Vanderbilt Law Review

Volume 47
Issue 6 *Issue 6 - November 1994*

Article 4

11-1994

Further Thoughts on Realizing Gains and Losses at Death

Joseph M. Dodge

Follow this and additional works at: https://scholarship.law.vanderbilt.edu/vlr

Part of the Estates and Trusts Commons

Recommended Citation

Joseph M. Dodge, Further Thoughts on Realizing Gains and Losses at Death, 47 *Vanderbilt Law Review* 1827 (1994)
Available at: https://scholarship.law.vanderbilt.edu/vlr/vol47/iss6/4

This Comment is brought to you for free and open access by Scholarship@Vanderbilt Law. It has been accepted for inclusion in Vanderbilt Law Review by an authorized editor of Scholarship@Vanderbilt Law. For more information, please contact mark.j.williams@vanderbilt.edu.

REPLY

Further Thoughts on Realizing Gains and Losses at Death

*Joseph M. Dodge**

I. INTRODUCTION 1828
II. THEORETICAL CONSIDERATIONS 1829
A. *Arguments Against Repeal of Section 1014* 1829
1 Preserving the Integrity of the Exclusion for Bequests and Inheritances 1830
2. Would Deemed Realization Produce Excessive Taxation? 1834
3. Death is Not a Realization Event 1835
B. *Why a Deemed-Realization Rule?* 1838
III. TECHNICAL FEATURES 1844
A. *General Considerations* 1844
B. *Life Insurance* 1845
C. *Employee Death Benefits, Annuities, IRAs, and IRD Items* 1847
D. *Inter Vivos Trusts* 1848
E. *Co-ownership Property* 1848
F. *Successive Interests* 1849
G. *Transfer Tax Deduction for Income Taxes* 1850
H. *Burden of the Tax* 1850
I. *Character* 1851
J. *Excess Losses* 1851
K. *Marital Exemption* 1853
L. *Exemption for Small and Moderate Estates* 1855
M. *Gift Exclusions* 1856

* William H. Francis, Jr. Professor, University of Texas School of Law.

N. *Gifts v. Support* 1857
O. *Nonliquid Assets* 1858
P. *The Decedent's Personal Residence* 1860
Q. *Transition* 1860
IV. CONCLUSION 1860

I. INTRODUCTION

Professor Lawrence Zelenak has put forth a detailed proposal[1] for repealing present Section 1014 of the Internal Revenue Code,[2] which gives a decedent's successor a basis equal to the estate tax value of property at death.[3] This rule, commonly known as the stepped-up basis (at death) rule, has been roundly criticized as producing an unwarranted (inequitable, nonneutral) income tax loophole, because the step up in basis without realization of gain removes the gain from the tax system entirely. Its repeal, therefore, offers a potential source of significant revenue.[4] Moreover, Section 1014 aggravates the "lock-in effect"; that is, it inhibits rational deployment of investment funds by inducing taxpayers to retain gain property until death. Repeal of Section 1014 alone, however, does not solve the problem, because it must then be decided whether the decedent's basis should carry over to her successors, as presently occurs under Section 1015 with respect to inter vivos gifts, or whether a gratuitous transfer should be treated as a realization event, with the amount

1. Lawrence Zelenak, *Taxing Gains at Death*, 46 Vand. L. Rev. 361, 395-440 (1993). See generally Charles O. Galvin, *Taxing Gains at Death: A Further Comment*, 46 Vand. L. Rev. 1525 (1993); Dan Subotnik, *On Constructively Realizing Constructive Realization: Building the Case for Death and Taxes*, 38 U. Kan. L. Rev. 1 (1989). The Treasury Department proposed taxing gains at death in 1969, but the proposal was not enacted. See Joint Pub. of House Comm. on Ways and Means and Senate Finance Comm., Tax Reform Studies and Proposals (Feb. 5, 1969). For an analysis of the proposals, see Jerome Kurtz and Stanley S. Surrey, *Reform of Death and Gift Taxes: The 1969 Treasury Proposals, The Criticisms, and a Rebuttal*, 70 Colum. L. Rev. 1365, 1381 (1970).

2. Unless otherwise noted, all statutory references in this Article are to the Internal Revenue Code of 1986, as amended, and Treasury Regulation references are codified in 26 C.F.R. § ___ (section number indicated in citation).

3. The estate tax value is the value on the estate tax valuation date, which, under an election hy the personal representative of the decedent's estate, is either the date of death or the alternate valuation date (the earlier of the date that is six months after the decedent's death or the date on which the estate or legatee sells or disposes of the asset). See I.R.C. § 2032. For the vast majority of decedents, the estate tax valuation date is the date of death.

4. The revenue gain from taxing gains at death is estimated to be in the $9 billion per year range. See Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options* 321 (March 21, 1994), reprinted in BNA Daily Tax Report, *Special Supplement of March 22, 1994*, at S-37. Professor Zelenak's sources indicate a possible revenue gain in the $11 billion te $30 billion range. Zelenak, 46 Vand. L. Rev. at 371 n.44 (cited in note 1).

realized deemed to be the fair market value of the property at death.[5] Professor Zelenak favors the deemed-realization approach. I concur in this view, wholly apart from the fact that the carryover basis approach was tried and repealed.[6]

This Article attempts to avoid unnecessary redundancy with Professor Zelenak's article. Unlike Professor Zelenak, who concentrates on the practical reasons for favoring repeal of Section 1014 and preferring the deemed-realization approach over the carryover basis approach, I emphasize the theory and policy reasons justifying these outcomes. In the section of this Article that addresses the technical details of the proposal, I point out areas of disagreement with Professor Zelenak, plus Professor Zelenak's areas of omission or light coverage. Ultimately, my preferred version of the taxing gains at death proposal would have fewer gaps than Professor Zelenak's proposal but would be more generous to taxpayers in certain instances.

II. THEORETICAL CONSIDERATIONS

At the theoretical level, the first issue is what is wrong with Section 1014 and the second issue is whether it should be replaced by a carryover basis rule or a deemed-realization rule.

A. Arguments Against Repeal of Section 1014

There exist only three possible arguments against repeal of Section 1014. One is that Section 1014 is necessary to preserve the integrity of the exclusion for bequests and inheritances. The second is that imposing both an income tax and a transfer tax upon a gratuitous transfer is excessive death taxation. The third is that

5. Of course, the amount realized in a gratuitous transfer is actually zero, producing a (nondeductible) loss. If the amount deemed to be realized were the fair market value, the accrued gain (or loss) would be attributed to the transferor. To prevent taxing the transferee on the same gain, the transferee would obtain a basis equal to the deemed amount realized, namely, the fair market value upon disposition or transfer. Numerous provisions of the Internal Revenue Code operate in this fashion. See, for example, I.R.C. § 311(b) (applying to nonliquidating distribution by corporation of appreciated property); I.R.C. § 336 (applying to corporate liquidating distribution); I.R.C. § 453B(a)(2) (applying to disposition of installment obligations); I.R.C. § 737 (applying to certain partnership distributions); I.R.C. § 1245 (applying to certain dispositions of depreciable personal property); I.R.C. § 1250 (applying to certain dispositions of depreciable real property); I.R.C. § 1254 (applying to certain dispositions of natural resource properties).

6. Congress enacted a carryover basis rule for death-time transfers in 1976, but retroactively repealed it in 1980. See Zelenak, 46 Vand. L. Rev. at 365 (cited in note 1).

"realization" is a necessary predicate for the existence of income, and that death is not a realization event.

1. Preserving the Integrity of the Exclusion for Bequests and Inheritances

Section 102 excludes from income any gifts, bequests, inheritances, and, by implication, other gratuitous transfers received. If a recipient of an in-kind gratuitous transfer did not receive a fair market value-at-transfer basis, the exclusion would be only temporary and illusory, in whole or in part, whereas that for a recipient of cash would be permanent.[7]

The value-at-transfer basis rule was abandoned very early on in the case of inter vivos gifts and replaced by a carryover basis rule, the present version of which is Section 1015.[8] If the value-at-transfer basis rule applied to gifts, the transfer of gifts of appreciating assets within families would eliminate gains from the tax system.[9] Thus, the principle in this case of preserving the Section 102 exclusion with respect to in-kind gifts can rightly yield to expediency when the fundamental integrity of the tax system as a whole is at stake.[10] In the practical sense, the Section 1014 basis rule does not threaten the total elimination of gain from the system, since death is a unique event for each individual and would not be undertaken solely to save income taxes.

On the theoretical level, the "integrity of the exclusion" rationale for Section 1014 is only as strong as the underlying rationale for the Section 102 exclusion itself. A compelling case can be made for the repeal of Section 102 and the inclusion of gratuitous receipts in income.[11] Because repeal of Section 102 is not immediately likely, it will suffice here to look at the possible rationales for Section 102.

---

7. See Joseph M. Dodge, *The Logic of Tax* 37-39 (West, 1989).

8. In *Taft v. Bowers*, 278 U.S. 470, 482 (1929), the Supreme Court upheld the carryover basis rule against the argument that taxing the transferees on income that accrued to the donor violated the Sixteenth Amendment to the Constitution.

9. See *Rice v. Eisner*, 16 F.2d 358, 360 (2d Cir. 1926).

10. Other examples occur with the numerous rules designed to prevent avoidance of income tax on wages provided in the form of goods and services in-kind. See, for example, I.R.C. § 61(a)(1) (stating that fringe benefits are included in gross income unless specifically excluded by the Code); I.R.C. § 83(a) (applying to receipt of property by service provider); I.R.C. § 7872(c)(1)(B) (applying to below-market compensation-related loans); Treas. Reg. § 1.61-2(a), (d) (regarding compensation in general).

11. See generally Joseph M. Dodge, *Beyond Estate and Gift Tax Reform: Including Gifts and Bequests in Income*, 91 Harv. L. Rev. 1177 (1978); Marjorie E. Kornhauser, *The Constitutional Meaning of Income and the Income Taxation of Gifts*, 25 Conn. L. Rev. 1 (1992).

There are two possible historical rationales that can be dispensed with in short order. The first is that gratuitous transfers received are a taxpayer's original endowment and, therefore, are "capital" rather than "income."[12] This means of distinguishing principal from income derives from the law of trust accounting, the basic principle of which is to protect the respective interests of income takers and remainders of trusts.[13] However, there is no reason why income taxation should follow trust accounting principles.[14] The modern concept of income refers to accessions to wealth,[15] a category into which the receipt of gratuitous transfers clearly falls.[16]

A second possible historical rationale is that the Section 102 exclusion was enacted in contemplation of the later enactment of an estate tax.[17] Prior to World War II, the income tax had such large exemptions (and low rates) that it impacted only a small portion of the population.[18] Today, the estate and gift taxes have such large deductions, exclusions, and credits that they impinge on less than ten percent of the population,[19] whereas the income tax is nearly univer-

---

Accord Henry Simons, *Personal Income Taxation* 125-47 (U. of Chicago, 1938); Galvin, 46 Vand. L. Rev. at 1529 (cited in note 1).

12. See Marjorie E. Kornhauser, *The Origins of Capital Gains Taxation: What's Law Got To Do With It?*, 39 Sw. L. J. 869, 885-93 (1985).

13. See Restatement (Second) of the Law of Trusts, §§ 176, 181, 183, 232 (1959). For trust accounting purposes, gains and losses are treated as increases and decreases in corpns, which ultimately pass to the remainders, not income. See Revised Uniform Principal and Income Act §§ 2(a), 3(b)(1), 7B U.L.A. 145 (1985).

14. The Supreme Court explicitly rejected the trust accounting view of income in *Merchants' Loan & Trust Co. v. Smietanka*, 255 U.S. 509, 521-22 (1921).

15. See Simons, *Personal Income Taxation* at 43-56 (cited in note 11) (stating, after dismissing other concepts of income, that income for income tax purposes should be net changes in wealth plus consumption for the taxable period). This work is undoubtedly the single most influential one in United States income tax theory. See *Glenshaw Glass Co. v. Commissioncr*, 348 U.S. 426, 431 (1955) (stating that "income" under I.R.C. § 22(a), where specific Code provisions are silent, means clearly realized accessions to wealth). See also I.R.C. § 74(a) (stating that prizes are included in income); Treas. Reg. § 1.61-14 (including treasure trove, illegal gains, and damage awards not excluded under I.R.C. § 104 in gross income).

16. See Simons, *Personal Income Taxation* at 56-58.

17. See William A. Klein, *An Enigma in the Federal Income Tax: The Meaning of the Word "Gift,"* 48 Minn. L. Rev. 215, 234-35 (1963).

18. See Stanley S. Surrey, et al., *Federal Income Taxation Cases And Materials* 6 (Foundation, 1986) (stating that less than 5% of the public paid income taxes).

19. In 1990, only 59,000 estate tax returns were filed. See Intornal Revenue Service, U.S. Dep't of Treasury, Puh. 55, *Annual Report 1990* 19 (1991) ("*I.R.S. Annual Report 1990*"). In 1990, there were 2,148,500 deaths. See Economics and Statistics Administration, U.S. Dept. of Commerce, *Statistical Abstract of the United States* 91 (1993). These statistics indicate that only 2.6% of the estates filed tax returns. Due to the marital and charitable deductions, it is safe to assume that estate tax actually was paid in substantially less than the total number of estates for which estate tax returns were filed.

sal.[20] Thus, it is unrealistic to view the Section 102 exclusion as being "made up for" by the estate and gift taxes.[21] Moreover, the two taxes are wholly separate in concept, since the estate and gift taxes are "second" taxes on amounts previously subject to the income tax. Finally, the revenue yield from the estate and gift taxes is paltry compared to that of the income tax.[22]

It is sometimes argued that the concept of income is connected with net national product; hence, gratuitous transfers should not be considered income because they do not involve the creation of wealth, but only its transfer.[23] The rationale for favoring this concept of income—which Henry Simons soundly rejected[24]—is that taxes on net income (meaning creation of net wealth) will not unduly inhibit economic activity, because the tax will always be less than the increase in social product.[25] This rationale, however, has no application whatsoever to taxes imposed by reason of death, an inevitable event uninhibited by taxation. Although taxes on inter vivos gifts—which are far lower in amount than death-time transfers—might reduce their making, there is no reason to suppose that the making of fewer gifts would hurt the economy in any way, unless one were to assume that donees would make more rational economic choices than donors.[26] Also, significant inter vivos gifts would be relatively uncommon even without any tax on them.[27] Finally, enactment of the

---

20. In 1990, 112.5 million individual income tax returns were filed, a hefty portion of which were undoubtedly joint returns covering two married individuals. See *I.R.S. Annual Report 1990* at 19.

21. Repeal of Section 102 might raise upwards of $100 billion per year. See Galvin, 46 Vand. L. Rev. at 1526 n.6 (cited in note 1).

22. In 1990, the individual income taxes accounted for 51.1% of federal revenues, whereas the estate and gift taxes accounted for only 1.1% of federal revenues. See *I.R.S. Annual Report 1990* at 19 (cited in note 19).

23. See Alvin Warren, *Would a Consumption Tax Be Fairer Than an Income Tax?*, 89 Yale L. J. 1081, 1088 (1980).

24. See Simons, *Personal Income Taxation* at 44-49, 58 (cited in note 11). See also Victor Thuronyi, *The Concept of Income*, 46 Tax L. Rev. 45, 74 (1990).

25. See Norman H. Lane, *A Theory of the Tax Base: The Exchange Model*, 3 Am. J. Tax Policy 1, 19-34 (1984).

26. Donees, being generally less well-off than donors, would be more likely than the donors to consume rather than invest the subject matter of the gift.

27. See Carl S. Shoup, *Federal Estate and Gift Taxes* 17-25 (Brookings Institute, 1966). During the 1989-90 period, estate tax revenue collections totaled about $17.8 billion, whereas gift tax collections totaled about $3 billion. See *I.R.S. Annual Report 1990* at 19 (cited in note 19). Estate tax returns in 1990 reported aggregate taxable estates of $48.6 billion and aggregate adjusted taxable gifts (post-1976 taxable gifts not included in the gross estate) of only $1.2 billion. See Internal Revenue Service, U.S. Dep't of Treasury, Vol. 11, No. 3, *Statistics of Income Bulletin* 69 (Winter 1991-92). Present transfer tax law provides at least two incentives to the making of lifetime gifts: (1) the $10,000 per donee per year exclusion of I.R.C. Section 2503(b) applies only for gift tax purposes; and (2) the transfer tax base excludes gift taxes (except for gifts made within three years of death, see I.R.C. § 2035(c)) but includes estate taxes.

deemed-realization proposal would not inhibit gifts when the taxpayer had cash or high basis assets to give.

Another theory for the Section 102 exclusion is that gifts represent the "shared" wealth of two taxpayers.[28] This argument is simply counterfactual with respect to money and property, since wealth is shifted, not shared. The sharing idea makes no sense at all with respect to bequests and inheritances. The argument that the gift exclusion treats the donor and donee as being in the same taxable unit[29] is not only counterfactual but also question begging.[30]

These last two arguments are ultimately reducible to the proposition that Congress simply does not want to tax both the transferor and the transferee with respect to the same item under the income tax. It could accomplish this result either by taxing the recipient and allowing the transferor a deduction or, as under present law, by disallowing any deduction to the transferor but excluding the receipt from income.[31] The former alternative would undermine the progressive rate structure by allowing gifts to shift income out of the high tax brackets of donors into the low brackets of donees. It also risks donors making sham gifts, donees underreporting accessions, and donors overreporting deductible transfers. Finally, it is somewhat absurd to give a *decedent* an income tax deduction for the entire amount of transferred wealth; how could such a large deduction be used effectively? Given the (perhaps misguided) premise of no double taxation, the Section 102 solution is self-evident.

---

28. See Richard Goode, *The Individual Income Tax* 99 (Brookings, 1976). Goode's "pooling of consumption" argument has more relevance to the concept of in-kind "support." See text accompanying notes 121-23.

29. The basic taxable unit is the individual. See I.R.C. § 1(b)-(d). Married couples filing jointly are treated as two individuals whose aggregate net income is split evenly between them. Compare I.R.C. § 1(a) with I.R.C. § 1(d). Investment income of children under the age of 14 is effectively attributed to their parents for rate purposes, but not for filing purposes. See I.R.C. § 1(g) (regarding the "kiddie tax").

30. Considering the donor and donee part of the same taxable unit is merely a fancy way of describing the *effect* of Section 102; it does not explain why this result *should* occur in the context of a tax system in which the basic taxable unit is the individual. See Kornhauser, 25 Conn. L. Rev. at 36-37 (cited in note 11).

31. As a matter of positive law, Section 262 disallows the deduction as a "personal . . . or family expense." I.R.C. § 262(a). On the theoretical level, a leading norm is that of "Haig-Simons income," net changes in wealth plus consumption over the taxable period. See Simons, *Personal Income Taxation* at 50-51 (cited in note 11). In the abstract, it is just as plausible to treat gratuiteus transfers as losses rather than as "consumption." For further discussion on the deductibility of gifts, see Kornhauser, 25 Conn. L. Rev. at 29-35. Although it has never been suggested that bequests be deductible, so long as gratuitous transfers are excludable under Section 102, the deductibility issue is moot. It is necessary to disallow the deduction solely by reason of the exclusion; otherwise, the tax base, especially with respect to the well-off, would be in serious jeopardy.

Thus, the only rational basis of Section 102 is to avoid double taxation of the same item to two taxpayers. This rationale clearly does not support the "integrity of the exclusion" argument for Section 1014, because the latter goes beyond avoiding double taxation to eliminating gain from the system entirely. In fact, the Section 102 approach to the double taxation issue, which is to tax the donor rather than the donee, supports the deemed-realization solution.

2. Would Deemed Realization Produce Excessive Taxation?

Under a deemed-realization system, it is conceivable that a zero basis asset would be subject to the highest income tax rate (39.6 percent), the highest gift or estate tax rate (fifty-five percent), and the highest generation-skipping tax rate (fifty-five percent). This looks like horrendous confiscatory taxation—and then some. However, because the income tax owed would be deductible from the estate or gift tax base, and the estate or gift tax would be subtracted from the generation-skipping tax base, the rates would not be cumulative. Thus, the maximum aggregate tax rate would be 87.75 percent, whereas without the deemed-realization tax the aggregate tax rate would still be 79.75 percent. Thus, in the worst case scenario—which makes the implausible assumption of a zero basis asset[32]—the deemed-realization tax would impose an incremental tax bite of only about twelve percent.[33]

Under present law, taxpayers who realize gains before death can end up paying all three taxes. Thus, Section 1014 enables some taxpayers to avoid a tax to which other taxpayers are subject. In order to put all taxpayers on the same footing, the alternatives are: (1) a deemed-realization rule; or (2) exemption of all gains, whenever realized, from income taxation, a solution that even the most die-hard advocates of Section 1014 have refrained from advancing. Even under a deemed-realization rule, taxpayers who avoided realizing gains during life would be better off economically than those who did and paid income taxes earlier.

It is misleading to consider all three taxes together, because the implication is that adoption of a deemed-realization rule would produce some monster death tax of arbitrary and capricious applica-

32. The most common zero basis assets, qualified pension plans and Individual Retirement Accounts ("IRAs"), would be subject to a carryover basis rule. See text accompanying notes 86-91.

33. The increased tax burden could be higher if state piggy-back income taxes are taken into account, but states could deviate from federal law in this instance.

tion. The taxes, however, are separate; it is only by coincidence that all three would be imposed by reason of the same event. As noted immediately above, the income tax could just as easily be imposed earlier upon the actual realization of the gains by the decedent prior to death. Indeed, with enactment of a deemed-realization system, it would be expected that inter vivos realizations would occur much more frequently than under current law. The generation-skipping tax is imposed by reason of the transferor's death only if it is a "direct skip" type of generation-skipping transfer; this tax can be delayed by making the transfer in another form, and it can be avoided altogether by omitting the generation skipping feature. Moreover, direct-skip generation-skipping transfers are taxed at a lower rate than other generation-skipping transfers, because the generation-skipping tax base does not include the generation-skipping tax.[34] Finally, the estate and gift taxes are imposed only when cumulative taxable transfers of a person exceed six hundred thousand dollars,[35] and the generation-skipping tax is imposed only where cumulative generation-skipping transfers of a person exceed one million dollars.[36]

Last, if enactment of a deemed-realization rule results in excessive taxation, the logical solution is modification or even repeal of the federal transfer taxes.[37]

3. Death is Not a Realization Event

It is argued that there can be no income without realization, and that death is not a realization event, nor should it be treated as a realization event, because it is involuntary.[38] However, all three components of this argument beg the question.

Although "realization" once was thought to be a constitutional prerequisite for the definition of income,[39] that is no longer the case. The Supreme Court has said that the realization principle is "founded

34. See I.R.C. § 2623.

35. See I.R.C. §§ 2010, 2505 (pertaining to unified transfer tax credit). Taxable transfers are those in excess of exemptions, exclusions, offsets, and deductions, including the unlimited marital and charitable deductions.

36. I.R.C. § 2631(a).

37. See Galvin, 46 Vand. L. Rev. at 1526-28 (cited in note 1). See generally Joel C. Dobris, *A Brief for the Abolition of All Transfer Taxes*, 35 Syracuse L. Rev. 1215 (1984). Canada repealed its federal transfer taxes upon enactment of a deemed-realization-at-death system. See Richard M. Bird, *Canada's Vanishing Death Taxes*, 16 Osgoode Hall L. J. 133, 137 (1978).

38. See Byrle M. Abbin, *Taxing Appreciation Hits Everything Up Front: Retirement Benefits, Deferred Compensation, And...*, 58 Tax Notes 1659, 1660 (March 22, 1993).

39. See generally *Eisner v. Macomber*, 252 U.S. 189, 207-08 (1920).

on administrative convenience."[40] Therefore, Congress can abolish or modify it in particular instances if it so desires, and Congress has in fact done so in numerous instances.[41] Indeed, the Supreme Court has held that the gift of property subject to a liability is a realization event,[42] and it is generally settled that any disposition of mortgaged property, where another party takes over the liability, is a realization event.[43]

"Administrative convenience" refers to possible difficulties in valuation and in raising liquid cash to pay the tax liability with respect to the included, if unrealized, income. Actually, difficulty of valuation usually stems from the fact of nonliquidity; a liquid investment would have a value no less than the net amount obtainable upon liquidation.[44] A deemed-realization-at-death rule would raise these issues about once a generation, as opposed to annually, if the realization requirement were abolished across the board. In any event, the *possible* existence of nonliquidity and difficulty in valuation depends on the type of asset involved. The fact that some kinds of assets raise these problems does not support the proposition that death (or gift) can never be a realization event.[45]

Perhaps the leading norm of tax policy is the Haig-Simons definition of income, "net increases in wealth plus consumption over the taxable period,"[46] which in its pure form abjures any realization doctrine.[47] The Haig-Simons concept of income, in turn, rests on the

---

40. See *Helvering v. Horst*, 311 U.S. 112, 116 (1940). Accord *Commissioner v. Indianapolis Power & Light Co.*, 493 U.S. 203, 209 (1990).

41. See, for example, I.R.C. § 305(b) (including non-pro rata stock dividends in income); I.R.C. § 475A(2)(a) (taxing unrealized gains and losses of dealers in securities); I.R.C. § 551 (taxing undistributed foreign personal holding company income to United States shareholders); I.R.C. § 671 (taxing income of certain trusts to grantor even when not received); I.R.C. § 702(a)(1)-(3) (taxing partner on share of partnership's profits and losses); I.R.C. § 951 (including undistributed profits of certain foreign corporations in income of United States shareholders); I.R.C. § 1256 (marking certain contracts to market); I.R.C. § 1272 (including original issue discount); I.R.C. § 1366 (regarding pass-thru of profits and losses to shareholders of S corporations). The Ninth Circuit upheld the constitutionality of Section 1256 in *Murphy v. United States*, 992 F.2d 929 (9th Cir. 1993). See also Rev. Rul. 91-31, 1991-1 Cum. Bull. 19, 20 (treating reduction of debt secured by property as cancellation of debt income even where property is not transferred).

42. *Diedrich v. Commissioner*, 457 U.S. 191, 199-200 (1982).

43. See, for example, *Johnson v. Commissioner*, 495 F.2d 1079, 1084 (6th Cir. 1974) (holding that a gift of property is subject to mortgage).

44. Actual liquidation might necessitate incurring significant transaction costs, such as appraisers' and brokers' fees. Such built-in costs would reduce value.

45. For a discussion of particular categories of assets that raise valuation and liquidity problems, see text accompanying notes 135-40.

46. See Simons, *Personal Income Taxation* at 50 (cited in note 11).

47. Id. at 153 (acknowledging, however, that administrative concerns in certain circumstances dictate the realization principle).

norms of ability to pay and economic neutrality. Ability to pay is a maxim of ethics or justice that holds that persons should contribute to government according to their material means. Ability to pay is not synonymous with cash in hand, but presumptively includes all the taxpayer's economic resources. One can debate the extent to which ability to pay allows for nonliquidity, and indeed that is precisely what will be undertaken herein.

Economic neutrality posits that the tax system should not favor some investments over others. Under the income tax, investments are made generally with after-tax dollars.[48] Unrealized appreciation that escapes income tax, however, deviates from this norm; functionally, it is a nontaxed additional investment in the same property. The realization principle distorts economic choices by favoring appreciating assets over assets that produce current income, such as interest, dividends, rents, and royalties. Section 1014 goes even beyond the realization principle by wholly excluding unrealized gains held until death. Taxing unrealized gains at death would move the income tax closer to the Haig-Simons concept of income and its underlying norms. But even under the neutrality norm, some concessions can be made with respect to nonliquid assets, because such assets, once acquired, are inherently locked in by the difficulties and (nontax) costs associated with disposing of them.[49]

The argument that death does not generate any "amount realized" to the decedent proves too much, because it suggests that the decedent should obtain a loss deduction on account of the disposition of property. Although it might be said that the loss would be disallowed because it is "personal,"[50] that concept relates to the taxpayer's holding purpose or use prior to disposition. It makes more sense to ground the disallowance of the loss on: (1) the fact that the taxpayer controlled the entire wealth during the taxable period; and (2) the fact that allowing the loss would greatly erode the tax base with respect to the wealthy, especially if such losses were carried back to prior taxable years. In any event, in the death situation, it is erroneous to say that there is any loss while the taxpayer was in existence. Any loss

---

48. An investment is made with previously taxed dollars, and the investment itself is nondeductible under the capitalization principle. See I.R.C. § 263(a). See generally Calvin H. Johnson, *Soft Money Investing Under the Income Tax*, 1989 U. Ill. L. Rev. 1019 (1990).

49. Nonmarketable assets obtain a valuation discount for estate and gift tax purposes. See, for example, Rev. Rul. 59-60, 1959-1 Cum. Bull. 237 (discussing effect of restrictions on sale of assets). Such a discount might be concession enough under a deemed-realization-at-death rule.

50. See I.R.C. § 165(c).

pertains to the decedent's own human capital,[51] not the property itself, which continues in existence after death.

That death normally is considered to be involuntary is irrelevant. There is no general tax principle that involuntariness yields an exemption or other tax benefit beyond those that Congress chooses to confer.[52] Tax benefits contingent on involuntariness take the form of allowances for additional unforeseen expenditures[53] or deferral of tax on account of premature realizations.[54] An exemption for all unrealized gains bears no relation to any incremental costs incurred by the decedent or her successors; such costs, in fact, are treated separately under the tax system.[55] Similarly, the accelerated realization theory only justifies deferral, not exemption. But, unlike the situation with involuntary conversions of property,[56] taxing gains at death should not be viewed as any kind of undue acceleration of tax, because for the decedent there is no tomorrow; it is either then or never. Of course, the tax system could waive taxation of gains at death in favor of a carryover basis rule, but that raises the next issue, namely, whether the gains should be taxed to the decedent or the decedent's successor.

B. Why a Deemed-Realization Rule?

Once the repeal of Section 1014 is decided upon, it is then necessary to decide whether the carryover basis rule of Section 1015 should be extended to death-time transfers or whether both gift and death should trigger a deemed-realization rule. Tax policies support

---

51. The tax system generally ignores losses of human capital. See Joseph M. Dodge, *Taxing Human Capital Acquisition Costs—Or Why Costs of Higher Education Should Not Be Deducted or Amortized*, 54 Ohio St. L. J. 927, 959-63 (1993).

52. See *Helvering v. Hammel*, 311 U.S. 504, 510-11 (1941) (holding that restrictions on capital losses apply even where losses result from a forced sale). See also I.R.C. § 61(a)(1) (including employee fringe benefits in gross income unless specifically excluded by Code provisions).

53. See I.R.C. § 123 (providing for exclusion of insurance recoveries attributable to incremental living expenses resulting from casualty te personal residence); I.R.C. § 165(c)(3), (h) (imposing limitation on casualty loss deduction); I.R.C. § 213 (giving deduction for extraordinary medical expenses).

54. See I.R.C. § 104 (providing exclusion for personal injury recoveries, which are mostly an acceleration of income from human capital); I.R.C. § 1033 (deferring, under certain circumstances, gains on involuntary conversions); I.R.C. § 1231 (treating casualty gains as capital gains). The casualty loss deduction, I.R.C. § 165(c)(3), (h), might also be rationalized on the ground that anticipated future consumption is aborted on account of an unforeseen involuntary loss or disposition.

55. Funeral expenses paid by the estate are deductible for estate tax purposes. See I.R.C. § 2053(a)(1). Estate administration expenses are allowed for either income tax purposes, I.R.C. § 212(1)-(2), or estate tax purposes, I.R.C. § 2053(a)(2), but not both. See I.R.C. § 642(g).

56. See I.R.C. § 1033(a) (requiring the taxpayer to reinvest in "similar use" property within prescribed period of time).

the latter alternative. Those policies include: (1) the internal logic of an income tax; (2) economics; (3) ethics (fairness); and (4) distributive justice.

The internal logic of an income tax posits that the same dollars should be neither taxed to, nor deducted by, a given taxpayer more than once. Neither approach would violate this norm. A deemed-realization rule would not produce double taxation of the transferor any more than in the common situation where a taxpayer sells gain property and spends the proceeds on personal consumption. The question is whether the gain or loss should be attributed to the transferor or to the transferee. Aside from Section 1015, carryover basis rules apply when entities and owners engage in tax-free exchanges and transfers.[57] In these cases, the owners and entities are alter egos. Here, a carryover basis rule prevents gain from disappearing as it moves from one pocket to the other. Essentially the same rationale justifies Section 1015's carryover basis rule for inter vivos gifts.[58] These rationales do not apply to the death situation, because the decedent's successor no longer can collaborate with the decedent to reduce taxes on the former. Moreover, the better way to curb tax avoidance, especially with respect to gifts,[59] is to treat the gift as a realization event.[60]

As to whether the pretransfer gain or loss should be attributed to the transferor to whom it accrued or the transferee, the general thrust of the income tax in general (as opposed to a consumption tax) is to tax transferors, because they controlled the gain or loss and the gain or loss is measured with reference to the investment of the transferors.[61] The argument that the transferee is the one who enjoys the gain proves too much: it is an argument for taxing the donee on the *full* amount or value of the receipt. Moreover, a carryover basis rule would allow the shifting of losses to donees.[62] But it is nonsense to

57. See I.R.C. §§ 334(b), 362, 723, 732(a).

58. See text accompanying notes 126-29.

59. Under I.R.C. § 1015, by making an inter vivos gift, a high bracket donor can shift a gain to a low bracket donee.

60. Tax-free exchanges and transfers are tolerated in entity owner transactions so as not to inhibit the formation and liquidation of business entities. No such rationale applies to gratuitous transfers.

61. See Marjorie E. Kornhauser, *Love, Money, and the IRS: Family, Income-Sharing, and the Joint Income Tax Return*, 45 Hastings L. J. 63, 97-98 (1993) (noting basic income attribution principles, assignment of income doctrine, and grantor trust rules).

62. Section 1015 does not allow the shifting of losses for inter vivos gifts, because the donee's basis is the lower of the donor's basis or the value at the time of gift. This rule is designed to prevent a low bracket donor from shifting a loss to a high bracket donee. It is unlikely that a similar rule would be enacted for death-time transfers, since transfers of losses at death would not be tax motivated.

treat the donee as incurring any loss on the transaction as a whole, because the donee is always better off as the result of the receipt.

By "economics," I mean neoclassical economics and the concept of economic efficiency, which is usually expressed by the term "neutrality." According to optimal taxation theory, death is the ideal time to impose a disproportionately heavy tax, since the tax would affect economic choices only minimally.[63] Yet, the most neutral income tax with respect to investments would be one that abolished the realization principle entirely and with it the preference for capital gains.[64] Thus, as a general proposition, unrealized appreciation and depreciation, at least of liquid assets and perhaps of all assets, should be incorporated into the tax base annually.[65] The deemed-realization rule lies far closer to that norm than a carryover basis rule, which would allow indefinite deferral of gain. A deemed-realization rule also would be much more potent in combating the lock-in effect. Finally, adoption of a deemed-realization rule would have the salutary effect of increasing revenue that can be balanced by lower rates in general and/or the elimination of preferences for capital gains.

By "ethics," I am referring to tax fairness among individual taxpayers, commonly expressed by the (inadequate) expression "horizontal equity." The basic idea is that individual taxpayers should contribute to a government that performs redistributive and public good functions according to their respective abilities to pay. In general, "ability to pay" refers to economic resources under the taxpayer's control, whether in cash or in kind.[66] In the present context,

63. For the argument that death taxes are undesirable because they are taxes on "capital" (savings and investment), see C. Lowell Harriss, *Estate Tax Revision and Capital Needs in the 1970's*, in Gersham Goldstein, *Readings in Death and Gift Tax Reform* 51 (Foundation, 1971), is naive. The measure of the tax base does not dictate whether the amount used to pay the tax reduces consumption as opposed to investment. Moreover, although death itself destroys human capital, death taxes do not destroy assets—they only affect who owns them—nor does the government appropriate assets in-kind. Another argument is that future death taxes reduce the incentive to save. See Michael Boskin, *An Economist's Perspective on Estate Taxation*, in Edward C, Halbach, ed., *Death, Taxes, and Family Property: Essays and American Assembly Report* 56, 62-64 (West, 1977). However, insofar as savings are target- or bequest-oriented, it is more logical to presume that the prospect of future death taxes would induce a person to save more to achieve the desired after tax result.

64. See text accompanying notes 48-49.

65. See David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. Pa. L. Rev. 1111, 1113-18 (1986) (proposing accrual taxation system as a more efficient alternative to the current income tax system).

66. Ronald D. Aucutt, in arguing against any change in present income tax law, equates "ability to pay" with actual voluntary realizations. See Ronald D. Aucutt, *Further Observations on Transfer Tax Restructuring: A Practitioner's Perspective*, 42 Tax Law. 343, 347 (1989). But one can have realization without liquidity (for example, an exchange of publicly traded stock for

unrealized appreciation generally constitutes ability to pay; whether nonliquid assets should fall in this category is an issue to be considered below. Aside from the possibility of a concession to nonliquidity, the ability to pay dictates that the transferor be subject to tax on net unrealized appreciation, preferably as it accrues. A deemed-realization rule would conform to ability to pay more readily than a carryover basis rule, although even the deemed-realization rule falls short of the ideal.

By "distributive justice," I refer to the effect of tax rules on the distribution of income or wealth among various classes in society. Under the name "welfare economics," a branch of applied utilitarianism, distributive justice is given a quasi-scientific aura and (misleadingly) linked to classical economics. It is also allied with ethics, because an ability to pay tax base combined with a progressive rate structure ("vertical equity") should automatically produce distributive justice. Thus, distributive justice is rarely given independent weight in tax policy discussions, except in the context of rates, tax rules with respect to transactions associated with certain economic classes, or situations where it is hard to tell whether tax base rules accurately reflect ability to pay. In any event, a deemed-realization rule *for inter vivos gifts* clearly will have a more progressive effect than a carryover basis rule, because it is safe to assume that donors are generally wealthier than donees.

In the case of death-time transfers, the actual tax cannot be borne by the transferor, who is now dead, but can be borne only by transferees. There is no guarantee that the transferees are otherwise well-off. Thus, the distributive justice preference for a deemed-realization rule over a carryover basis rule here is somewhat indirect: one can assume that wealthy transferors tend to have well-off successors (after accessions), and that taxes on transferors generally reduce inherited wealth, which is somehow less worthy or useful than earned wealth and more in the nature of a windfall.

It might be said that the same point applies with equal respect to the ability-to-pay norm. However, in that case the tax is viewed as being imposed properly on the party who controlled the unrealized appreciation. In the context of distributive justice, what counts is the economic effect of the tax on various income groups. But this point (again) is an argument for including the full amount of gratuitous

---

nonpublicly held restricted stock) and liquidity without realization (any asset for which a ready market exists). Nor does the voluntariness of realizations have anything to do with whether the gains should be taxed, because the tax system itself (the realization rule) induces people to choose *not* to realize gains.

transfers in the income tax base of transferees, an argument that is out of bounds in the context of the present discussion.

A carryover basis rule is wholly inadequate under ability-to-pay and progressivity norms (not to mention horizontal equity) because it results in differential taxation among various transferees receiving identical amounts according to the fortuitous circumstance of differing bases attached to the various properties. This disparate basis problem is avoidable in theory by figuring out the aggregate basis of all properties transferred and then allocating the aggregate basis pro rata among the various transferees. This solution involves design and computational difficulties,[67] however, and it simply cannot be applied to inter vivos transfers.[68] More fundamentally, any basis assigned to any successor misstates the successor's investment in the property. Finally, the allocation of basis only operates among a given decedent's transferees; it does not eliminate basis disparities among all recipients of death-time transfers.

As a kind of footnote to this discussion, the well-known *Davis* case[69] is worth a brief discussion. There, a husband transferring appreciated property in connection with a divorce was taxed on the unrealized appreciation; the Internal Revenue Service conceded that the wife took the property tax free with a nonstatutory stepped-up basis.[70] This case is often thought of as a "deemed-realization" case. Unfortunately for this line of analysis, the husband probably had a zero amount realized. Although the wife surrendered inchoate support and inheritance rights in connection with the settlement, the surrender or cessation of such rights is not income or amount realized under the income tax.[71] The cancellation of debt theory does not apply here, because the husband received no asset or other economic benefit

67. Unless all bases and all asset values are known, an allocation cannot work. If some assets are subject to a carryover basis rule, see text accompanying notes 124-25, then such assets must be identifiable readily and rules must be designed to prevent tax avoidance by selecting the lowest basis assets to fund the carryover basis bequests and inheritances.

68. The bases and values of all transferred assets cannot be known until the donor's death.

69. *United States v. Davis*, 370 U.S. 65 (1962).

70. See Rev. Rul. 67-221, 1967-2 Cum. Bull. 63 (holding that transfer to wife of husband's interest in apartment building in discharge of wife's dower rights resulted in no gain or loss to wife, and basis of property was fair market value at time of transfer).

71. A wife's surrender of support, but not inheritance, rights constitutes "consideration in money or money's worth" for gift tax purposes. See, for example, *Estate of Glen v. Commissioner*, 45 T.C. 323 (1966). The reason for this result is that the support itself would not have been a gift by the husband, whereas the inheritance would have been included in the husband's gross estate. These doctrines have no relevance for income tax purposes.

in advance of the settlement.[72] Generally, income does not arise simply by reason of avoiding future expenses, even if the future expenses are imposed by law and are determinable in amount. The wife's exclusion in this case is not based directly on Section 102, but probably on the theory that the property received was a substitute for future tax-free support (or inheritance).[73] Once the settlement is excluded, then the "integrity of the exclusion" principle might justify giving the wife a stepped-up basis, notwithstanding the absence of any applicable provision of the Code or regulations. But that proposition too is doubtful, for exactly the same reasons as stated above in connection with the discussion of Sections 102 and 1014. In any event, the Supreme Court in *Davis*, faced with these government concessions, was left to decide whether the husband was taxed on the unrealized gain or whether nobody was taxed on it.[74] By taxing the husband, the Court possibly compounded error upon error.[75] More charitably, *Davis* can be viewed essentially as an income attribution case. In the divorce situation, given the fact that the wife would not be taxed on the entire value of the property received (another debatable point in the abstract),[76] the Court decided that it was better

---

72. See *Commissioner v. Rail Joint Co.*, 61 F.2d 751, 752 (2d Cir. 1932) (holding that no taxable gain resulted where corporation repurchased, below face value, bonds previously distributed as dividends). A father subject to an obligation to pay monthly amounts of child support does not have cancellation of debt income when the obligation is cancelled prematurely by the child's death, marriage, or emancipation.

73. Rev. Rul. 67-221 (cited in note 70) does not articulate its rationale. Nevertheless, there is an income tax doctrine that holds that the tax treatment of (damage) recoveries depends on what the recovery compensates. See, for example, *Raytheon Prod. Co. v. Commissioner*, 144 F.2d 110, 113-14 (1st Cir. 1944) (holding that damages recovery in question was for lost goodwill, not future profits).

74. The parties in *Davis* apparently raised the issue of whether the transaction was more like a division of property or more like a sale or exchange. Hence, the Court, after deciding that the property division analogy was inappesite, leapt to the conclusion that the transfer was like a taxable sale or exchange. See *Davis*, 370 U.S. at 69-71. The Court did not consider whether the transfer was analogeus to a gift or bequest, a support payment, or a contribution to capital.

75. The recent case of *Newark Morning Ledger v. United States*, 113 S. Ct. 1670 (1993), presented a similar choice to the Court. There the taxpayer acquired a small town newspaper and attempted to depreciate the subscriber base. The government argued unsuccessfully that the subscriber base was "goodwill," which is per se nondepreciable. The Court held that the subscriber base had a finito useful life because subscribers die, move away, or allow subscriptions to lapse. 113 S. Ct. at 1681. The better government argument would have been that subscriber lists should be treated as nondepreciable under the "mass asset" convention precisely because any costs of replacing expired customers are currently deductible under a tax accounting convention based on administrative convenience, although such replacement costs are actually capital expenditures that should not be deducted currently in theory. In other words, should the Court have sanctioned two accounting conventions, both based on administrative convenience, each of which is wrong in isolation but which combined produce an approximately correct overall result?

76. In Dodge, *The Logic of Tax* at 118-19 (cited in note 7), I argue that the disparato tax treatment of "alimony" and "child support," see I.R.C. § 71(a), (c), is not justified, because in

to tax the husband to whom the wealth accrued as opposed to having the gain completely escape tax. Implicitly, *Davis* is a precedent for a deemed-realization rule for gratuitous transfers. Otherwise, *Davis* has little precedential value or relevance.[77] In fact, it was overturned by Congress in favor of a carryover basis rule on its very facts.[78] That rule is now the subject of intense controversy.[79]

III. TECHNICAL FEATURES

This section sets forth various suggestions on how to implement a deemed-realization rule. Most of these suggestions fill in gaps left in Professor Zelenak's proposal or manifest points of disagreement with him.

A. General Considerations

Treating a gratuitous transfer as a realization event under the income tax should not be viewed, conceptually at least, as a substitute for an estate tax or other death tax. An income tax is wholly separate from a transfer tax, which is explicitly a tax on "capital," i.e., previously taxed income. A very wealthy person will avoid income tax, but not estate tax, by reason of death where the aggregate basis exceeds the aggregate value. The income tax has only to do with the annual economic attributes of individual taxpayers, nothing to do with generations, and little to do with families. In general, then, there is no a priori reason to import estate and gift tax concepts into the deemed-realization rules. At the same time, it must be considered that the burden of the deemed-realization tax, especially the one imposed by reason of death, will be borne ultimately by the decedent's

---

both cases the recipient (usually the wife) has a cash accession to wealth with no obligation to account for the funds.

77. *Davis* should be relegated to the note material of casebooks. It is hard to see that it has any precedential value whatsoever, and on its own facts it has been superseded by statute. See I.R.C. § 1041 (stating that no gain or loss results on transfer of property to former spouse if the transfer is incident to divorce). As suggested in the text, the government's concessions probably constrained the holding, but analyzing the propriety of such concessions leads the class far astray from the realization topic.

78. I.R.C. § 1041.

79. See, for example, C. Garrison Lepow, *Tax Policy for Lovers and Cynics: How Divorce Settlement Became the Last Tax Shelter in America*, 62 Notre Dame L. Rev. 32, 60 (1986) (concluding that Section 1041 fails to address an "essential problem of unfairness" in tax treatment of property transferred in a property settlement); Michael Asimow, *The Assault on Tax-Free Divorce: Carryover Basis and Assignment of Income*, 44 Tax L. Rev. 65, 66 (1988) (arguing for the superiority of the carryover basis principle of Section 1041).

successors. Also, the deemed-realization tax must be designed so that it is capable of efficient administration.

B. Life Insurance

Under present law, life insurance is tax favored in three ways: (1) the proceeds are generally excludable by the recipient under Section 101(a); (2) the "inside build-up" is not subject to tax as it is earned;[80] and (3) withdrawals are treated as coming first out of basis and last out of accrued but untaxed income.[81] Professor Zelenak's proposal only implicates directly the first: The Section 101(a) exclusion is the equivalent of giving the recipient of the proceeds a stepped-up basis. If life insurance is to be treated consistently with other assets, the gain should be subject to tax at the insured's death. Such gain should be taxed to the person who owned the policy immediately before the insured's death.

The problem here is how to compute the gain. A pure term life or accident insurance policy is nothing but a betting pool. Each premium payment is a wager that expires at the end of the policy year, and, hence, is conceptually an "expense" rather than a capital expenditure creating basis. It might be argued that the proceeds of term insurance should be tax free on the ground that all of the premiums going into the actuarial pool were nondeductible; thus, the winnings already have been taxed elsewhere in the system.[82] Under this view, Section 101(a) with regards to term insurance has a similar rationale to that of Section 102. However, Section 102 prohibits double tax of the same thing when the transfer involves related parties; the participants in the actuarial pool, in contrast, are total

80. Arguably, the inside build-up, i.e., the earnings on the savings component, should be taxed as it accrues even to cash method taxpayers by analogy to the original issue discount rules, see I.R.C. § 1272, or to the constructive receipt doctrine, see Treas. Reg. § 1.451-2(a). But see *Griffith v. Commissioner*, 35 T.C. 882 (1961) (reviewed) (holding that constructive receipt doctrine does not actually require inclusion of inside build-up). The neutrality norm dictates that similar investments should be taxed alike, preferably as the income accrues. See text accompanying note 48.

81. See I.R.C. § 72(e)(5)(A), (C).

82. Another version of the same argument is that actuarial pools (and betting pools) do not involve the creation of new wealth and, therefore, should not be taxed. See Lane, 3 Am. J. Tax Policy at 31-32 (cited in note 25). Another argument for excluding life insurance proceeds is that they compensate the beneficiaries for loss. See Goode, *The Individual Income Tax* at 126 (cited in note 28). If the loss referred to is the economic loss of support, only in some cases does a life insurance beneficiary incur the loss. The tax system generally ignores losses of human capital, see Joseph M. Dodge, *Taxes and Torts*, 77 Cornell L. Rev. 143, 152-53 (1992) (analyzing a similar argument in the context of Section 104), and in any case it cannot be said that the lost human capital was ever owned by the life insurance beneficiary. If life insurance merely makes up for a lost bequest, then Section 101(a) stands on the same footing as Section 102.

strangers. In that context, the tax treatment of the premium payors should not dictate the tax treatment of the winners who do have a clear accession to wealth. Lottery winners and gamblers cannot avoid tax by showing that the losers could not deduct their bets. Also, personal casualty insurance recoveries in excess of basis are included in gross income notwithstanding the nondeductibility of the premiums.[83] Moreover, it is possible that disallowing any deduction to the premium payers is wrong; they can be said to have incurred short-term investment losses.[84] The reason Section 102 taxes the transferor rather than the transferee, i.e., to protect the integrity of progressive rate structure, is not applicable where strangers are involved. Thus, the excess of the proceeds over the current year's premium is gain that should be taxed to the policy owner.

A conventional ordinary life insurance policy has a savings component (reserve values) in addition to the actuarial pool component (term insurance). In theory, the owner's policy basis should be determined by only the premiums allocable to the savings component from year to year. In practice, however, it is hard to separate out the two components. The policy reserve typically will support term insurance coverage for a period even after premiums cease.[85] Retroactively allocating premiums between the savings component and the actuarial pool component may be too difficult.

Treating all premiums as capital expenditures under a deemed-realization rule is a rough solution. Such a rule favors ordinary life insurance by overstating basis. But it is less favorable than allowing current deductions for pure insurance premiums. And it is easy to administer.

---

83. Compare with I.R.C. § 165(h) (stating that personal casualty gains should be netted against personal casualty losses). The gain may be deferred under Section 1033 if certain conditions are met.

84. It might be argued that allowing a deduction for term insurance premiums would suggest allowing deductions for personal casualty insurance premiums. See generally Louis Kaplow, *The Income Tax as Insurance: The Casualty Loss and Medical Expense Deductions and the Exclusion of Medical Insurance Premiums*, 79 Cal. L. Rev. 1485 (1991). However, the two situations are distinguishable. The loss that life insurance protects against is the loss of human capital by reason of death. Human capital, however, has no basis. Because human capital is ignored for tax purposes, see generally Joseph M. Dodge, 54 Ohio St. Law J. 927 (cited in note 51), life insurance transactions are self-contained investments. Personal casualty insurance, on the other hand, relates to losses on assets that possess tax attributes, including basis. Thus, a casualty insurance recovery is offset against the basis of the lost or destroyed property, producing gain or loss or reducing basis. The premiums are analogous to nondeductible repairs on personal consumption property. Treating them as capital expenditures would be impractical (except for car and home insurance), because the policy likely covers several assets. Premiums on life insurance, in contrast, are not analogous to repairs; they are simply bets.

85. See D. M. McGill, *Life Insurance* 315-25 (R. D. Irwin, 1967).

C. Employee Death Benefits, Annuities, IRAs, and IRD Items

Under current law, employee death benefits, annuities, and Individual Retirement Accounts ("IRAs") are categorized as income in respect of a decedent ("IRD") and do not receive a value at death basis under Section 1014.[86] Instead, the decedent's basis carries over to the beneficiary, who is taxed as payments are received[87] with basis offsets (if any) calculated under the Section 72 annuity rules.[88] Professor Zelenak favors retention of existing law in this area (which is essentially a carryover basis approach) in lieu of a deemed-realization rule.

I agree with this conclusion as far as employee death benefits (and other deferred compensation) are concerned, but mainly on the ground that these items (as well as most other IRD items) have a zero or low basis,[89] so that the beneficiary would usually be taxed on the full amounts received. Thus, the issue here is essentially that of the simple attribution of income from services. Unlike conventional investments under a carryover basis rule, here there would be no basis allocation problem. Given a system where employees are not taxed on compensation and related benefits as they accrue, it is better to attribute this income to the beneficiary, who receives the payments by reason of death, rather than the employee who is dead and who never enjoyed the income. A carryover basis rule for employee death benefits would continue to treat such benefits as income from human capital, as opposed to income from investments.[90]

---

86. I.R.C. § 1014(c).

87. I.R.C. § 691(a), (d).

88. See I.R.C. § 72(b) (excluding from gross income certain payments received as an annuity); I.R.C. § 402(a) (applying Section 72 annuity rules to qualified plans); I.R.C. § 402(b) (applying Section 72 annuity rules to nonqualified plans); I.R.C. § 408(d)(1) (applying Section 72 annuity rules to IRA distributions).

89. The decedent would have a zero or low basis in the case of qualified plans and IRAs because contributions to such plans generally are deductible or excludable. Unfunded nonqualified plans have a zero basis because nothing has been included in income. See Treas. Reg. § 1.83-3(e); Rev. Rul. 60-31, 1960-1 Cum. Bull. 174, modified by Rev. Rul. 70-435, 1970-2 Cum. Bull. 100. Funded nonqualified plans would have a significant basis if they were included earlier in the employee's gross income under Section 83(a) on account of such rights being vested, but this situation is relatively rare. See, for example, Priv. Ltr. Rul. 8113107 (concluding that funded nonqualified plan is not included under Section 83 where creditors of employer can reach the plan).

90. Income from human capital is taxed as received in the form of wages or deferred compensation, with no basis recovery with respect to human capital acquisition costs such as education. Investments are made with after tax dollars: the nondeductible capital expenditures produce a basis that is recovered through depreciation and loss deductions. If rights to employee death benefits and deferred compensation were taxed at death, they would henceforth be taxed as investments. See generally Mary L. Heen, *An Alternative Approach to the Taxation of Employment Discrimination Recoveries Under Federal Civil Rights Statutes: Income From Human Capital, Realization and Nonrecognition*, 72 N.C. L. Rev. 549 (1994).

Commercial annuities, which have a substantial basis, should be subject to the deemed-realization rule; they are easy to value and are otherwise indistinguishable from life insurance.

The IRD items that have a zero basis should be treated in the same manner as employee death benefits,[91] whereas IRD items with a substantial basis (such as installment obligations) should be subject to the deemed-realization rule.

D. Inter Vivos Trusts

In the case of inter vivos trusts, the deemed-realization rule should be keyed to the grantor trust rules[92] rather than the estate and gift tax rules on completed transfers.[93] Thus, a transfer to a trust the income (or gains) of which, to any extent, would be taxed to the grantor should not be a deemed-realization event. In such case, the deemed-realization event would be the earlier of death or loss of "grantor trust" status. A transfer to a nongrantor trust would be a deemed-realization event.

E. Co-ownership Property

One of the more outrageous features of present law is that the surviving spouse's share of community property, as well as the decedent's share, receives a Section 1014 basis.[94] Otherwise, the benefits of Section 1014 accrue to only that fraction of the property included in the gross estate of the decedent.[95]

Under the deemed-realization rule, however, gain or loss would be recognized only with respect to the undivided fractional interest owned by the decedent.

In the case of survivorship property, where ownership is not subject to undivided interests, the two alternatives are: (1) to treat the property as if it were tenancy in common property; or (2) to treat the entire property as being owned by each decedent in turn. The

---

91. Individual Retirement Accounts are like do-it-yourself deferred compensation plans; the annual IRA deduction (which cannot create any basis) for contributions te an IRA cannot exceed the lesser of $2,000 or compensation income. I.R.C. § 219(b). Nondeductible contributions can be made to an IRA under I.R.C. § 408(o); such contributions create basis.

92. I.R.C. §§ 671-677.

93. I.R.C. §§ 2036-2038, 2511-2512.

94. See I.R.C. § 1014(b)(6). This rule is based on the assumption that husbands earn 100% of the wealth and die before their wives; in a separate property jurisdiction, wives would obtain a Section 1014 basis for all of the marital assets only in cases where these assumptions hold true.

95. See Treas. Reg. § 1.1014-2(b)(2).

first alternative would present a tempting opportunity for partially deferring the deemed-realization tax. However, Congress might prefer to sanction such deferral in cases where the joint tenants are husband and wife.[96] Otherwise, the second alternative should prevail.[97]

F. Successive Interests

It would appear that the deemed-realization tax can be avoided after the initial taxable transfer into trust upon the death of successive trust beneficiaries. However, unlike Professor Zelenak,[98] I do not view this as being a problem, because the income tax—including any of its deemed-realization aspects—is not based on the idea of generations. For better or worse, the trust is a taxable entity separate from the beneficiaries. Moreover, unlike present law,[99] unrealized gain in trusts would not be able to avoid tax permanently. If tax deferral through trusts is considered a significant problem, there is no reason why any deemed taxable event must be keyed to the death of a beneficiary or the passing of generations of beneficiaries. In other words, the taxable event could be deemed to be the last day of the year in which, say, the tenth, twentieth, etc., anniversary of the birth of the trust occurred.

Should trust distributions in-kind be treated as deemed-realization events?[100] Such a rule would be preferable to a carryover basis rule, because the latter would allow the trustee, if authorized by the will or state law, to target high basis assets to high income beneficiaries, and so on, and possibly create problems under fiduciary law by reason of favoring some beneficiaries over others. A deemed-realization rule simply would treat the distribution as a sale followed by a distribution at fair market value; the burden of the taxes payable by the trust would be felt pro rata by all remaining beneficiaries.

---

96. Compare with I.R.C. § 2040(b) (stating that first spouse to die is deemed to own half for estate tax and Section 1014 purposes).

97. Compare with I.R.C. § 2040(a) (providing rebuttable presumption that the first decedent is the "transferor" of the entire property where joint tenants are not husband and wife).

98. See Zelenak, 46 Vand. L. Rev. at 410-13 (cited in note 1).

99. Under present law, assets in trust obtain a Section 1014 basis in any case where any person includes the trust in a gross estate, probably by way of a general power of appointment, see I.R.C. § 2041(a)(2), whether or not any estate tax is due. Trust assets also obtain a Section 1014 basis to the extent that the trust is subject to the generation-skipping tax by reason of a taxable termination type of generation-skipping transfer. See I.R.C. § 2654(a)(2).

100. Current law treats a trust or estate distribution as a nontaxable event with carryover basis, but allows the trustee or estate representative to elect to realize gain or loss. See I.R.C. § 643(e).

An estate distribution could be treated according to the existing rules,[101] except where the estate resembles a trust, i.e., continues past five years or so.

In a nontrust situation where a legal life estate or term interest is followed by a remainder, there is no separation of legal and equitable ownership. In this situation, the holder of the life estate or term interest, who received the benefit of any depreciation and depletion deductions,[102] should be treated as the owner of the property and be subject to the deemed-realization rule upon expiration of the interest.

G. Transfer Tax Deduction for Income Taxes

I agree with Professor Zelenak that the income tax paid or due should reduce the tax bases under the gift, estate, and generation-skipping taxes, just as would taxes paid on predeath realizations.

H. Burden of the Tax

In the case of gifts, deemed-realization tax would be paid by the donor. In the case of death, the tax would be paid by the decedent's estate to the economic detriment of the decedent's successors. The main issue here is whether the tax should be borne by the decedent's successors: (1) in proportion to the gain allocable to the assets received by each; (2) in proportion to the value of the property received by each; (3) by the residue (or intestate takers); or (4) according to the decedent's will (or in default thereof under state law). If the gains had been realized before death, the taxes would have been borne by the residuary takers (or heirs) in accordance with alternative (3). However, a federal rule so mandating would create an additional but unnecessary layer of probate law. Alternative (4) is the simplest solution, and in many cases would produce the same results as alternative (3). However, states would have to decide whether to treat deemed-realization taxes as "death taxes" or "estate debts," since the allocation rules may differ between the two.[103]

---

101. See note 100.

102. See I.R.C. §§ 167(d), 611(b) (stating that life tenants receive the benefit of any depreciation and depletion deductions).

103. Estate debts typically are charged first against residuary assets (or if there is no residuary clause, against assets passing by intestacy). See William M. McGovern, Jr., Sheldon F. Kurtz, and Jan Ellen Rein, *Wills, Trusts, and Estates* § 10.2 at 407 (West, 1988). Death taxes may be charged in the same fashion, but the trend appears to be to charge them against all estate transfers on a pro rata basis. See id. § 10.3 at 412-13.

I. Character

The main purpose of the tax preference for long-term capital gains is to mitigate the lock-in effect produced by the realization principle and Section 1014. These rationales dissolve under a deemed-realization rule. Death is the ultimate involuntary event; at this point tax incentives can have no effect. Therefore, gains deemed realized at death should be capital only to the extent of current capital losses plus unused capital loss carryovers, and the rest should be treated as ordinary gains.

Gains deemed realized through inter vivos gifts arguably might be treated as capital since they are associated with a voluntary event. Although this rule would create some incentive to make gifts of appreciated property prior to death, the taxpayer always could have sold the property prior to death (and perhaps have given the gross proceeds to a donee). In any event, gains deemed realized within three years of death could be treated as having the same character as such gains deemed realized at death. The best solution is to eliminate the capital gains preference entirely.

Currently, capital losses for a year (including carryovers to the year) can be deducted only to the extent of capital gains for the year plus three thousand dollars, with any excess being carried forward.[104] This rule prevents the taxpayer from selectively realizing losses to produce the tax base while failing to realize gain from appreciated assets. This rationale would continue to apply in the case of deemed-realization gifts but not to losses deemed realized at death, which should be ordinary.

J. Excess Losses

Under current law, unused capital losses (and business net operating losses) disappear at death and do not pass to the decedent's estate or successors. Perhaps such losses could have been used in whole or in part if the decedent had realized all available capital gains prior to death. In contrast, unused capital losses (and net operating losses) of an estate pass to the estate's distributees.[105] The issue under a deemed-realization rule is what should happen to deemed-realization losses in excess of deemed-realization gains in the year of death. Such excess losses should be applied first against ordinary

---

104. I.R.C. § 1211(a).
105. I.R.C. § 642(h).

income in the year of death, with any remaining excess carried back first to offset any net capital gains over the three years prior to the year of death, and then to offset ordinary income in such years.[106] Due to the statute of limitations, it is not feasible to carry any remaining excess losses back further than three years. However, to the extent that the losses, if realized in earlier years, would have produced a tax benefit in those years, the ultimate beneficiaries of such tax savings would have been the decedent's residuary legatees (or heirs).[107] Because the burden of estate income taxes ultimately is borne by the same residuary legatees (or heirs),[108] it is not illogical to allow unused excess deemed-realization net losses to be carried over to the estate and perhaps to the residuary legatees (or heirs), notwithstanding the general principal that losses are to be deducted only by those incurring them.[109] The government might object on the ground that estates are subject to the highest marginal rates (39.6 percent) after only $7,500 of taxable income, compared to $250,000 of taxable income for other taxpayers, but the compressed rate schedule for estates itself makes no sense, at least for the first two or three years, because estates are not created to avoid income tax.

As an alternative to carrying the losses over to the estate, the decedent's final return could receive a refundable tax credit equal to some arbitrary percentage (say, twenty percent, but no more than twenty-eight percent) of the amount of any unused excess losses. However, any scheme allowing tax benefits for any excess losses remaining after all carrybacks and carryforwards are exhausted should be designed to safeguard against the possibility that such losses might never have produced any tax benefits to the decedent.[110]

---

106. Professor Zelenak would follow a slightly different order of utilization. See Zelenak, 46 Vand. L. Rev. at 435 (cited in note 1).

107. Under the law of wills, the residuary legatees (or the intestate heirs if there is no residuary bequest) receive the estate's net wealth after satisfaction of specific property and fixed monetary bequests. See McGovern, et al., *Wills, Trusts, and Estates* § 10.2 at 407-08 (cited in note 103). Thus, such persons enjoy the benefits, and bear the burden, of changes in the decedent's general net worth.

108. Income taxes can be charged in part against estate income and in part against principal. See Uniform Principal and Income Act, § 13(a)(6), (c)(4), 7B U.L.A. 145 (1985). But the residuary legatees (or heirs) receive all of the estate income, except income on fixed property bequests, and all principal in excess of specific property and fixed monetary bequests (and after claims, etc.). Fixed monetary legatees receive no estate income.

109. There is precedent for economic losses accrued by one taxpayer being deducted by another in Internal Revenue Code Section 691(b), dealing with "deduction[s] . . . in respect of a decedent," although that section only refers to certain expenses and not losses. I.R.C. § 691(b). In general, it is more plausible te view the estate as being a continuation of the decedent than to view the legatees and heirs as being continuations of the estate, as under present law.

110. It is conceivable that a taxpayer could have negative lifetime income. An example would be where an infant inherited high value property that decreased in value and generated a

Any unused capital loss carryforwards remaining in the decedent's final year should be given similar treatment.

K. Marital Exemption

There appears to be some consensus that the deemed-realization rule should yield to a carryover basis rule in the case of transfers between spouses.[111] I am not sure that the consensus is justified. There is also a certain irony in opponents of the taxation of gains at death taking this tack, since the same spousal unity argument would seem to compel a carryover basis exception even under the current stepped-up basis regime.[112]

It is true that transfers between spouses are not subject to gift, estate, or generation-skipping tax.[113] However, the transfer taxes are different from the income tax, so the argument by analogy is not convincing, especially insofar as the reason for not taxing interspousal transfers is that husband and wife are viewed as being in the same generation,[114] whereas the generational concept is irrelevant under the income tax.

Within the income tax, husband and wife can be treated plausibly as a single taxable unit only so long as both are alive. Actually, the joint return system does not treat them as a single unit as much as it treats them as separate taxpayers each owning half of the aggregate taxable income. Nevertheless, the income splitting function of

---

loss before the infant acquired any income of her own. Here the negative taxable income would not have produced any refund. To avoid the possibility that losses could generate an unjustified refund, the refund could be limited to a maximum of the number of years the decedent lived past the age of 25 (the assumption being that the taxpayer would have minimal income of her own before that age) multiplied by 50% of the average taxable income (disregarding loss carrybacks) for the decedent's 3 years prior to the year of death (as a proxy of assumed average lifetime tax rate).

111. See Zelenak, 46 Vand. L. Rev. at 395 (cited in note 1); Kurtz and Surrey, 70 Colum. L. Rev. at 1385 (cited in note 1) (referring to 1969 Treasury Department tax reform proposal).

112. See Harry L. Gutman, *Reforming Federal Wealth Transfer Taxes after ERTA*, 69 Va. L. Rev. 1183, 1235-36 (1983).

113. See I.R.C. § 2056 (regarding an estate tax marital deduction); I.R.C. § 2523 (regarding a gift tax marital deduction); I.R.C. § 2651(c)(1) (providing that spouse of transferor is a nonskip porson).

114. The transfer tax system as a whole can be viewed as attempting to tax transfers from generation to generation. See I.R.C. § 2013 (providing estate tax credit for estate tax on prior decedent who died within ten years of current decedent); I.R.C. §§ 2056, 2523 (providing estate and gift tax marital deduction); I.R.C. §§ 2601-2663 (imposing tax on generation-skipping transfers). As a matter of positive law, nonmarital same-generation transfers are subject to estate and gift, but not generation-skipping, tax. Such transfers, however, are probably relatively insignificant in the total wealth transfer context.

the joint return election ceases to have any conceptual relevance at death.[115]

Section 1041, enacted to overrule the *Davis* case, disregards transfers between husbands and wives for tax purposes. The government supported enactment of Section 1041 because it was too hard to enforce the *Davis* rule in the context of divorcing spouses.[116] Section 1041 has been criticized on the merits, because: (1) the tax result to the transferee spouse depends on the fortuitous circumstance of the transferor's basis; and (2) the transferor should have been taxed on gain that accrued while the transferor controlled the property.[117] These arguments echo those favoring a preference for a deemed-realization rule over a carryover basis rule in the case of gratuitous transfers. In the case of interspousal death-time transfers, enforcement would not be a problem, since the Internal Revenue Service would be aware of the death of a decedent[118] and could require production of information on assets the decedent held at death.

However one views Section 1041 on the merits, there is actually no compelling reason why it cannot be retained for inter vivos transfers between spouses.[119] It is true that a carryover basis rule for gifts combined with a deemed-realization rule at death could induce tax motivated gifts of low basis property. But the making of gifts entails sufficient nontax costs and detriments such that massive erosion of the tax would not occur.[120]

If a spousal exemption at death were nevertheless adopted on sentimental or political grounds, steps can be taken to make it easy to administer and to reduce its tax avoidance potential. In general, the exemption should not be linked to the artificial estate tax rules involving the marital deduction; instead, the exemption should be available only where the item in question passes unequivocally to the surviving spouse alone.[121] This basic principle not only will insure that the

---

115. The word "conceptual" is used to recognize the fact that, as a matter of positive tax law, the surviving spouse can file under the joint return rate schedule. I.R.C. §§ 1(a) and 2(a). This privilege, however, lasts for only two years following the year of death; it does not last until the death or remarriage of the surviving spouse. Id.

116. It is said that husbands were not reporting gain, whereas wives did not neglect to claim a stepped-up basis. Also, there were the issues of just what transfers were subject to *Davis* (divisions of community property were not) and the larger one of the lack of geographical uniformity. See Jt. Comm. on Taxation, General Explanation of The Revenue Provisions of the Deficit Reduction Act of 1984, 98th Cong., 2d Sess. 710-11 (1984).

117. See note 61.

118. The taxable year of the decedent ends at the moment of death. See I.R.C. § 443(a)(2).

119. See note 116.

120. See note 27 and accompanying text.

121. By far the most popular form of marital deduction transfer appears to be the qualified terminable interest property ("QTIP") trust, which was made possible by the 1981 addition of

exemption inures solely to the surviving spouse, but also will: (1) reduce uncertainty as to the amount of the deemed-realization tax (which would operate as a deduction against the estate tax base); (2) be easy to administer; and (3) limit the ability of the estate's personal representative to manipulate the system by selecting low basis property to fund marital transfers.

Thus, all transfers into a marital trust should be subject to the deemed-realization rule, because the surviving spouse will bear only indirectly the burden of any tax borne by the trust,[122] as will the other beneficiaries, just as would be the case with a nonmarital trust of which the surviving spouse is a beneficiary. For nontrust transfers, the marital exemption should be allowed only for: (1) bequests of specific property (such as tangibles, automobiles, and the personal residence) solely to the surviving spouse; (2) residual bequests (or inheritances) where the surviving spouse is the sole residual legatee (or heir);[123] and (3) nonprobate transfers exclusively to the surviving spouse. Although these rules would not cover the situation where a residual bequest or inheritance passes to one or more parties in addition to the surviving spouse, any burden of the deemed realization rule in such a situation would be shared with the other parties.

L. Exemption for Small and Moderate Estates

Contrary to received wisdom,[124] I see no persuasive justification for any small estate exemption to the deemed-realization-at-death rule. Certainly, to confer an income tax exemption keyed to the six hundred thousand dollars estate and gift tax exemption makes a

---

I.R.C. § 2056(b)(7). See Chris J. Prestophina, *Strategies Recommended by Experienced Estate Planners*, 133 Trusts & Estates 50 (Jan. 1994). The QTIP trust qualifies for the marital deduction even though the surviving spouse (usually the wife) has only a right to income and no right to consume or control the corpus. While under prior law the surviving spouse had the right to control the corpus, the QTIP rules have the overall social effect of increasing the economic control of decedent spouses relative to the surviving spouses. Compare I.R.C. § 2056(b)(5) (requiring transferee spouse to possess general power of appointment over corpus). By providing an income tax incentive to leave property outright to the surviving spouse, the proposed income tax rules would have the opposite effect.

122. The surviving spouse would have only the right to the income from such trust. I.R.C. § 2056(b)(5)-(8).

123. For example, if X bequeaths her residue to her husband and son in equal shares, the husband and son will presumptively become co-owners of each asset in the residue. Although the assets eventually may be partitioned or allocated between the husband and son on a noncoownership basis, this result cannot be assured at the time of X's death. Even if X's will mandates a partition or allocation, it cannot be determined as of X's death which assets the husband and son will receive.

124. See Galvin, 46 Vand. L. Rev. at 1529-30 (cited in note 1) (explaining his support for a basis exemption).

mockery of the income tax and its underlying aims and policies. No one has ever suggested that low income taxpayers should not pay tax on realized gains or any other discrete category of income. The exemption idea treats the deemed-realization proposal as if it were merely an incremental estate tax. Again, the two taxes are unrelated.

It is said that valuation in the case of small estates is not worth the effort, especially because no valuation would be required for estate tax purposes. This argument is disingenuous, because a valuation is required even in small estates under current law to establish a Section 1014 basis. In any event, valuation difficulties are a function of the assets involved, not the size of the estate in question. Assets such as life insurance, employee death benefits, annuities, liquidated claims, and most IRD items are both easy to value and highly liquid, as are debt obligations and any asset traded on an exchange. (Some of these items would be subject to a carryover basis rule.) Basis is also easy to compute in these cases, because the relevant information is in the hands of third parties, such as brokers. Hard to value items are such because of nonliquidity. Nonliquidity raises special problems that are considered separately below. Also, a narrowly drawn marital exemption along the lines suggested above can be utilized so as to postpone valuation of nonliquid assets, including such borderline items as art works and collectibles.

A small estate exemption actually would create more administrative problems than it would avoid. First, it would have to be decided whether the exemption was to be applied against value, gain, or basis. Then, the estate would be required to decide what assets, etc., were used up against the exemption. Antiabuse rules would have to be designed to prevent selective manipulation of the exemption rules.[125]

M. Gift Exclusions

Admittedly, it would be harder for the Internal Revenue Service to enforce a deemed-realization rule in the case of inter vivos gifts. However, there is no reason to create any unnecessary exemptions for gifts, and the current gift tax exemption rules should not be adopted as a model.[126] First, nonmarital gifts in excess of ten thou-

---

125. Professor Zelenak devotes eight pages to elaborate upon these issues. Zelenak, 46 Vand. L. Rev. at 416-24.

126. I.R.C. Section 2503(b) exempts from gift tax gifts up to $10,000 per donee per year per donor. Robert B. Smith thoroughly criticizes this provision in *Should We Give Away the Annual Exclusion?*, 1 Fla. Tax Rev. 361, ___ (1993). See also Jeffrey G. Sherman, *'Tis a Gift To Be*

sand dollars per donee per year must be reported on a gift tax return,[127] and a schedule could be designed to alert the donor and the Service of any income tax gain or loss. Second, any gift of property in registered form creates a paper trail in the hands of third parties who could be required to file information returns.[128] Third, any transfer to a nongrantor trust creates a new taxable entity that could be required to file an information return. The same is also true of any transfers to charity.[129] Any exemption, therefore, would be limited to relatively small value transfers of nonregistered tangible personal property outright and not in trust.

N. Gifts v. Support

Gifts, which would be subject to the deemed-realization rule, are analytically distinct from support. Thus, the question arises whether this distinction presents a problem for the deemed-realization proposal, and the answer is "no." In-kind support, rather than gifts, can tolerate the "shared consumption" characterization. Basically, the provision of lodging, food, clothing, and transportation is ignored for income tax purposes, although collateral income tax consequences flow from the provision or receipt of support.[130] Other categories of support, such as health care and education, typically involve cash payments. The actual transfer of the ownership of property can be considered support only in the case of consumption items, such as cars, audio and video systems, boats, personal computers, and so on, which depreciate in value after purchase. Any deemed loss on these items would be nondeductible anyway. Transfers of appreciating tangible personal property, such as art works and collectibles, should be treated as gifts and not support. In sum, the gifts of any appreciated property should be per se subject to the deemed-realization-at-gift rule.

Property transfers to or for the benefit of an ex-spouse in connection with a divorce are currently nonrecognition, carryover basis,

---

Simple: The Need for a New Definition of "Future Interest" for Gift Tax Purposes, 55 U. Cin. L. Rev. 585, 664-75 (1987) (criticizing the availability of the annual gift tax exclusion).

127. I.R.C. § 6019.

128. Compare with I.R.C. §§ 6041-6050P (imposing existing information return requirements on nontaxpayers).

129. In general, I agree with Professor Zelenak that gifts in-kind to charity should track the existing charitable deduction rules of I.R.C. Section 170(e). See Zelenak, 46 Vand. L. Rev. at 401-03 (cited in note 1).

130. See I.R.C. § 63(c)(5) (providing for partial loss of standard deduction for person claimed as a dependent); I.R.C. § 151(c) (providing dependency exemptions for support providers); I.R.C. § 151(d)(2) (regarding loss by dependent of personal exemption).

events under Section 1041. This provision does not, however, apply to transfers to or for the benefit of minor children incident to a divorce, which presumably are governed by the Section 1015 basis rules. The considerations that lead me to prefer a deemed-realization approach over a carryover basis approach apply in the divorce context as well as in the gift context.[131] Admittedly, residents of community property jurisdictions would be relatively unimpacted by this rule,[132] but the problem there lies in following community property law for income tax purposes.[133] These matters are controversial.[134] In any event, it would do no great violence to the deemed-realization proposal to carve out an exception to it for divorce-related transfers.

O. Nonliquid Assets

If transfers of nonliquid assets were to trigger gain, the transferor may in certain cases be unable to come up with the cash to pay the tax, although this concern is probably somewhat exaggerated, because other cash or liquid assets may be available and any gift transfer of this type can be delayed until the taxpayer achieves liquidity. A collateral concern is the difficulty of valuation that often accompanies nonliquid assets. These problems perhaps might be avoided by artificial rules that, for example, result in the valuation of an interest in a closely held enterprise at its pro rata liquidation value.[135] At the same time, it also must be acknowledged that farm and closely held business interests probably could block enactment of a deemed-realization proposal if their interests are threatened too

131. At the same time, I am also of the opinion that all amounts transferred in connection with a divorce should be deducted by the transferor and included in the transferee's income. See note 75. See also *International Freighting Corp. v. Commissioner*, 135 F.2d 310 (2d Cir. 1943), confirmed by Treas. Reg. § 1.83-6(a)-(b), holding that an employer paying an employee in-kind receives a deduction for the full value of the property but realizes gain or loss on the transfer.

132. See Rev. Rul. 76-83, 1976-1 Cum. Bull. 213 (recognizing gain or loss in a divorce settlement division of community property).

133. See *Poe v. Seaborn*, 282 U.S. 101, 118 (1930) (holding that for income tax purposes community property income may be split fifty-fifty between husband and wife).

134. See, for example, Pamela B. Gann, *Abandoning Marital Status as a Factor in Allocating Income Tax Burdens*, 59 Tex. L. Rev. 1, 52-65 (1980) (critiquing *Poe v. Seaborn*).

135. I.R.C. Sections 2701, 2703, and 2704, were added to the estate and gift tax in 1991 to combat estate freezes and certain other devices that cause value to disappear. These provisions did not, however, abolish discounts pertaining to minority interests, blockage, lack of marketability, inability to liquidate, and so on. See Treas. Reg. § 25.2701-3(b)(4). If the estate and gift tax valuation rules pertaining to closely held business interests and farms were more satisfactory, one might favor carrying them over to the income tax arena. However, they are not, and the estate and gift tax rules would not apply in many instances where the income tax deemed-realization rule would apply.

seriously.[136] Although it is distasteful for an academic to acknowledge political influence, especially where the underlying policy claims are dubious,[137] it would be frivolous to float a proposal that has no chance of success.

Accordingly—and only if necessary to enact the deemed-realization proposal—a carryover basis exception could be allowed for hard to value nonliquid interests in closely held businesses and farms,[138] but not for real estate in general, art works, collectibles, and other items for which a market exists.

Although legal tax academics generally abhor exceptions to general tax rules, in this case the exception would not be as undesirable as most tax expenditure provisions, because nonliquid interests in closely held enterprises are typically the creation of entrepreneurship and are not normally purchased in the same manner as conventional (and more passive) investments. In other words, such interests are not meaningfully substitutable with other property and investments.[139] Therefore, the availability of the exception likely will not lead to overallocation of resources to closely held enterprises, and, for the same reason, the exception will not be overly exploited for the

---

136. Farm and small business interests successfully lobbied for the enactment of I.R.C. Section 2032A, which values farm real estate at its going concern, rather than highest and best use, value for estate tax purposes. They also obtained repeal of former I.R.C. Section 2036(c), although they had to settle for Chapter 14 (I.R.C. §§ 2701-2704) in its stead. See also I.R.C. §§ 303, 6166 (applying special rules te mitigate liquidity concerns where closely held business interests comprise a substantial portion of the net estate). One reason for increasing the gift and estate tax credit, I.R.C. §§ 2010, 2505, from $47,000 in 1981 to $192,800 in 1987 (a credit of $192,800 exempts taxable transfers cumulating $600,000 from any estate or gift tax) was to provide relief for farms, ranches, and small businesses. Similar concerns motivated the reduction of the highest marginal rate from 70% to (what was then expected to be) 50%. See Tax Incentive Act of 1981, H.R. Rep. No. 97-201, 97th Cong., 1st Sess. 154, 156 (1981) (stating reasons for increasing the gift and estate tax credit). For a commentary on the politics of the 1981 estate and gift tax changes, see Michael Kinsley, *High on the Hog, III: Triumph of the Will*, New Republic 17-21 (Aug. 22 and 29, 1981). See also Willard H. Pedrick, *Oh, To Die Down Under! Abolition of Death and Gift Duties in Australia*, 35 Tax Law. 113, 114-17 (1981) (discussing the death duty abolition movement in Australia).

137. The interest of farm and small business owners vis-à-vis death taxes is to be able to convey their interests te their successors (children) intact. However, there is no reason to believe that family members are better managers of business property than willing buyers in the market. Death taxes might force such assets onto the market where they will be subject to highest and best use. See generally Ronald Hjorth, *Special Estate Tax Valuation of Farmland and the Emergence of a Landholding Elite Class*, 53 Wash. L. Rev. 609 (1978).

138. Such an interest would be one that either is not traded on an exchange or over the counter, or is subject to restrictions that render the interest nonmarketable in ordinary commerce. Closely held investment entities would be subject to a look-through rule.

139. It would be folly for a family outsider to purchase a minority equity interest in a closely held entorprise, since the outsider would be at the mercy of the controlling interests, except perhaps in the case of a general partnership interest.

sake of tax avoidance.[140] Also, because the number of carryover basis assets in any given estate will be few—perhaps only one—any basis allocation problems will be minimal.

P. The Decedent's Personal Residence

If the personal residence passes exclusively to the surviving spouse, it would qualify for the narrow marital carryover basis exception discussed earlier. Farm residences would fall within a separate carryover basis exception. Otherwise, there is no persuasive policy reason to carve out an exemption to personal residences as such.

Q. Transition

I basically agree with Professor Zelenak's discussion of the transition problem.[141] I too would oppose any grandfathering, but if any transitional relief is provided, it should not be so complex that it provides an excuse for repeal.[142]

IV. CONCLUSION

I strongly agree with Professor Zelenak's basic position that death and gift generally should be treated as deemed-realization events, although my reasons for doing so may differ, or supplement, his. At the design level, I oppose importing estate and gift tax features into the deemed-realization income tax system. In particular, I oppose any small estate exemption, and any marital exemption should be drawn as narrowly as possible so as to benefit exclusively the surviving spouse and not be a vehicle for tax avoidance. Proposals are made for accommodating various nonprobate dispositions to the deemed-realization rule. On the other side, I would allow a carryover

140. On estate tax returns filed in 1990, aggregate gross estates totalled $87.1 billion. Of this total, closely held stock totalled $7.1 billion, limited partnership interests totalled $0.8 billion, and farm assets totalled $0.2 billion. (It is not clear what is meant by "closely held stock.") Noncorporate business interests, presumably including general partnership interests, totalled $2.5 billion. Internal Revenue Service, U.S. Dept. of Treasury, Vol. 11, No. 3, *Statistics of Income Bulletin* 67-68 (Vol. 11, No. 3, Winter 1991-92). Thus, it appears that carryover basis assets would account for about 10% of total assets.

141. See Zelenak, 46 Vand. L. Rev. at 375-95 (cited in note 1) (discussing options for transition relief).

142. One of the reasons Congress repealed carryover basis, see note 6, was the complexity of grandfather rules and various basis adjustments. See, for example, Richard B. Covey and Dan T. Hastings, *Cleaning Up Carryover Basis*, 31 Tax Law. 615, 621-22, 641-57 (1978).

basis rule for deferred income from the decedent's human capital. Also, I propose a very liberal scheme for allowing deductions for excess losses, and also am willing to carve out a narrow carryover basis exception for hard to value nonliquid assets connected with the decedent's (and successor's) livelihood. Whether my (or any other) proposal for abolishing tax-free stepped-up basis at death is politically feasible will have to await future events.