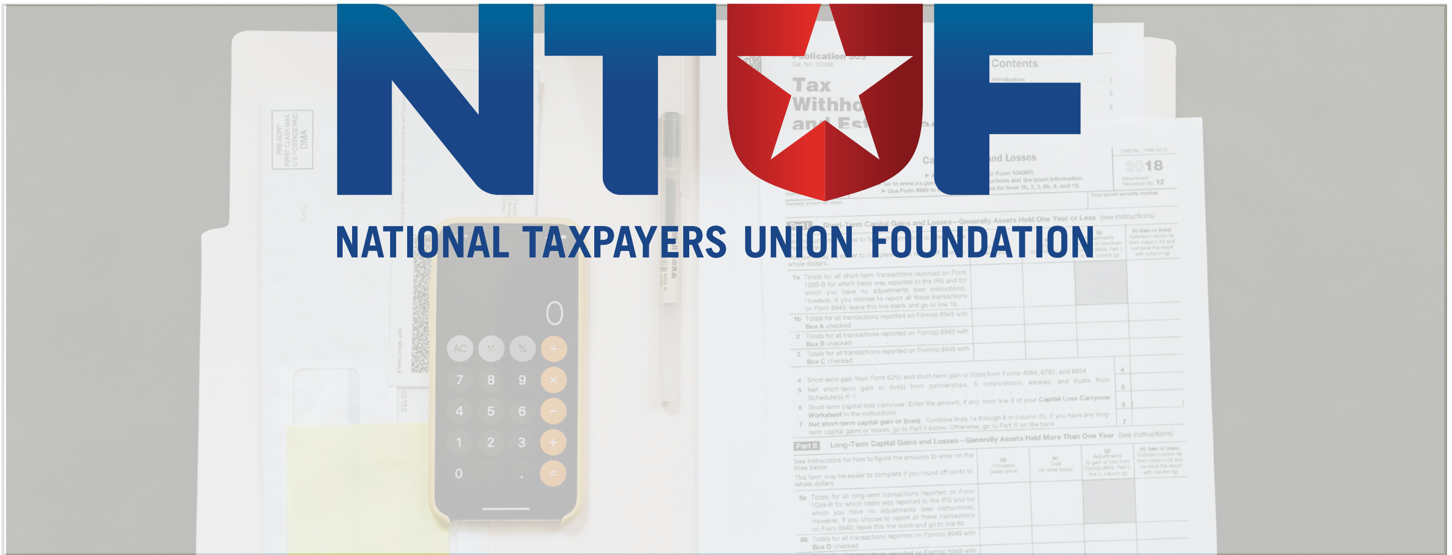

How Congress Can Address "Buy Borrow Die"

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Key Takeaways

- A recent Senate Finance Committee hearing focused on the tax planning strategy known as "buy borrow die" — or borrowing against an asset until its cost basis is reset upon its original owner's death.

- While many of the participants in the hearing suggested that the way to combat this strategy would be to tax wealth instead of income, wealth taxes would create new (and far greater) economic and practical problems.

- Ultimately, "buy borrow die" can be traced back to the death tax and the fact that capital gains are not indexed to inflation. Any comprehensive solution to "buy borrow die" would first have to solve these issues.

Recently, the Senate Finance Committee held a hearing on strategies utilized by the wealthiest Americans to avoid or minimize their tax obligations. Soon after, Sen. Ron Wyden (D-OR), along with fifteen other Democratic and Independent Senators, introduced a new version of Sen. Wyden's previously proposed "Billionaires Income Tax." Highlighting this hearing and the renewed push for a "Billionaires Income Tax" was a tax planning strategy colloquially termed "buy borrow die."

NTUF has discussed "buy borrow die" in the past, but given continued conversations around the concept, it's worth digging into it once again and why the problem remains so intractable.

As far as these types of arrangements go, "buy borrow die" is fairly straightforward. The three steps of the strategy are as follows:

- **"Buy"** non-liquid assets (or own them to begin with,)
- **"Borrow"** against the value of these assets rather than selling them, avoiding the tax on capital gains income in the process,
- **"Die,"** and allow the non-liquid assets to be passed on to heirs. At this point, the step-up in basis resets the value of the assets for tax purposes.

During the Senate Finance hearing, Sen. Wyden and friendly witnesses emphasized the need for new tax obligations on the wealthy and crackdowns on tax avoidance strategies. Implicit in these statements was the idea that "buy borrow die" is indicative of widespread and pervasive tax shirking by the wealthy.

While it remains unclear precisely how commonplace "buy borrow die" has become, it should not be overstated. The top 1 percent paid 45.8 percent of all individual income taxes as of the last IRS data release for tax year 2021, approaching twice their share of adjusted gross income. What's more, a new analysis by Gerald Auten and David Splinter, economists at the Treasury Department's Office of Tax Analysis and Congress's Joint Committee on Taxation, finds that levels of income inequality have stayed nearly static since the 1960s once taxes and transfers are taken into account. However prevalent "buy borrow die" is, it has not begun to shake the fundamental reality that the wealthiest Americans pay more than their fair share.

There are also drawbacks. Securities-backed lines of credit (SBLOCs) usually only allow investors to borrow against a fraction of the asset's value. Additionally, using the wrong asset as collateral can result in the lender calling in the loan — or seizing the collateral — should the value of the asset dip past a certain point. SBLOCs are also non-purpose loans, meaning that they cannot be used to purchase additional securities. And while they are often extended, SBLOCs in theory represent lines of credit that must eventually be repaid and are subject to rates of interest, albeit often low ones.

Borrowing against collateral is a valid practice with many justifiable reasons outside of tax avoidance, and legislators should be careful not to attack this practice when their quarrel is truly with the death tax. Fixing the problems the step-up in basis imperfectly addresses and then phasing down the step-up in basis only as reforms are implemented is the best way to address "buy borrow die."

But while it's easy to recognize "buy borrow die" as an unintended consequence of the way the tax code is structured, coming up with a solution that does not lead to even greater problems is far more difficult. It's worth a deeper examination of the elements of the tax code that allow "buy borrow die" to work.

Parts of the Tax Code that Enable "Buy Borrow Die"

The Step-Up in Basis

Likely the most controversial element to be discussed here, the step-up in basis resets the cost basis of assets when they are inherited. For example, imagine an individual purchases a share of stock in 1970 when it is worth $10, passing away in 2000 when the stock is worth $30. The share's basis would be reset to $30 for tax purposes. In other words, should the heir sell the stock in 2005 when the asset is worth $35, they would only pay capital gains tax on the $5 gain between 2000 and 2005, not the full $25 gain between 1970 and 2005.

The step-up in basis enables the "die" component of "buy borrow die." Without the step-up in basis, the assets being borrowed against would eventually face hefty tax obligations upon their eventual sale. Instead, it allows heirs to essentially wipe the slate clean, allowing unsold capital assets to appreciate untaxed throughout an individual's entire lifetime.

But while the step-up in basis is a somewhat unwieldy piece of the tax code, the practical effects of doing away with it would likely be significant. The policy exists to rectify other problems in the tax code, and getting rid of the step-up in basis without addressing these other issues is likely to magnify them.

One such issue is the lack of indexing for inflation for capital gains. In the above example, the $25 appreciation in value between 1970 and 2005 is actually lower than the rate of inflation — $10 in 1970 dollars is worth roughly $50 in 2005 dollars. Absent the step-up in basis, the heir would be forced to pay capital gains tax on an asset that hasn't gained and may actually have *lost* real value.

Along the same lines, the step-up in basis prevents capital assets from becoming essentially unsellable. Assets that have been appreciating in value for decades, particularly shares of family-owned enterprises for which the original cost basis would be zero, would be in for a massive tax bill upon being sold absent the step-up in basis. This is particularly true given the fact that, once again, a substantial portion of the appreciation in these long-held assets would be illusory and due to inflation.

The step-up in basis also provides some protection to taxpayers against the ravages of the death tax. Absent the step-up in basis, heirs forced to sell inherited assets to pay off the death tax bill that falls on their shoulders would *also* have to pay capital gains tax on assets they are selling entirely in order to pay their tax bill. Those compounding obligations would require heirs to sell even more of their inherited assets to pay their estate tax bill.

Lastly, there's a practical issue with getting rid of the step-up in basis. Decedents cannot always be counted on to keep detailed records of their assets' original cost bases, and failure to do so would make it very difficult for heirs to establish the cost basis of their newly inherited assets, through no fault of their own. The step-up in basis gets around this issue of poor record-keeping by requiring heirs to know only assets' cost bases at the time of inheritance.

So, while it is true that eliminating the step-up in basis would address the "die" portion of "buy borrow die," it would do so at the expense of aggravating all the other problems with the tax code the step-up in basis is currently helping to ameliorate.

Non-Taxability of Loan Income

Fundamentally, "buy borrow die" relies on the fact that loan income is non-taxable while capital gains income is taxable. But making loan income taxable is not really much of an option.

Most Americans who take out loans (be it student loans, a mortgage, or a source of money to bridge the gap between paychecks like a payday loan) are not doing so to avoid or defer tax obligations. Most Americans see debt as a liability. Tax obligations rarely, if ever, factor into decisions to pursue any of these types of loans.

Taxing loan income would also open up a can of worms. While some SBLOCs can function as nearly indefinite, low-interest loans, they remain *loans* that have to be repaid at some point. Treating the "income" from these loans as taxable would ignore the other end of the transaction, where the loan would have to be repaid at some point. Presumably, if loan *proceeds* became taxable, loan *repayments* would have to become deductible. That might create greater opportunities for strategic tax planning than "buy borrow die."

Additionally, wealthier Americans have good, non-tax-related reasons to take out SBLOCs. Cash-poor but asset-rich entrepreneurs who wish to benefit from the success of their start-up without selling off shares of their business often choose to take out SBLOCs. Stripped of this alternative, entrepreneurs would have to choose between control of their business and access to liquidity.

In this context, any form of taxation of loan income does not appear to be much of a viable option for addressing the issue, even with a substantial safe harbor built in.

Non-Taxability of Wealth

Like hammers seeing nails, progressives prone to view a wealth tax as a solution to just about every problem in the tax code tend to suggest a wealth tax to solve "buy borrow die." There are three main arguments against a wealth tax: the moral argument, the economic argument, and the practical argument.

The moral argument is that unrealized income is inherently unfair to tax, as its owner does not directly benefit from it until it is realized. Americans hold assets of all kinds that appreciate in unrealized value, and would be angry and frustrated if they were subjected to taxes on that appreciation.

In fact, the one type of wealth tax that Americans currently face — and the one frequently invoked by wealth tax advocates to argue that such taxes are indeed feasible — consistently ranks as the most-hated tax in opinion surveys of taxpayers. That tax is the property tax, which frustrates taxpayers who nearly every year are forced to pay more tax despite not materially benefiting from their home's value appreciation. Any wealth tax would similarly offend the sensibilities of Americans who don't understand why they are expected to pay more tax when their realized incomes remain the same.

SBLOCs and other loans offer somewhat of a counterpoint to the idea that wealth is only useful to taxpayers when realized, but they remain the exception rather than the rule. Once again, differentiating between taxpayers who are taking out SBLOCs to limit their tax liability and taxpayers who are taking out SBLOCs for legitimate business reasons would be nearly impossible.

The economic argument against wealth taxes is that they are detrimental to the economy. Not only do they pull investment capital out of the hands of private investors, they also discourage entrepreneurship by assessing hefty tax obligations on cash-poor entrepreneurs. This has the added effect of making it easier for large, established competitors to buy out upstart competitors before they have a chance to displace them.

While these would be the first-order effects, the impacts of a wealth tax would ripple throughout the economy. The taxation of private charitable foundations under a wealth tax, for example, presents unique challenges — should the direct assets of charitable foundations be taxable, this would have a significant negative impact on private altruism, while even indirect taxation by taxing their donors would still hamper private foundations' resources and capabilities.

The final argument is a practical one. European countries that once had wealth taxes have largely moved away from them not just because they are economically harmful, but because the hassle of administering them makes the juice not worth the squeeze.

Consider that under a wealth tax, there would need to be a reliable, consistent means of establishing the value of non-liquid assets for thousands of wealthy individuals across the country. While wealth tax advocates raise property taxes as proof that this is feasible, houses remain just one type of asset — one for which many similarly valued and located assets are often on the market at any given time. Even given these advantages, courts and administrative employees have to deal with many valuation appeals and challenges each year.

A wealth tax would fall on many more types of assets that would be far more difficult to fairly value. When singer Michael Jackson passed away in 2009, his heirs valued the use of Jackson's image and likeness at $2,105. The IRS disagreed, valuing it at *$434 million*. It took twelve years of legal proceedings and a 271-page ruling for the value to finally be set at $4 million.

Now imagine if tax administrators had to fight that battle every single year for everyone exceeding a certain wealth threshold. With the often fickle nature of public images, celebrity wealth valuations might spike and crater with every latest twist and scandal in the media. Then realize that even *if* that could be accomplished, it would represent only one small element of an individual's wealth.

Of course, some proposals for wealth taxation have recognized these practical problems and sought more targeted approaches. Sen. Ron Wyden (D-OR), who chaired the aforementioned Senate Finance Committee hearing on tax avoidance strategies, has long advocated the establishment of a "mark to market" scheme of taxing unrealized capital gains of publicly-traded assets. Unrealized gains on non-publicly-traded assets, such as privately-held shares in a business, would essentially owe interest for the years the tax was "deferred" on top of the existing capital gains tax upon realization. Sen. Wyden's latest "Billionaires Income Tax" proposal is again a version of mark-to-market.

While this proposal avoids some of the most serious practical problems noted above in regard to traditional wealth taxes, it suffers from the same issues of other kinds. Mark-to-market taxation of assets would impose taxes on unrealized income, as well as discourage investment.

Furthermore, cash-poor but asset-rich entrepreneurs would face the same problems under a mark-to-market system as a wealth tax, essentially being discouraged from taking their companies public lest they face a hefty tax bill right then and there when they lack the cash to pay for it. Entrepreneurs who had already taken their companies public would likely have to sell off parts of their business just to pay their tax bills.

More in-the-weeds problems exist as well. Taxation of unrealized gains would require allowing deductions for unrealized *losses*, lest taxpayers face taxes on gains they never realized before being left out to dry when that asset loses value the subsequent year. The deferral portion of the proposal for non-publicly-traded assets would also have to figure out a way to handle potential changes in capital gains taxes when looking back retrospectively.

Wealth taxes, even more limited ones like "mark to market," may appear at first glance to solve the "buy borrow die" issue, but the problems they would create far outweigh "buy borrow die." Legislators should dismiss them as an option for addressing the issue.

A Problem Ultimately Created by the Death Tax

While "buy borrow die" has become a problem for legislators, they should recognize that it is a symptom rather than the cause. Ultimately, "buy borrow die" can be traced back to the death tax. The step-up in basis exists because the death tax necessitates it. By eliminating the death tax and

indexing capital gains to inflation, the biggest reasons for the step-up in basis's existence would be gone. Congress could then phase out the step-up in basis without fear of creating a bigger problem than it would be solving.

With the step-up in basis in place, heirs can pay off their decedent's SBLOC by selling assets without paying any capital gains, making it logical to extend SBLOCs up until the point of death and inheritance. Without the step-up in basis, death would no longer offer an opportunity for heirs to reset the cost basis of an asset.

At the same time, the elimination of the death tax and removal of the hefty "inflation tax" on long-held capital assets would protect heirs from being forced into selling their assets by the tax code. When they eventually did so to pay back the loan, they would face capital gains tax only on the real gain in value, not decades' worth of inflationary gains.

Eliminating the step-up in basis would still allow asset-rich individuals to defer capital gains taxes through the use of SBLOCs, but the elimination of the step-up in basis would remove much of the incentive to extend an SBLOC up until death. While currently the cost of paying interest on a loan is outweighed by the opportunity to reset the cost basis of an asset at death, the elimination of the step-up in basis would make deferral of tax obligations less financially beneficial.

It's true that the aforementioned problem of poor decedent record-keeping would remain a practical issue, but a reasonableness standard for estimating cost basis for inherited assets lacking adequate paperwork could mostly address this problem.

Conclusion

Legislators out to solve "buy borrow die" must be careful not to create problems worse than the one they seek to solve. Addressing the problem by eliminating the step-up in basis on its own, making loan income taxable, or establishing a wealth tax would represent ham-fisted solutions that would create far greater pains elsewhere.

Rather, Congress should consider eliminating the death tax and indexing capital gains to inflation. Doing so would allow for an end to the step-up in basis, which ultimately drives "buy borrow die."

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