February 22, 2024

Vermont House Ways and Means Committee
Hearing on H.827
Testimony of Stephen Land

Contents

I. Personal Background

A. ***Employment.*** I have been a tax lawyer since 1979, practicing at four firms: Sullivan & Cromwell, a large Wall Street firm; Howard & Darby & Levin (now part of Covington & Burling), a corporate M&A boutique; Linklaters, a large London firm; and Adler & Stachenfeld, a real estate boutique.

B. ***Education.*** I received a B.A. from Harvard College in 1975, and an M.B.A. and J.D. in 1979 from Harvard Business School and Harvard Law School.

C. ***NYSBA Tax Section.*** I have been on the Executive Committee of the Tax Section of the New York State Bar Association for many years, and was the Section Chair in 2016. The Tax Section provides objective, technical commentary on proposed tax laws and regulations at both the federal and New York State levels.

D. ***American Tax Policy Institute.*** I was the lead author and counsel of record on a brief submitted by the ATPI to the U.S. Supreme Court in the pending *Moore* case, dealing with the authority of the federal government to tax unrealized income.

E. ***Oxfam America.*** I have worked closely over the past fifty years with Oxfam America, a global organization that fights inequality to end poverty and injustice, having served as a Board member and Treasurer, and more recently having advised on their campaign to require multinational corporations to pay their fair share of taxes in the global South.

F. ***Publications.*** I have written a number of law review articles over the years, including a pair that focus on the taxation of unrealized income: *Contingent Payments and the Time Value of Money,* 40 TAX LAWYER 237 (1987); and *Defeating Deferral: A Proposal for Retrospective Taxation,* 52 TAX LAW REVIEW 45 (1996).

G. ***Personal.*** I have been a Vermont resident since 2019, and so I am potentially subject to the provisions of the Bill.

H. ***Disclaimers.*** I am a member of the New York bar only, and am not familiar with the particulars of Vermont law. I have had just over a week to review the text of the Bill, and the comments here should be viewed as partial and preliminary.

II. General Comments

A. Importance

The failure of the tax law to tax unrealized gains is the biggest factor that undermines progressivity. Vermont is to be commended for seeking to attack this problem head-on. In the face of federal inaction, the states can lead the way.

B. Turbocharging Deferral

1. ***Portfolios.*** Investors in stock portfolios can magnify the effects of tax deferral by selectively recognizing losses to offset realized gains and deferring unrealized gains. Through this practice, the proportion of unrealized gain in the portfolio tends to grow over time.

2. ***Real Estate.*** Real estate investors can engage in "like kind" exchanges to swap from one asset to another without recognizing gain. Cash to fund new investments can be obtained tax-free from existing appreciated investments by borrowing against them rather than disposing of them. Real estate investors are allowed deductions against ordinary income for depreciation, even though real estate tends to appreciate; and those deductions increase the amount of unrealized gain.

C. Turning Deferral into Exemption

1. ***Philanthropy.*** Wealthy donors can give away appreciated assets with a double tax benefit: they avoid tax on the gain, and they get a federal tax deduction for the full fair market value of the gift. Although Vermont has only a limited charitable deduction, it allows donors to avoid recognizing gains on donated property.

2. ***Buy, borrow, die.*** Not taxing gains until they are realized is not just a question of timing. The federal tax law *exempts* gains on assets held at death. Wealthy taxpayers can fund their lifestyles without selling appreciated assets: instead, they borrow against those assets, and their heirs repay those debts by selling assets (with no tax cost) after they die.

D. Complexity

1. ***Federal-state disconnect.*** The taxation of unrealized gains at the state but not the federal level will require taxpayers to perform calculations, and obtain appraisals, that would not otherwise be required, and they will have to maintain separate federal and state basis amounts for each asset. Since the tax imposed at a modest rate, the recordkeeping and compliance burden will be great in relation to the tax actually due.

2. ***Thresholds and exclusions.*** The bill contains a number of provisions that effectively exempt the vast majority of Vermont taxpayers from this tax on unrealized income. While limiting the number of affected taxpayers is itself a simplification, these provisions greatly complicate the application of the tax to those who are, or might be, subject to it.

3. ***Dual systems.*** The bill creates two new tax regimes: one taxes unrealized gain each year; the other allows the tax to be deferred, with adjustments to the amount of tax under the optional deferral account (ODA) system. The presence of these two regimes alongside the existing tax regime, and the interactions between them, adds significant complexity.

4. ***Vagaries of valuation.*** Although the statute contains a definition of value, the term is not well defined in practice or even in theory. The Bill deals with some aspects of this problem by creating valuation surrogates for some types of assets, but those surrogates create their own distortions and complexities.

5. ***Burden on the government.*** Vermont is a small state, and the burden of developing guidance and auditing taxpayers on the taxes on unrealized gains and ODAs will be large in relation to the amount of revenues produced by the tax. There is no opportunity to piggyback off of federal audits, since these issues will not arise at the federal level.

III. Tax on Unrealized Gains

A. Joint Ownership

1. ***Co-owned property.*** If two individuals own property as tenants in common, then presumably each takes his or her share into account under the Bill. The situation is less clear, however, in the case of jointly owned property, which is often, but not always, co-owned by spouses. In determining the net assets of each joint owner, is each person deemed to own the entire amount, or a fraction of the amount based on the number of joint owners?

2. ***Joint returns.*** A couple filing a joint return is generally treated as a single individual. *32 V.S.A. § 5811(6).* The bill taxes resident individuals, with residency determined by reference to the individual's domicile or presence in Vermont. *Prop. 32 V.S.A. § 5601(6); 32 V.S.A. § 5811(13).* A couple that files a joint federal return "may" file a joint return in Vermont. *32 V.S.A. § 5861(c).*

   It is unclear whether the $10 million asset threshold is intended to apply to a couple filing a joint return, or to each spouse separately. If the assets of the couple filing a joint return are aggregated and subject to a single $10 million threshold, then they will have an incentive to file separately and adjust their asset holdings so that each spouse fits within the threshold to the extent possible. If a single $10 million threshold amount is intended to apply to joint returns, the incentive to file separate returns would be eliminated if the threshold amount were reduced to $5 million for married couples filing separately.

B. Basis

1. ***Documentation and reporting.*** A taxpayer is required to establish basis by adequate records or clear or convincing evidence; otherwise, the basis is zero. *Prop. 32 V.S.A. § 5602(e).* This rule could be harsh for taxpayers that lack these records: a taxpayer who cannot meet this standard is effectively subject to a tax on wealth in relation to these assets rather than just on unrealized gains.

   The basis of assets received by gift is the donor's basis, which may not be available to the donee. While this problem can arise at the federal level, the donee can avoid having to ascertain this basis by either donating the asset to charity or holding it until death. Under the Bill, the mere act of continuing to hold the asset will require an investigation into its basis.

   If unrealized gains and losses on personal assets are meant to be taken into account (as discussed in item III.B.5 below *(page 8)*), then taxpayers will need to keep careful records of the cost of these items, including amounts spent on a home. While the cost of home improvements can be relevant for federal income tax purposes when a home is sold, the exclusion of $250,000 ($500,000 for joint returns) of gain from the sale of a principal residence makes this cost information irrelevant for most taxpayers. *I.R.C. § 121(b).* Curiously, the Bill taxes unrealized gain from a personal residence, even though that same gain, when realized, would not be taxed by Vermont, to the extent that it falls within the federal exclusion.

   At the federal level, there has been a trend for requiring brokers and partnerships to track and report basis information. *I.R.C. § 6045(g)(2); Notice 2021-13, 2021-6 I.R.B.* However, the additional basis adjustments required under the Bill will not be reflected in this reporting, and will have to be separately generated by the taxpayer.

2. ***Effect of basis adjustments.*** At first blush, it might seem that 50% of unrealized gains are taxed under the Bill, and the other 50% is not taxed until the gains are realized. However, the basis adjustments under the bill do not have this effect, and the portion of the unrealized gain that is not taxed under the Bill remains available

to be taxed as an unrealized gain in subsequent years. It is not clear whether this result is intended.

> *Example 1.* A taxpayer has a single asset that increases in value by \$100,000 in year 1, and half of this increase, *i.e.,* \$50,000, is below the phase-in cap amount and is therefore subject to tax under the Bill. The basis of the asset therefore increases by \$50,000. In year 2, the asset does not change in value, but there is still \$50,000 of remaining unrealized gain in that asset. Accordingly, half of that amount, or \$25,000, would be taxed in year 2. If in year 3 there is no further change in value, then \$12,500 would be taxed in that year.

If this result is not intended, then each asset would need to have a split basis, and the unrealized gain or loss would be calculated by reference to the difference between half of the value of the asset at year-end, and the portion of the split basis that tracks adjustments under the Bill.

3. ***Effect of phase-in cap amount.*** The Bill provides for adjustments to basis to reflect unrealized gains that are recognized. The adjustment for gains, however, is limited to the extent that 50 percent of all assets having unrealized gains exceeds the phase-in cap amount. *Prop. 32 V.S.A. § 5602(b)(1).* This rule, as drafted, appears to be more than just a basis adjustment, as it affirmatively states how much of the unrealized gain on these assets is deemed to be recognized. As such, it contradicts the general taxing rule, while applies the phase-in cap amount to the *net* gain. *Prop. 32 V.S.A. § 5602(a).*

Adjustments for losses, on the other hand, are made without regard to the phase-in cap amount. *Prop. 32 V.S.A. § 5602(b)(2).*

Without further adjustments, these rules create problems for built-in gains that are limited by the phase-in cap amount and also offset by losses that are deemed realized:

> *Example 2.* A taxpayer has two assets: one with \$300,000 of unrealized gain, and the other with \$150,000 of unrealized loss. The phase-in cap amount is \$100,000. The net unrealized gain is \$150,000; 50% of that amount is \$75,000, so the phase-in cap amount does not come into play. However, without further adjustments, the basis adjustment to the gain assets would be limited to \$100,000, even though those assets had \$150,000 of unrealized gain that was taken into account in determining the tax.

The Bill purports to provide relief in this circumstance, by allowing an additional adjustment to the basis of the gain assets to the extent that the adjustment was limited by the phase-in cap amount and the gains were offset by losses that were deemed realized. *Prop. 32 V.S.A. § 5602(b)(3).* These adjustments are complicated, and fail to cover cases like the example above, where the phase-in cap amount does not come into play.

A more effective approach would simply look to the percentage of net gains that do not exceed the phase-in cap amount, and apply that percentage to each of the unrealized gains and losses that are taken into account in determining those net gains. In the example above, since 100% of the net gains do not exceed the phase-in cap amount, all of the unrealized gains and losses that are taken into account (*i.e.,* 50% of those items) would produce a basis adjustment, and the phase-in cap amount would not enter into those adjustments at all.

In cases where the phase-in cap amount does come into play, it would affect the adjustments to basis for both gain and loss assets:

> *Example 3.* The facts are the same as in Example 2, except that the phase-in cap amount is $50,000. This amount is two-thirds of the net realized gain of $75,000, so the adjustment to basis would be two-thirds of the realized gain or loss that is recognized for each asset (*i.e.,* one-third of the total unrealized gain or loss, since only 50% of the unrealized gain or loss is recognized).

This approach differs from the rule in the statute in that it applies to both gain and loss assets, rather than focusing on gain assets only. It can also be directly applied to each asset, which avoids having to compute aggregate amounts for all built-in gain assets and then allocating those amounts among each asset.

4. ***Application to realized gains.*** Vermont taxable income for individuals and trusts is determined by reference to federal adjusted gross income, with specified adjustments. *32 V.S.A. §§ 5811(21), (28).* The Bill adds further adjustments, to include unrealized gains that it causes to be subject to tax. *Bill §§ 2, 3.* The Bill also provides that adjustments to basis to reflect unrealized gains and losses shall be taken into account in determining Vermont taxable income for individuals. *Prop. 32 V.S.A. § 5601(g).* No comparable provisions exists for trusts, however, so any unrealized gains of a trust that are taxed under the bill will be taxed again when realized. To avoid this double taxation, the rules for individuals should be extended to trusts. As a drafting matter, it would be preferable if these adjustments were directly included in the relevant definitions of Vermont taxable income.

5. ***Losses on personal assets.*** The Bill expressly applies to personal assets such as homes and automobiles. *Prop. 32 V.S.A. §§ 5604(c)(4), (h).* Under federal income tax law, no deduction is allowed for losses on personal assets. *I.R.C. § 165(c).* Since these losses are not taken into account for federal income tax purposes when realized, they are effectively non-deductible when realized for Vermont tax purposes as well. The Bill, however, provides that all unrealized losses from assets within its scope shall be taken into account in measuring net unrealized gains that are subject to tax. *Prop. 32 V.S.A. § 5602(a).*

   > *Example 4.* A taxpayer owns a home with $100,000 of unrealized loss, and a securities portfolio with $100,000 of unrealized gain. No tax is due under the Bill.

   Although real estate tends to rise in value, homeowners may create unrealized losses by reason of home improvements, such as swimming pools, that add to the basis of the home but add less to its value. Also, automobiles are potentially a tax shelter under the Bill, since they typically decline in value over time. The Bill provides for "proper adjustments" to value to reflect depreciation, but no corresponding adjustments are provided for asset basis. *Prop. 32 V.S.A. § 5604(h).*

C. Liabilities

1. ***Joint recourse liabilities.*** The Bill allows a reduction in net assets for liabilities for which the taxpayer is fully liable. *Prop. 32 V.S.A. § 5602(f)(1).* It does not, however, address the treatment of liabilities for which more than one person is fully liable. A routine example is a mortgage on a jointly owned home. If the co-owners are not married, do not file a joint return, or are otherwise treated as separate individuals for purposes of the Bill, then under the literal terms of the Bill each co-owner can deduct the full amount of the debt in computing net assets. That would make sense only if each co-owner were treated as owning the entire property, as discussed in item III.A.1 above *(page 4).*

2. ***Joint nonrecourse liabilities.*** For nonrecourse liabilities, each obligor must reduce the amount of the liability by the value of any property pledged by a co-obligor. *Prop. 32 V.S.A. § 5602(f)(2).* This rule can cause a double exclusion of the liability:

   > *Example 5.* Individual *A* owns Blackacre, worth $1 million; individual *B* owns Whiteacre, also worth $1 million. Both assets are pledged to secure $1 million of non-recourse liability. Under the Bill, neither individual can take into account any portion of this liability.

This double exclusion can be avoided if each individual is allowed to take into account a proportionate share of the liability, based on the value of the assets of each individual that secure it.

3. ***Related party debt.*** The Bill excludes debt owed to a related party or not negotiated at arm's length. *Prop. 32 V.S.A. § 5602(f)(3).* Thus, a child who acquires a home with a loan from the child's parents would have to include the home as an asset, but could not deduct the loan. This rule may be based on the premise that such a loan would likely be a "soft" loan that would not be enforced in the same manner as a commercial loan. However, if the loan is respected as such for tax purposes generally, this treatment is at variance with other tax consequences of the loan; for example, the parents would be taxable on the interest income, and would have to include the loan in their estates. The parents would presumably also have to treat the loan as an asset for purposes of the Bill, which has the effect of causing the same amount of wealth to be taken into account in determining the net assets of two separate taxpayers.

   The Bill contains the further requirement that "market" rates of interest must be charged. It is unclear why this requirement is needed, since there is already a requirement that the loan be negotiated at arm's length. The federal income tax law has special rules that apply to below-market rate loans; for that purpose, market rates are determined by applicable federal rates published by the Internal Revenue Service. *I.R.C. § 7872(e).* It is unclear whether the Bill requires the market rate to be determined instead by references to the borrower's own creditworthiness, in which case the required rate might be much higher than that prescribed by federal law.

4. ***Contingent debt.*** The Bill excludes debt with principal or interest that is contingent on future events that are uncertain to occur. *Prop. 32 V.S.A. § 5602(f)(3).* It is unclear why this rule is needed, in cases where the principal amount is itself fixed, since that is the amount that the taxpayer would normally be seeking to deduct from net assets. Even garden-variety floating rate debt is excluded under this rule, since the interest depends on the level of future interest rates. Similarly, debt is excluded if the principal amount is adjusted upwards for inflation, even if the amount of the liability at any point in time cannot be adjusted downwards. The dollar amount of debt that is denominated in a foreign currency is contingent on future foreign exchange rates, even if the amount in the foreign currency is fixed; it is unclear whether this debt is meant to be excluded.

5. ***Debt connected to excluded property.*** There are $1 million exclusions for interests in business entities, real estate, Roth IRAs, and other miscellaneous property *Prop.*

32 V.S.A. §§ 5604(c)(3)(A) (c)(4)(a), (c)(6)(b), (h). There are also exclusions, not limited by dollar amount, for various retirement assets and other forms of deferred compensation. *Prop. 32 V.S.A. § 5604(c)(6).* It is unclear whether these exclusions would have the effect of also excluding any liabilities that may be connected with these properties; and if so, how that connection is to be defined.

D. Credits for Taxes Paid Elsewhere

1. ***Timing.*** If gain of a Vermont resident is sourced in another state that (unlike the Bill) taxes unrealized gains of a nonresident arising in that state, then the Vermont tax and the tax imposed by the other state would be imposed in the same year. Even if the other state imposed such a tax only on its residents, unrealized gains that are taxed to a resident in that state would, absent a credit, be taxed again by Vermont after such a resident moves to Vermont. It appears therefore that the credit is intended to apply to taxes imposed elsewhere in a year that precedes the year in which the Vermont tax is imposed by the Bill.

2. ***Foreign jurisdictions.*** The Bill offers a credit for taxes paid to "another state or jurisdiction" on net gains covered by the Bill. *Prop. 32 V.S.A. § 5602(d).* It is unclear whether the reference to a "jurisdiction" is meant to bring taxes paid to taxing authorities outside the United States, or whether it is limited to taxing authorities with another state, such as a municipality. Since taxing unrealized gains is novel, there are unlikely to be any such credits in the near future if the credit is limited to domestic jurisdictions. A foreign country, however, might tax unrealized gains upon expatriation, under rules similar to those that apply to U.S. expatriates. *I.R.C. § 877A(a)(1).* To the extent that this credit is being offered merely to satisfy U.S. constitutional requirements, it would not appear necessary to include foreign taxes.

3. ***Amount of tax on the gain.*** The credit is limited to the lesser of the amount of tax imposed by the other state or jurisdiction on the gain, and the amount of tax imposed under the Bill. *Prop. 32 V.S.A. § 5602(d).* In both cases, there needs to be a methodology for associating some amount of tax with the gain. Under the Bill, what is taxed is the overall net gain, up to the phase-in cap amount. *Prop. 32 V.S.A. § 5602(a).* Any particular item of gross gain might be partially or entirely offset by losses, or might be attributable to amounts in excess of the phase-in cap amount. Some methodology is needed to determine how much of each item of gain is taxed rather than offset or excluded. A similar exercise is needed under the tax laws of the other state or jurisdiction, but the particulars will depend on the contours of that other taxing statute.

4. ***Gains followed by losses.*** Suppose another state or jurisdiction has a tax that mirrors the provisions of the Bill. Since assets fluctuate in value, gains that are taxed elsewhere may be followed by losses, which may or may not produce a tax benefit. When gains reappear, the question arises whether a credit arises for tax paid on the earlier gain:

> *Example 6.* In year 1, a taxpayer has unrealized gain of $100 on an asset, and pays $5 in tax to another state. In year 2, the asset declines in value by $100, but no refund is available from that state. At the beginning of year 3, the taxpayer moves to Vermont. In year 7, the asset increases in value by $100, and half of that increase is subject to tax under the Bill. Can the taxpayer claim a credit based on the tax paid on the prior gain, or is the gain taxed in Vermont treated as a "new" gain for which no credit is available?

This example shows that it may not always be clear whether the gain being taxed under the Bill is the same gain as the gain that was previously taxed by another state.

5. ***Tax on realized gains.*** The credit can only be applied against taxes imposed by the Bill, and not against Vermont tax that may be payable when the gain is realized. The failure to extend the credit to taxes on realized gains could create a constitutional infirmity, since if the Bill were uniformly adopted by all states, double taxation could result whenever a taxpayer moved from one state to another after the unrealized gain was taxed but before the gain was actually realized.

Even if Vermont made the credit available to offset tax on realized gains, there would still be potential for double taxation, in cases where a Vermont resident paid tax on unrealized gain, but then moved to another state that taxes those gains when realized. This problem is exacerbated by the fact that a taxpayer who ceases to be Vermont resident remains subject to tax under the Bill for the succeeding four years. *Prop. 32 V.S.A. § 5601(6).* Curiously, the Bill taxes unrealized net gains during that post-residency period, but does not tax realized gains.

E. Apportionment

1. ***The apportionment formula.*** The Bill provides that, for the first four years of Vermont residency, the taxable net gains shall be multiplied by a fraction that generally causes 0%, 25%, 50% and 75% of these net gains to be taxed in each of those four years, respectively. *Prop. 32 V.S.A. § 5603(a).* The fraction is constructed having a numerator the number of the preceding four years in which the taxpayer was a full-year, part-year, or temporary resident, and a denominator equal to four.

Prop. 32 V.S.A. § 5603(b). It appears that the numerator is always an integer: a year in which the taxpayer was a part-year or temporary resident counts as a full year.

A temporary resident is defined as a person who would be treated as a resident of Vermont under rules analogous to the substantial presence test for determining U.S. residency for federal income tax purposes. *Prop. 32 V.S.A. § 5601(8).* Under that test, an individual is a U.S. resident for a year if the days in which the individual was present in the United States during the current year, plus one-third of the days of presence during the preceding year, plus one-sixth of the days of presence during the year before that, equals or exceeds 183 days. *I.R.C. § 7701(b)(3).* By its terms, a person is treated as having substantial presence for the entire year when that test is satisfied. Thus, the reference to "period" of temporary residency in the Bill is needlessly vague; it suffices to say that any year of temporary residency shall be included in the numerator.

The term "temporary resident" is used nowhere else in the Bill. Given that the apportionment formula is a crude tool, as discussed immediately below, the adoption of this concept may be an unnecessary refinement.

2. ***Purpose of apportionment.*** The Bill authorizes the use of an alternative appointment method if the apportionment formula described above "does not fairly represent the extent of the gain that occurred which the taxpayer was a resident in this State." *Prop. 32 V.S.A. § 5603(c).* If that is the purpose of the formula, then it represents a crude assumption that one-fourth of the gain on each asset arises each year. This assumption will almost never be true in practice, so in each cases either the taxpayer or the Commissioner should be able to show that another method is more accurate. Indeed, the only method that achieves this result precisely would be a full mark to market of the basis of the taxpayer's assets in the first year of residency as measured for purposes of the tax on unrealized income. (Presumably there would continue to be no restriction on Vermont's taxation of *realized* gains, even if those gains arose during pre-residency periods.)

3. ***Standard of proof.*** A taxpayer seeking alternative apportionment must demonstrate by "clear and convincing evidence" that the formula is "unfair" and that a "more fair and reasonable method" is available. *Prop. 32 V.S.A. § 5603(c)(1).* The requirement of "clear and convincing evidence" is used multiple times in the Bill; this standard represents a higher level of proof than a preponderance of the evidence. This is a higher level of proof than is normally required of taxpayers, who normally have the burden of establishing the correctness of their determinations of tax liability, and it is unclear why a higher standard should be needed here (or elsewhere in the Bill).

The Commissioner can also seek to vary the standard formula, and the Bill authorizes the Commissioner to develop guidelines for recurring fact patterns. *Prop. 32 V.S.A. § 5603(c)(2).* The Bill does not, however, specify the standard of proof that must be met by the Commissioner in order to impose an alternative method on a particular taxpayer.

4. ***Effect of apportionment.*** The apportionment formula, whether standard or alternative, reduces the amount of net gain subject to tax under the Bill. It appears that the basis adjustments are determined without regard to this reduction, so the taxpayer gets an increase in basis without having paid any tax on the unrealized gain. That result may be intended insofar as the tax on unrealized gains is concerned, but the basis adjustments under the Bill also apply in determining *realized* gains. *Prop. 32 V.S.A. § 5602(g).* Accordingly, the use of apportionment in this context has the effect of enabling new Vermont residents to avoid tax on a portion of their realized gains, which would not be possible under current law.

5. ***Sourcing rules.*** The apportionment rule contains a savings clause, in which the invalidity of any portion shall not affect the validity of the remainder. *Prop. 32 V.S.A. § 5603(d).* That clause refers to the apportionment formula as a "sourcing rule", but that formula says nothing about source; rather, it allows portion of the net gain of a new Vermont resident to escape current taxation.

The clause goes on to say that if the apportionment formula is found to be invalid, the 100% of the unrealized gains of a Vermont resident are to be sourced to Vermont. It is unclear, however, how such a sourcing rule would cure any infirmity in the formula.

Finally, the clause states that 100% of unrealized gains during a period of partial or temporary residency are to be sourced to Vermont. It is unclear whether this rule is meant to apply only if the apportionment formula is invalid. In any case, the sourcing to Vermont of otherwise non-Vermont gains of a temporary resident would be an astonishing development, since temporary residents who are not otherwise full-year or part-year residents are not generally subject to tax on non-Vermont gains, and in the absence of Vermont gains are not required to file Vermont tax returns.

F. Valuation

1. ***Publicly traded assets.*** The Bill states that the fair market value of a publicly traded asset shall be "presumed" to be its year-end trading price. *Prop. 32 V.S.A. § 5604(c)(1).* It is unclear whether this presumption is meant to be conclusive; and if not, what it would take to rebut it. Trading prices are often thought to be the gold standard of valuation for publicly traded assets, but many publicly traded assets trade in thin markets with high volatility. Their trading prices may only reflect the views of the people who happen to be in the market on a particular day. The thinness of a trading market might be a reason to rebut the presumption; on the other hand, if the presumption is meant to be conclusive (to avoid disputes), then it would be best to avoid the word "presumption" altogether, and fix the valuation at the trading price.

2. ***Excluded business interests.*** A sole proprietorship is valued as if directly owned by the taxpayer, even if held through an entity such as a limited liability company. *Prop. 32 V.S.A. § 5604(c)(2).* By contrast, in the case of any other interests in business entities, the taxpayer is entitled to exclude $1 million in asset value from the calculation of whether the taxpayer has more than $10 million in net assets. *Prop. 32 V.S.A. § 5604(c)(3)(A).* The reason for this distinction between wholly-owned and jointly-owned entities is unclear, and works to the detriment of small businesses that lack co-owners.

It is unclear what is being excluded. Is the taxpayer entitled to pick and choose assets, so long as the aggregate value of those assets is less than $1 million? Suppose a taxpayer owns an interest in a business worth $2 million. Can it exclude half of that asset? If not, there would be an incentive to create separate interests, so that the taxpayer can exclude some of them.

Presumably the exclusion must be determined annually, and an increase in value of an excluded asset may cause it to be no longer eligible in a subsequent year. There does not appear to be any restriction on allowing a taxpayer to vary the choice of excluded assets from year to year, so long as the total value excluded in each year does not exceed $1 million. However, if an asset that was excluded in one year is not excluded in the next, then the unrealized gain in the excluded asset, including gain earned while the asset was excluded, will be taken into account in the year in which the asset is no longer excluded.

If an asset worth less than $1 million is excluded, but is then worth more than $1 million in a subsequent year, is the taxpayer no longer able to exclude it? If so, the unrealized gain that was earned during the years of exclusion will lose the benefit of that exclusion.

Excluded assets are exempt from reporting requirements, which will deprive the Commissioner of information that may be helpful in determining whether the excluded assets have been fairly valued. That information, however, could be sought on audit.

As a drafting matter, the sentence providing for this exclusion (and other similar exclusions in the Bill) should contain commas after both occurrences of "chapter", to make clear that the exclusion has three effects: first, the excluded interest is not subject to tax; second the excluded interest is disregarded in determining whether the $10 million threshold has been met; and third, the excluded interest is not subject to reporting requirements.

3. ***Percentage interest.*** A taxpayer's percentage interest in a business entity is presumed to be no less than the taxpayer's percentage of the overall voting or control rights. *Prop. 32 V.S.A. § 5604(c)(3)(C).* This presumption is rebuttable, upon a showing by "clear and convincing evidence" that the presumption overvalues the actual percentage of the entity that is owned by the taxpayer. In such a case, the taxpayer must submit a certified appraisal of the percentage "and then use the certified appraisal value in place of the presumed percentage."

It is questionable whether all of this machinery is necessary. If a taxpayer owns x% of the voting rights, and some different percentage y% of the economic rights, it would appear that y% is the appropriate percentage. If a certified appraisal is needed, it is unclear whether the appraiser is simply certifying as to the percentage, or is also valuing the business interest itself. A business interest would not generally require a certified appraisal if the taxpayer is able to report its book value and book profits. *Prop. 32 V.S.A. § 5604(c)(3)(A).* That being the case, such an appraisal of value should not be needed in cases where the only further question is the taxpayer's percentage interest.

There may be cases where the taxpayer's percentage interest is unclear because the economic rights are not held pro rata; for example, the taxpayer's interest may benefit from, or be burdened by, a carried interest in profits that is disproportionate to invested capital. In those cases, a certified appraisal could be helpful in valuing the interest. But this circumstance can arise regardless of the allocation of control or voting rights.

4. ***Valuation of business interests.*** The Bill has a presumptive formula for valuing business interests, based on book value plus 7.5 times book profits. *Prop. 32 V.S.A. § 5604(c)(3)(D).* This valuation formula is a blunt instrument, since the amount by which the actual value of a business exceeds its book value may be a number that is quite different from 7.5 times book profits. In any case, such a uniform rule is of dubious applicability across all sectors.

The taxpayer can rebut this presumption with "clear and convincing" evidence that the presumption would "substantially overstate value", in which case the taxpayer can use a value set forth in a certified appraisal. There is, however, no provision that authorizes the Commissioner to rebut the presumption. Since profits can be volatile, this asymmetry opens the door to taxpayers relying on the presumption in years when profits are low, and challenging the presumption in years when profits are high.

The presumptive rule requires that book value and book profits be computed under generally accepted accounting principles (GAAP). Many small businesses operate on a cash basis, which is not consistent with GAAP. These businesses will have to maintain a separate set of books solely to comply with the Bill, or else obtain certified appraisals.

G. Real Estate

1. ***Valuation methodology.*** There appears to be a drafting error in the rule that states that real estate shall be valued "as set forth in subdivisions (5)(A)–(G) of this subsection." *Prop. 32 V.S.A. § 5604(c)(4).* Those subdivisions contain rules governing interests in trusts, and do not pertain to real estate.

   Taxpayers are required to value real estate as set forth in the most recent equalized grand list published by the Commissioner, unless the taxpayer can provide "clear and convincing" evidence that those values "substantially overstate" the fair market value, in which case the taxpayer can use a different value as provided in a certified appraisal. *Prop. 32 V.S.A. § 5604(c)(4)(B).* It is unclear whether the Commissioner is required to accept that value set forth in that appraisal, and whether the Commissioner can depart from a value set forth in the equalized grand list on the grounds that it is too low. If not, the asymmetry will work against the government.

2. ***Non-Vermont real estate.*** The equalized grand list does not apply to real estate outside Vermont. In such a case, the taxpayer "may" submit a certified appraisal, but there does not appear to be a requirement to do so. To avoid the need for annual valuations and possible appraisals, consideration could be given to a rule the would permit a prior year's valuation to be adjusted by the published economy-wide rate of return, as provided for other types of assets. *Prop. 32 V.S.A. § 5604(h).* For real estate, however, it may be more appropriate to use an index of real estate values for the area where the real estate is located.

3. ***Excluded real estate.*** A taxpayer is allowed to exclude up to $1 million of value of interests in real estate. *Prop. 32 V.S.A. § 5604(c)(4)(A).* This exclusion raises many of the same questions as those raised by the exclusion for interests in business entities, which are discussed in item III.F.2 above *(page 14),* and therefore not

repeated here. The most important question in the real estate context is whether a taxpayer is entitled to exclude any portion of a personal residence that is worth more than $1 million.

The exclusion is available only for assets that are "held directly" by the taxpayer. It is unclear whether this restriction is intended to prevent exclusion of real estate held through a wholly-owned LLC or revocable trust.

H. Trusts

1. ***Grantor trusts.*** The Bill provides that "any trust" resident in Vermont shall be taxed as if it were an individual. *Prop. 32 V.S.A. § 5604(c)(5)(A).* A trust is generally resident in Vermont if it was funded by a Vermont resident. *32 V.S.A. § 5811(11)(B).* Revocable trusts and some irrevocable trusts are treated as "grantor trusts" for federal income tax purposes, with the result that the grantor is treated as the direct owner of the trust's assets. *I.R.C. §§ 671 et seq.* If similar treatment is intended for purposes of the Bill, it should make clear that the grantor, not the trust, is taxed on assets owned by a grantor trust.

2. ***Tax favored accounts.*** Some types of accounts that are used to fund education (529 accounts) or medical costs (health savings accounts) are trusts that enjoy exemption from federal income tax, so long as the requirements for those accounts are satisfied. *I.R.C. § 223(e)(1), 529(c)(1).* These trusts are generally exempt from Vermont tax under current law, but there is no express exclusion under the Bill. If such an exclusion is intended, it should be added.

3. ***Transfers of exemption and exclusion amounts.*** A resident trust does not benefit in its own right from the four-year apportionment, the phase-in cap amount, the $10 million threshold amount, or any of the $1 million exclusions. *Prop. 32 V.S.A. §§ 5604(c)(5)(A), (C).* This harsh rule is mitigated by a provision that allows the individual trust grantor to transfer to the trust a fraction of that individual's own $10 million threshold amount or $1 million exclusion amounts. *Prop. 32 V.S.A. § 5604(c)(5)(D).* Presumably these transfers need to be renewed annually, and can be modified from year to year.

   There is no relief, however, after the grantor dies. This means that all testamentary trusts established by Vermont decedents, no matter how small, will be subject to tax under the Bill. This rule will cause many people of modest means to bear this tax who would otherwise be untouched by it.

4. ***Discretionary nonresident trusts.*** If a trust is not resident in Vermont, and does not elect to be treated as a resident, then any beneficiary who is a Vermont resident

will be treated as the owner of the trust's assets "to the extent that the assets are distributable to the beneficiary, whether distributed or not." *Prop. 32 V.S.A. § 5604(c)(5)(E).* It is unclear how this rule applies to discretionary trusts, whose assets may be distributed among multiple beneficiaries; some of these may reside in Vermont and some may reside elsewhere. Even where all of the beneficiaries are Vermont residents, it is unclear how much of the trust's assets should be deemed to be owned by each beneficiary. In these cases, it may be necessary to attach the trust's assets to each beneficiary's ODA, so that the tax can be worked out when distributions are actually made. That approach would be analogous to the rules for accumulation distributions, which are applied under the federal tax law to distributions by foreign trusts to U.S. beneficiaries. *I.R.C. § 667(a).* Those rules, however, are difficult to apply in practice, in cases where the beneficiary does not have access to the trust's records, which can go back decades. These difficulties may be forced upon these beneficiaries, since this is the one circumstance under the Bill where the use of an ODA is not elective ("the beneficiary *shall* attach the assets to the beneficiary's optional deferred account" [emphasis added]). *Prop. 32 V.S.A. § 5604(c)(5)(F).*

5. ***Exclusion by beneficiaries.*** The Bill allows a Vermont beneficiary of a nonresident trust to exclude up to $1 million in asset value of any nondistributed interests. *Prop. 32 V.S.A. § 5604(c)(5)(G).* To the extent that the beneficiary is treated as the owner of the trust's assets, it appears that the beneficiary can apply the other $1 million exclusions, such as those for business interests and real estate. It would be good to clarify whether this special exclusion for beneficiaries is intended to be in addition to, or in lieu of, these other exclusions.

I. Deferred Compensation

1. ***Roth IRAs.*** The Bill exempts most forms of qualified retirement accounts and plans, but Roth qualified plan accounts and Roth IRAs are subject to tax to the extent that their aggregate value exceeds $1 million. *Prop. 32 V.S.A. § 5604(c)(6)(B).* Unlike regular IRAs and qualified plan accounts, which are funded with pre-tax dollars and are taxable when distributed, Roth accounts are funded with after-tax dollars and are tax-free when distributed. A regular IRA or qualified plan account can be converted to a Roth IRA if the taxpayer pays tax on the value of the account at the time of conversion. *I.R.C. § 408A(d)(3).*

   Roth accounts are not subject to federal income tax, and are not subject to Vermont income tax under current law. As a result, there has been to date no reason to track basis information in these accounts, some of which have been maintained for decades. Even if perfect records were available, it is unclear whether the "basis" of assets in a Roth account is the cost of the particular investments in that account, or the amount contributed to the account or taxed on conversion from a regular IRA or qualified plan account.

Roth accounts are always held by a trustee, and the trustee is required to report annual valuation information on IRS Form 5498. There is no requirement, however, for the trustee to report basis information. *Treas. Reg. § 1.6045-1(k)(3), Ex. (3).*

A taxpayer who cannot establish basis is required to treat the basis as zero. In the case of a Roth account, a failure to establish basis means that the entire value of the account will be a realized gain that is taken into account in determining the tax under the Bill. This will be the case even though the taxpayer will have paid federal and possibly state taxes on the amounts invested in the Roth account, or held in the Roth account at the time of a conversion. If those taxes were paid to another state, the question arises when Vermont would allow a credit for those taxes. If those taxes were paid to Vermont, then the tax imposed on the account by the Bill would represent a second round of taxation on the same gain.

2. ***Unvested compensation.*** Compensation that is deferred under an arrangement that is not a tax-qualified plan is taxable under the Bill if the taxpayer has a "legally binding right" to receive it. *Prop. 32 V.S.A. § 5604(c)(6)(C).* It is unclear how this rule applies to compensation that has not yet vested; *i.e.,* amounts which are subject to forfeiture if the employee quits, or if certain performance criteria are not met.

In the federal context, a taxpayer can have a legally binding right to unvested compensation, in the sense that the taxpayer has a right to receive it if the vesting criteria are satisfied. *Treas. Reg. § 1.409A-1(b)(1).* However, unvested compensation is generally not taxed at the federal level unless the taxpayer has actually or constructively received it (although subject to forfeiture) and elects to treated it as vested. *I.R.C. § 83(b).*

If the Bill intends to tax unvested compensation, question arises whether a valuation discount is allowed to reflect the risk of forfeiture. No such discount is allowed at the federal level when an employee elects to treat deferred compensation as vested. If a forfeiture occurs, presumably any prior amounts that have been treated as realized gains will have been added to basis. Although a loss will be realized as a result of the forfeiture, the federal income tax rules limit the loss deduction to amounts actually paid for the forfeited property, *Treas. Reg. § 1.83-2(a),* and therefore the loss will not enter into the calculation of Vermont taxable income.

3. ***Valuation.*** Vested deferred compensation may be fixed in amount, or determined under a formula. In the case of a defined benefit plan, the Bill values the compensation as the present value of the taxpayer's accrued benefit. *Prop. 32 V.S.A. § 5604(e).* The federal rules generally defer taxation of deferred compensation, since an unsecured promise to pay cash in the future is not treated as the receipt of property. *Treas. Reg. § 1.83-3(e).* However, in some contexts, this deferred compensation is taxed when earned, and therefore the value of that deferred compensation needs to be determined. For example, deferred compensation is taxable when earned in cases where the employer is not subject to U.S. federal income tax. *I.R.C. § 457A(a).* And for all employers, deferred compensation is treated as "wages" subject to social security and Medicare taxes when earned. *I.R.C. § 3121(v)(2).*

   Federal tax law provides valuation rules to deal with these cases, both for account plans, where the compensation is measured by an actual or notional account balance, and for other plans, such as defined benefit plans. *Treas. Reg. § 31.3121(v)(2)-1(c); Notice 2009-8, 2009-4 I.R.B. 347, ¶ A-16; Notice 2008-115, 2008-2 C.B. 1367, ¶ 3.* It would be efficient for Vermont to piggyback off of this body of federal law in applying its own valuation rules.

J. Other Assets

1. ***Valuation.*** There is a catchall provision for assets not covered by the specified categories in the Bill. *Prop. 32 V.S.A. § 5604(h).* For assets acquired within the preceding ten years, the value of those assets "shall" be their cost as adjusted by the annual published estimated economy-wide normal rates of return over the holding period, and further adjusted for withdrawals, contributions, improvements, and depreciation. The use of the term "shall" suggests that this methodology is mandatory for these assets, rather than a presumption that can be rebutted in appropriate circumstances. For older assets, a certified appraisal must be obtained every ten years, and the formula is applied during periods between appraisals.

   Because this category is a hodgepodge, it is doubtful that any single valuation approach can produce reliable results. For example, taxpayers can close positions in many non-publicly traded financial instruments at readily ascertainable prices; similarly, interests in non-traded funds may be redeemable at quoted prices. Those assets would be best governed by the same rules that apply to publicly traded assets.

2. ***Debt.*** Debts and other liabilities owed to the taxpayer may also be publicly traded, in which case they would presumably not be included in the catchall category. Nontraded debt is normally best valued at its face amount plus accrued interest.

3. ***Life insurance.*** Life insurance is not expressly included or excluded, but is presumably implicitly included in this category, since it is not mentioned elsewhere. There are methodologies for valuing life insurance policies; for federal estate and gift tax purposes, they may be valued based on their interpolated terminal reserve, although that value may not be accurate if the insured is in ill health. *Treas. Reg. §§ 20.2031-8(a)(2), 25.2512-6(a).* Information on the interpolated terminal reserve is not typically included in annual reports provided to the owner by the insurance company, but can be obtained on request via IRS Form 712.

   Unrealized value that builds up inside a life insurance policy is not subject to federal income tax, and there is an exemption for proceeds payable upon the death of the insured. *I.R.C. §101(a)(1).* If the proposed tax on unrealized gains is only meant to reach gains that would be taxed when realized, then it may be appropriate to have an exclusion for life insurance policies. Such an exclusion, however, would continue to make it possible for a taxpayer to defer tax on a "viatical" settlement of a life insurance policy before the death of the insured.

IV. Optional Deferral Accounts

A. Interaction with Other Tax Regimes

1. ***Two ways to fight deferral.*** There are two ways to address the deferral of tax on unrealized gains. The first is to tax unrealized gains each year under a mark to market approach, which is the general approach followed by the Bill. The second is to allow deferral, but adjust the amount of taxes ultimately payable in order to offset the benefits of deferral. This second approach is followed by the provisions of the Bill governing ODAs.

   These two regimes operate independently. Assets in ODAs are not subject to tax on unrealized gains, and the tax on ODAs does not apply to assets outside those accounts. *Prop. 32 V.S.A. §§ 5604(c)(3)(B), (4)(B), (5)(F), (d), (h).* It is less clear whether assets in optional deferred accounts are counted towards the $10 million threshold under the mark to market regime. If they are included, then they will have to be valued annually, which undermines a principal purpose of the ODA regime.

2. ***Persistence of conventional regime.*** The two new regimes—mark to market and ODAs—supplement but do not replace the conventional regime that taxes realized gains. As a result, affected taxpayers will need to navigate all three regimes in order to determine their tax liabilities.

The mark to market regime applies to only half of unrealized gains, and the remaining half is taxed upon realization under the conventional regime, subject to the ambiguities described in item III.B.2 above *(page 5).* Adjustments to basis are intended to ensure that the same gains are not taxed twice.

It is less clear how the taxes on ODAs relate to the potentially concurrent application of the conventional regime to the assets in those accounts. Unlike the mark to market regime, the taxes on ODAs are not limited to one-half of the gains on the assets in those accounts. Also, assets in an ODA can be taxed under the conventional regime. Some relief is provided in cases where a material distribution transaction is taxable under both the conventional regime and the ODA regime, as discussed in item IV.C.4 below *(page 26),* but the scope of that relief is unclear.

3. ***Electivity.*** No taxpayer is required to have an ODA, or to attach any particular assets to it (with the important exception of trust beneficiaries, described in item III.H.4 above *(page 17)*). The resulting electivity means that taxpayers will use ODAs only if it makes them better off. If the tax on those accounts is unduly burdensome, taxpayers will stick with the mark to market regime, even for hard-to-value assets. This taxpayer choice will always work against the government, which will collect less revenues than if either regime were mandatory.

On the other hand, there will be a tendency for taxpayers to bear an increased tax burden when their assets are split between the mark to market and ODA regimes. The particulars will vary in each case, but apart from the application of the various threshold amounts and exclusions, and the vagaries of the taxation of material distributions transactions, taxpayers will be better off if all of their assets are in one bucket or the other.

B. Reconciliation

1. ***Goal.*** The core of the ODA regime is the reconciliation that occurs when the ODA is closed. The Bill makes clear that the tax payable on reconciliation is intended "to equalize the lifetime tax treatment of assets attached to an ODA with the total tax that would have been payable had such assets not been attached to an ODA and instead been subject to [the mark to market regime]." *Prop. 32 V.S.A. § 5605(j)(2).* This goal is tempered by possible departures that may be necessary to maintain "ease of compliance and administration." In any case, the overall tax due under the ODA regime must be at least as great as the total tax due under the mark to market regime.

It is unclear what is means "to equalize the lifetime tax treatment of assets." It has to mean something different from simply equalizing the total amount of tax paid, since the total tax on an ODA must be at least equal to the total tax paid under the mark to market regime, which implies that it could be greater. To the extent that the ODA regime allows the tax to be paid later, then it makes sense for the absolute amount of tax to be greater, in order to offset the benefit of deferring the tax. In some cases, however, it is possible that an ODA may *accelerate* the payment of tax, because the taxes imposed on material distribution transactions are measured without regard to any unrealized gain in the ODA.

2. ***Formula.*** The Bill provides a default formula for calculating the tax on reconciliation. That formula is not easy to decipher, and it is easiest to first consider the simplest case of an ODA that has no material distribution transactions other than at closing. In such a case, an asset goes into the account when the ODA is opened, but nothing goes in or comes out until the ODA is closed. Because there are no interim material distribution transactions, there is no additional tax to include in the formula, and the formula reduces to the following:

$$MDTS\left(1-\left(\frac{MDTS}{BASIS}\right)^{-t}\right)$$

It is important to note that *"t"* in this formula refers to the tax rate, not time. In this simple case, *MDTS* is the value of the ODA upon closing, and *BASIS* is the basis of the asset attached to it.

This formula has the effect of scaling down the pre-tax yield by the tax rate. Thus, if the tax rate is 8.75% and the pre-tax yield is 10%, then the after-tax yield, after paying the tax due under the formula, would be 9.25%. The formula assumes that both the pre-tax yield and after-tax yield are measured using continuous compounding, which as a practical matter is the same as daily compounding. I will pass over the math here, but the derivation of this formula can be found in Part III.B of my article, *Defeating Deferral,* mentioned in item I.F above *(page 2).*

An important feature of this formula is its implicit assumption about the value of tax deferral. In particular, the formula assumes that the deferred taxes are reinvested in the ODA itself. Put differently, it assumes that had tax been due over time on a mark to market basis, the taxpayer would have financed those taxes by selling off pro rata bits of the ODA, rather than paying the tax out of other assets (which might have a different yield) or by borrowing (which would have its own borrowing cost). But judgments about the value of tax deferral are matters of policy, not mathematics, and designers of a regime which, like the ODA regime, seeks to offset the value of tax deferral have to make some judgment about what that value is.

3. ***Comparison to mark to market regime.*** In the simplest case described just above, the formula purports to equalize the after-tax proceeds to the taxpayer from the ODA to the amount that the taxpayer would have under the mark to market regime, if the mark to market adjustments, and payment of tax occurred on a continuous (or daily) basis. There are, however, some important differences. The mark to market regime applies to only a portion of the taxpayer's unrealized gain; the balance is taxed under the conventional regime. By contrast, the ODA reconciliation tax applies to the entire return on the investment; moreover, the gain on the ODA assets may also be taxed under the conventional regime. Also, the mark to market regime does not affect the deferral of gain before the time when assets fist become subject to it, *i.e.,* they were acquired before the effective date of the Bill, or before the taxpayer moved to Vermont. Yet the tax on ODAs reaches back to offset deferral from the time when the asset was first acquired. The combined effects of these differences can make the ODA regime much more costly to the taxpayer, and may inhibit taxpayers from using it.

4. ***Assets with little or no basis.*** Assets produced by the taxpayer's own efforts, such as art or a literary copyright, will typically have little or no basis. These assets can be hard to value, which makes them suitable candidates for an ODA. Deferred compensation will often have a zero basis, and assets with an unknown basis are also treated as having a zero basis. However, the presence of a low basis in the denominator of the reconciliation formula can cause the tax to reach confiscatory levels, and if the only asset in the ODA has a zero basis, the formula blows up entirely. Any solution to this problem would likely require valuing these assets when they are attached to the ODA, and assigning an initial basis equal to that value less any tax that would have been payable if the asset had been sold at that time.

C. Material Distribution Transactions

1. ***Definition.*** A material distribution transaction is defined to include any transaction that removes assets from the ODA or applies them for the benefit of the taxpayer or a related person. *Prop. 32 V.S.A. § 5605(g)(1).* It does not include the application of assets in an ODA to maintain or improve those assets. *Prop. 32 V.S.A. § 5605(g)(2).* Notwithstanding the use of the word "material", there does not appears to be any materiality threshold in the definition of a material distribution transaction, and so there is no indication of when a transaction might be disregarded as immaterial. The Bill also provides that transfers made in the ordinary course of business, and exchanges of non-readily tradable assets, are not material distribution transactions.

A more straightforward way to think about material distribution transactions is to view them as any arrangement that removes value from the ODA. Visually, the ODA can be thought of as a line drawn around the pool of assets that are attached to it: any activity within the pool would not be a material distribution transaction, but any activity that moves assets out of the pool would be.

It is unclear whether a taxpayer can trigger a material distribution transaction simply by "unattaching" an asset from an ODA. An unconstrained ability to add or remove assets from an ODA could open significant tax planning opportunities. On the other hand, attempts to restrict removal of assets may simply force taxpayers into more costly planning steps, such as selling the asset and replacing it with an asset outside the ODA.

2. ***Tax amount.*** The income realized on a material distribution transaction is determined by multiplying the value of the assets removed from the ODA by the taxpayer's accumulated unliquidated withholding percentage. An important feature of this income amount is that it has nothing to do with the basis or value of the assets in the ODA, or whether those assets have gone up or down in value. The formula simply dictates the portion of the material distribution transaction that is treated as currently taxable gain.

When a pool of assets generates proceeds that are removed from the pool, there is no general means of saying whether those proceeds represent a return on, or a return of, the taxpayer's investment. The formula for taxing material distribution proceeds designates the portion of these proceeds that represents a return on investment, and therefore amenable to current tax. While that assumption is unlikely to be accurate as a general matter, any resulting inaccuracies may be somewhat mitigated by the subsequent adjustments in tax upon reconciliation, as discussed in item IV.C.4 below *(page 26).*

3. ***Accumulated unliquidated withholding percentage.*** The accumulated unliquidated withholding percentage is equal to the top marginal Vermont income tax rate for the year in which the ODA is established, and then is increased by the product of the published incremental ODA withholding percentage for the year and 100% minus the accumulated unliquidated withholding percentage for the prior year. *Prop. 32 V.S.A. § 5605(f).*

The published incremental ODA withholding percentage is to be published by the Commissioner each year, obtained by multiplying the estimated economy-wide normal rate of return for the prior year by the highest marginal Vermont income tax rate for that prior year. *Prop. 32 V.S.A. § 5607(c).* The estimated economy-wide normal rate of return is to be the one-year Treasury bill rate plus 3 percentage points, unless the Commissioner determines that some other methodology is more appropriate. *Prop. 32 V.S.A. § 5607(b).* What is considered to be a "normal" rate of return will depend on the degree of risk associated with that return, but the default rate, which is 3 percentage points above the risk-free rate, suggests that some meaningful quantum of risk is intended to be reflected in that rate.

It is difficult to parse what the annual adjustments to the accumulated unliquidated withholding percentage are intended to accomplish. Written as a formula, the accumulated unliquidated withholding percentage for the second year after the ODA is established looks like this:

$$AUTWP_2 = AUTWP_1 + PIOWP(1 - AUTWP_1),$$

where $AUTWP_i$ is the accumulated unliquidated withholding percentage for year *i,* and *PIOWP* is published incremental ODA withholding percentage.

To see an example with simple numbers, suppose the highest tax rate is 8%, and the estimated economy-wide rate of return is 6%. In the first year, the accumulated unliquidated withholding percentage would simply be 8%, the highest marginal tax rate. In the second year, the published incremental ODA withholding percentage would be 6% times (100% minus 8%), which is 5.52%. Plugging these amounts into the formula yields an accumulated unliquidated withholding percentage for year 2 of 13.08%.

Repetitive applications of the formula in subsequent years will cause the accumulated unliquidated withholding percentage to continue to rise, but in diminishing amounts, since each year's increase will be less than the amount by which the prior year's percentage falls short of 100%.

4. ***Interplay with conventional regime.*** In some cases, the income inclusion that results from a material distribution transaction may be itself taxed under the conventional regime. If a material distribution transaction is separately taxable under the conventional regime, then the taxable amount is the greater of the amounts that would be included under either regime. *Prop. 32 V.S.A. § 5605(g)(4).* The ODA contract requires the taxpayer to keep a running tally of additional taxes paid by reason of material distribution transactions. *32 V.S.A. § 5605(g)(4).* That tally then enters into the reconciliation formula to reduce the tax payable when the ODA is closed, as described in the next section. When a material distribution transaction is taxable under both regimes, it is unclear whether the amount of tax that is included in the tally is the full amount of tax that is imposed, or only the incremental amount, if any, that is imposed by reason of the ODA regime.

Some events will cause income from assets in an ODA to be taxable under the conventional regime but not the ODA regime; conversely, some material distribution transactions will be taxable under the ODA regime but not the conventional regime. There is nothing to prevent both taxes from being imposed, but in the former case the tax will not be reflected in the additional tax tally.

5. ***Effect on reconciliation.*** Taxes paid on material distribution transactions enter into the reconciliation formula. That formula, presented in simplified form in item IV.B.2 above *(page 23),* is presented in its complete form here:

$$(MDTS - TAX)\left(1 - \left(\frac{MDTS - TAX}{BASIS}\right)^{-t}\right) - TAX.$$

Prop. 32 V.S.A. § 5605(j)(2)(A). Here, *TAX* represents the total amount of additional tax paid on material distribution transactions under the ODA regime over the life of the ODA. It acts as an offset to *MDTS,* which represents the full pretax proceeds of the ODA. Importantly, if *TAX* does not include any tax imposed under conventional regime upon the closure of the ODA, then the gain in the ODA will be taxed under both the conventional and the ODA regimes.

There is an inconsistency in the use of the term *MDTS,* which purports to be the aggregate value of all of the ODA's material distribution transactions. The term should include the balance of the ODA when it is closed, but it makes no sense to treat that balance as itself a material distribution transaction for purposes of imposing a separate tax on it; the reconciliation tax itself should be enough. It appears that the Bill itself does not contemplate taxing material distribution transactions in the year in which the ODA is closed, since the definition of accumulated unliquidated withholding percentage is defined only for years that precede the year of closure. *Prop. 32 V.S.A. § 5605(f).*

In the formula, *BASIS* is determined at the time the asset becomes attached to the ODA. *Prop. 32 V.S.A. § 5605(j)(2)(A)(i).* The formula therefore disregards adjustments to basis over the life of the ODA, even though those adjustments may have had tax effects under the conventional regime that are not reflected in *TAX* as used in the formula.

The formula is a blend of two different judgments about the value of tax deferral. As noted in item IV.B.2 above *(page 23),* the reconciliation formula is largely based on the assumption that the value of tax deferral is based on the return actually earned in the ODA itself. However, the rate of tax imposed on material distribution transactions is a formula that operates without regard to the taxpayer's actual investment experience. It is understandable that actual investment experience would be disregarded in calculating the tax on material distribution transactions, since the premise of an ODA is that, without interim valuations, there is no way, prior to the final reconciliation, to know what the actual return is.

It is difficult to say, without further analysis, how this incorporation into the reconciliation formula of additional taxes that are paid over the life of the ODA will affect the aim of equalizing the tax treatment. The Bill allows taxpayers to proffer an alternative method that might achieve a fairer result under the taxpayer's own facts. *Prop. 32 V.S.A. § 5605(j)(2)(B)(i).* There is, however, no provision for the Commissioner to challenge the standard formula in cases where it produces results that are unfairly favorable to the taxpayer. This asymmetry will work against the interests of the government, and tend to reduce the tax revenue from the ODA regime.

6. ***Additions to the ODA.*** The reconciliation formula does not take into account the fact that assets may be attached to the ODA at different points in time. If the taxpayer attaches to the ODA a high-basis asset shortly before reconciliation, it could have an effect on the formula that is very favorable to the taxpayer.

Many of these distortions could be avoided if a reconciliation were performed every time an asset went in or out of the ODA. The reconciliation would be performed using the simplified formula stated in item IV.B.2 above *(page 23)*, based on the aggregate value of the ODA upon each such event. This approach would require frequent valuations, which would appear to undercut the whole point of the ODA. However, the valuations would not need to be precise, since the tax benefit of a lower valuation in a particular period will be largely offset by a higher tax in a subsequent period. Accordingly, there would be less need for certified appraisals, and crude valuation surrogates may be acceptable.

D. Loans

1. ***Initial indebtedness.*** Assets that are attached to an ODA may already have debt associated with them. The taxpayer should be allowed to attach the debt as well, but doing so should reduce the taxpayer's basis in the ODA, so that the basis reflects only the taxpayer's equity in the attached asset.

2. ***Subsequent indebtedness.*** The Bill treats subsequently incurred debt as a material distribution transaction, subject to exclusions for qualified residence indebtedness and up to $1 million of other indebtedness. *Prop. 32 V.S.A. § 5605(h)(1).* There is no reason to view borrowings as a material distribution transaction, if the proceeds of the borrowing are invested in assets attached to the ODA. A material distribution transaction should arise only if the proceeds are removed from the ODA, in which case those proceeds would be a material distribution transaction under the general rules for withdrawals from an ODA.

Prior to amendments made at the end of 2017, qualified residence interest included up to $1 million of debt incurred to purchase a principal residence or one other residence of the taxpayer, as well as up to $100,000 of home equity indebtedness, which could be incurred for any purpose. *I.R.C. §§ 163(h)(3)(B), (C).* Under current rules, the $1 million permitted amount for acquisition indebtedness is reduced to $750,000 and home equity loans are excluded entirely, but those rules sunset at the end of 2026, and the law reverts back to its pre-2018 state. *I.R.C. § 163(h)(3)(F).* It is unclear whether the reference in the Bill to qualified residence indebtedness refers only to the rules currently in effect, or is intended to change as that definition changes over time. Even without an exclusion, indebtedness incurred to acquire a residence that is attached to an ODA should not be treated as a material distribution transaction, since the proceeds will have been invested in the residence itself, and not distributed to the taxpayer.

3. ***$1 million exclusion.*** The elective exclusion of up to $1 million of indebtedness effectively allows a taxpayer to withdraw that amount from the ODA without paying tax. Moreover, that amount will not be reflected in the reconciliation formula when the ODA closes. This exclusion will effectively wipe out an amount of gain equal to the amount of the excluded debt, which would seriously undermine the tax revenues generated by the ODA.

E. Changes in Residency

1. ***Pre-residency gains.*** Assets attached to an ODA that were acquired before the taxpayer became a Vermont resident will have built-in gain that will be reflected in the ODA reconciliation formula. This built-in gain is not necessarily problematic: Vermont already taxes realized gains of a resident, even if those gains reflect some pre-residency appreciation.

   The mark to market regime also picks up pre-residency gains, although the recognition of those gains can be mitigated by the phase-in cap amount.

2. ***Post residency gains.*** The ODA contract requires the taxpayer to agree to remain subject to Vermont's taxing jurisdiction with respect to the assets attached to the ODA, even after the taxpayer is no longer a Vermont resident. *Prop. 32 V.S.A. § 5605(a)(3).* This rule contrasts with the treatment of realized gains under the conventional regime, since realized gains for a former resident are not subject to Vermont tax under the conventional regime, even if those gains reflect appreciation that occurred while the taxpayer was a resident of Vermont.

Moreover, the ODA would tax gains that accrue *after* the taxpayer is no longer a Vermont resident. In that respect, the ODA regime is harsher than the mark to market regime, which does not reach post-residency gains. This aspect of the ODA regime may deter taxpayers from attaching assets to an ODA if they do not plan to remain in Vermont indefinitely.

F. Deceased ODA Holders

1. ***Treatment of estate.*** An ODA contract is binding on the taxpayer's estate and assigns. *Prop. 32 V.S.A. § 5605(b).* There is nothing in the Bill that treats the taxpayer's death as a closing of the ODA, but presumably the taxpayer's estate will need to close the ODA, and pay the reconciliation tax, in connection with winding up the estate.

2. ***Non-probate assets.*** Many assets of a deceased taxpayer with an ODA, including assets attached to the ODA, may be outside the taxpayer's probate estate. Those assets include jointly held assets, life insurance, revocable trusts, IRAs, and deferred compensation plans. The assets in the taxpayer's probate estate may be insufficient to pay the reconciliation tax. In the case of unpaid estate tax, the recipients of property included in the taxable estate are responsible for the tax. *32. V.S.A. § 7452.* Consideration should be given as to whether existing provisions of the Bill and Vermont law are adequate to ensure collection of tax from a deceased holder of an ODA, particularly in cases where the holder was not a Vermont resident at the time of death. This question may turn on whether recipients of those non-probate assets are "assigns" who are bound by the ODA contract.