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Cryptocurrency is Becoming Commonplace

In this Issue:

Recently, Tesla announced in a SEC filing that it bought $1.5 billion in Bitcoin and that it would begin accepting Bitcoin as payment for its products. This action, along with increasing receptivity among businesses and investors around the world for cryptocurrency has driven the price of digital currencies to never before seen highs.

The increasing acceptance and use of cryptocurrency in business and individual transactions has also drawn the attention of the IRS for two reasons. First, although digital currency transactions are traceable, it is possible for individuals to mix coins from multiple parties to effectively break the connection between the sender and receiver of the coins. This makes such transactions much more difficult for the IRS to trace. The IRS and law enforcement in general is obviously concerned about the misuse of cryptocurrency in criminal activities or tax evasion. Second, cryptocurrency is viewed by the IRS as property and accordingly transactions in such currency may have tax consequences that require reporting and the payment of income taxes.

The IRS has been studying cryptocurrencies and has provided guidance to those who own them. The sale or exchange of virtual currencies, or the use of virtual currencies to pay for goods or services, or holding virtual currencies as an investment generally has tax consequences that could result in a tax liability.

The IRS published guidance in IRS Notice 2014-21, IRB 2014-16, to instruct individuals and businesses on the tax treatment of transactions using virtual currencies. You should pay close attention when you file your personal income tax return that there are several virtual currency inquiries that must be answered under penalties of perjury. You may not have transacted in virtual currency during a reporting year, but you still may need to disclose whether you own any.

Taxpayers who do not properly report the income tax consequences of virtual currency transactions can be audited for those transactions and, when appropriate, can be liable for taxes, penalties and interest. In more extreme situations, taxpayers could be subject to criminal prosecution for knowingly failing to properly report the income tax consequences of virtual currency transactions. Criminal charges could include tax evasion and filing a false tax return. Anyone convicted of tax evasion is subject to a prison term of up to five years and a fine of up to $250,000. Anyone convicted of filing a false return is subject to a prison term of up to three years and a fine of up to $250,000.

Cryptocurrency appears to be here to stay, so if you own and transact with them, pay attention to your tax filing obligations of disclosure and tax reporting, and paying of taxes where required related to these transactions.

Who's Going to Pay for All this?

The Biden Administration is backing a large infrastructure spending bill that could result in a $2 trillion price tag. In all likelihood, the Democratic majority has the votes and the political will to get this bill enacted into law. And, don't expect for this bill to be the last major spending bill you'll see coming from the current administration.

So the age-old question that follows is how this spending package will be paid for. Taxes, of course, but who will pay? Most of the US tax burden today is born by businesses and individuals through individual taxes, payroll taxes and corporate income taxes. Other sources of tax revenue include excise taxes, the estate tax, and other taxes and fees.

Half of all annual federal revenue comes from individual income taxes. The income tax is generally progressive meaning higher-income households generally pay a larger share of their income in income taxes than lower-income households do. The Tax Foundation reports that for tax year 2018, the top 10% of income earners paid 71.4% of total income taxes. The bottom 50% paid 2.9%.

But most of the bottom earners are employed and are subject to payroll taxes that take a big chunk of the disposable income from the group. Thirty-six percent of federal revenue comes from payroll taxes, which are assessed on the paychecks of almost all workers and are used to fund Social Security, Medicare Hospital Insurance, and unemployment insurance. Payroll taxes as a whole are regressive. As such, they collect a higher percentage of total earnings from lower-income workers than higher-income workers. By law, employers and employees split the cost of payroll taxes, but research has shown that employers pass their portion of the cost on to workers in the form of lower wages.

Corporate income taxes make up about 7 percent of federal revenue, with the remaining 8 percent coming from excise taxes, estate taxes, and other revenue sources. Excise taxes are collected on the sale of certain goods (e.g., fuel, alcohol, and tobacco); they are intended to raise revenue and, in some cases, discourage consumption of the taxed product. These made up about 3 percent of federal receipts in 2019. Corporations make up a small percentage of total tax revenues, so there is obviously great interest in making corporations pay more.

The estate tax is a tax on assets, such as cash, real estate, or stock, that are transferred from deceased persons to their heirs. Because the first $23.4 million of a married couple's estate is exempt from the estate tax in 2021, less than 1 of every 1,000 estates will owe the estate tax in 2021. Because it affects only those who are most able to pay, the estate tax is the most progressive component of the tax code. However, the estate tax revenues only accounted for 0.5 percent of total federal receipts in 2019, which translates that the tax can be significantly lowered through legal planning efforts regardless of rates.

Perspective

Strength

Wealth Tax Discussions, Again

In keeping with her presidential platform, Senator Elizabeth Warren again proposes to add a 2 percent annual tax on the net worth of households and trusts above $50 million, plus an extra 1 percent tax above $1 billion. She is one of several progressives who advocate that this tax is needed in order for the wealthy to pay their "fair share." Why would billionaires object when it is only 2 cents from every dollar of their wealth (year after year)?

Neither Warren nor the United States is the first country to explore a wealth tax on billionaires. There are no countries today who have implemented a wealth tax that tout significant success with it. The main reason is that billionaires are mobile tax sources. If they don't like paying the country's wealth tax, they can leave that country and its jurisdiction to tax. Most of those countries that have implemented the wealth tax have discovered that practical enforcement of such a tax was more difficult than assumed. France lost 12,000 millionaires a year and then it later reversed course with tax cuts to lure back the rich. Only a handful of countries are still trying to make a wealth tax work.

There are two major hurdles to implementing a wealth tax in the United States. Article One of the Constitution allows Congress to "lay and collect taxes, duties, imposts, and excises" so long as they are uniformly imposed on American taxpayers. The next section of Article One says "no capitation or other direct tax shall be laid, unless in proportion to the census or enumeration herein before directed to be taken." A wealth tax is a direct tax.

There are viable arguments that a wealth tax could be constitutional, and there are cases on both sides of that issue. But the second hurdle to wealth tax advocates lies with the 16th Amendment. When the 16th Amendment was ratified, it made for a new federal tax, but just on our income.

Despite the legal issues, there are also some practical problems. Valuing wealth from real estate to luxury items would mean a significant increase in resources required by the IRS to administer taxpayer reporting responsibilities. It is common for ultra-high net worth individuals to have a large portion of their wealth tied up in assets that are not liquid or easily valued, which will necessarily invite long, drawn out disputes over the value being taxed. The legislation acknowledges the depth of this undertaking and provides a whopping $100 billion increase for IRS funding across the next decade.

As mentioned, most countries have failed at attempts to tax "wealth" because the subjects of the tax are mobile and can easily remove themselves from those jurisdictions. Warren's solution is a "captivity tax." For the privilege of leaving the United States and its taxing authority, a confiscatory tax of 40 percent of your net worth above $50 million would be imposed.

Who knows, we may end up with a wealth tax in the United States. This would thrill progressive audiences who relish the thought of billionaires paying taxes on their "Rembrandts, portfolios, diamonds, and yachts." I am confident that as proposed it will not affect me or anyone that I know personally. In today's times, politics drives policy, so whether the wealth tax actually works as progressives envision is unimportant. It's the thought that counts.

For the 99.5% Act

On March 25th, Senator Bernie Sanders introduced a bill entitled "For the 99.5% Act." When you read the proposals in the bill, you find that it's the same "Golden Oldies" he has unsuccessfully presented before to raise estate and gift transfer taxes. Sanders is a longtime proponent of the progressive mantra that the wealthy do not pay their fair share of taxes.

Summarized below are some of the more impactful provisions that would accomplish his objectives:

Rates and Exemptions:

- The bill would reduce the current $11.7 million estate and gift tax exemption to $3.5 million per person.
- The bill would reduce the exemption for lifetime gifts from $11.7 million to $1 million per person.
- The estate and gift tax rate would be raised to 45% from the current 40% up to $50 million of taxable value, 55% up to $1 billion and 65% on value over $1 billion.
- The effective date for these changes would apply to deaths or gifts made after 12/31/21.

Valuation Discounts and Basis Step Up

- Elimination or reduction of valuation discounts for transfers of business entity interests that do not conduct a trade or business.
- Disallowance of basis step on death for assets held in a grantor trust, if those assets are not included in the grantor's gross estate at death. Note that President Biden wants to eliminate basis step ups altogether.
- The effective date for these changes would apply to transfers made after date of enactment.

Eliminate Grantor Trust Planning

- New grantor trust rule would cause estate inclusion of all trust assets deemed owned under income tax rules by the grantor at the time of the grantor's death.
- Actions that would cause grantor trust status to cease taken after date of enactment would be treated as taxable gifts by the grantor of all trust property that was deemed to be owned by the grantor for income tax purposes.
- The effective date for these changes would apply to trusts created after the enactment of the legislation, or in relation to trusts created before the enactment of which contributions are made to such trust after the enactment.

I must say that as an estate planner with many years of experience, Senator Sanders has eliminated virtually every tool in the estate planner's tax reduction tool chest if these provisions are enacted as proposed. As I see it, there will be only one major escape hatch from estate taxation for the uber wealthy – charity.

What's the likelihood of these provisions passing? I believe that there is a reasonable likelihood of these provisions becoming law in 2021. Congress is trying to fill a $2 trillion gap which is well beyond the ability of increased income taxes to cover and offending rich people is of no concern. So if you have any desire to avoid the application of these provisions to your personal estate plans, you should immediately consult with your estate planning advisors to determine whether you should expedite your planning in advance of this potential legislation.

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We seek to bring wealth planning best practices and a wide range of non-proprietary solutions to our clients. We also conduct our own research and diligence on world markets and investment alternatives.

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