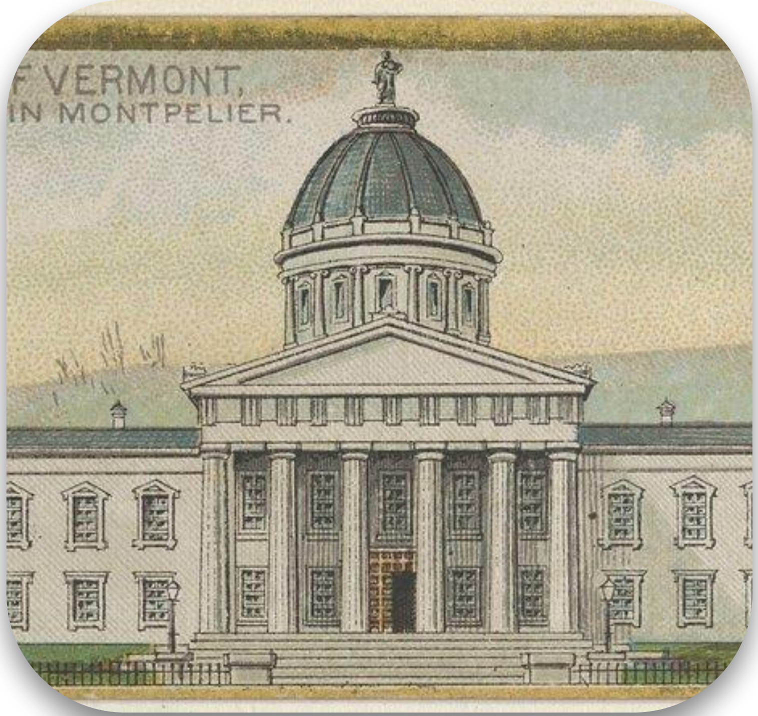
$$\text{Business Value} = \left[\left(\frac{\text{Average of 3-years of Adjusted Net Profits}}{\text{Capitalization Rate}}\right) \times 2 + \text{Net Asset Value}\right] \times 1/3$$

An example may help to clarify this. Let's suppose that this model is used in the U.S. and a private company has a net asset value of $10 million at the end of 2023 and adjusted net profits of $1 million in 2021, $2 million in 2022, and $3 million in 2023. Let's also assume a capitalization rate of 8%, which would be determined by statute or regulation.

$$\text{2023 Business Value} = \left[\left(\left(\underline{\$1M + \$2M + \$3m)/3}\right) \times 2\right) + \$10M\right] \times ⅓ = \$20M$$

Source: Eckert & Aebi, L. (2020).

Unrealized Capital Gains Tax: Valuing Private Businesses



From 2024 VT HB 827

Fair market value = Book value + (Book profits x 7.5)

Deemed realized gain = Fair market value x % of business entity owned by taxpayer

Example using earlier numbers:

Fair market value = $10 million + ($3 million x 7.5) = $32.5 million

Unrealized Capital Gains Tax: Administration

Reporting requirements

- New tax forms (e.g., IRS Form 8854)
- Financial institution reporting

Enforcement mechanisms

- Tax base = total wealth × top wealth share × (1 − evasion rate)

Unrealized Capital Gains Tax: Tax Administration

From 2024 VT HB 827

- Threshold exemption (i.e., amount of net wealth exempted from this tax) is indexed for inflation
- Tax commissioner to publish:
  - Estimated economy-wide normal rate of return (e.g. rate of return on one-year U.S Treasury Bill + 300 basis points or 3 percentage points)
  - Incremental optional deferral account (ODA) withholding percentage (i.e. estimated economy-wide normal rate of return x highest marginal state income tax rate)

Thank you!

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