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Taxing Gains at Death

Lawrence Zelenak*

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I. INTRODUCTION

If a taxpayer sells property for more than the property cost him, the gain realized on the sale is subject to income tax.¹ If a taxpayer makes a gift of appreciated property, the donee takes the property with the donor's basis, so the appreciation will be taxed when the donee sells the property.² But if a taxpayer dies owning appreciated property, the appreciation is not taxed at death, and the basis of the property becomes its fair market value at death.³ The result is that the appreciation is never subject to income tax. This permanent forgiveness of income tax on appreciation transferred at death has been called "the most serious defect in our federal tax structure" by two leading experts.⁴ It is certainly one of the most expensive gaps in the tax base. The President's Budget estimates the annual revenue loss from the failure to tax gains at death at more than \$25 billion.⁵ Current law is objectionable also for its lock-in effect: elderly taxpayers are discouraged from disposing of appreciated assets, because if they hold the assets until death, the appreciation will escape income taxation permanently.⁶

This tax forgiveness did not originate as a conscious policy decision.⁷ Rather it occurred almost accidentally from the combination of two ideas that were accepted instinctively during the early years of the income tax: that the mere transfer of property at death did not consti-

1. I.R.C. §§ 61(a)(3), 1001(a) (1992). Unless otherwise noted, all references in this Article are to the current I.R.C.

2. I.R.C. Section 1015.

3. I.R.C. § 1014 provides for the increase in basis. No provision of the I.R.C. explicitly states that appreciation is not taxed at death, but the IRS has never claimed that death constitutes a realization event under Section 1001 or otherwise.

4. Stanley Surrey and Jerome Kurtz, *Reform of Death and Gift Taxes: The 1969 Treasury Proposals, The Criticisms, and a Rebuttal*, 70 Colum. L. Rev. 1365, 1381 (1970).

5. The Budget of the United States Government for Fiscal Year 1993 estimates the revenue loss at \$24.365 billion in 1991, \$26.8 billion in 1992, and \$28.4 billion in 1993. Office of the President, *Budget of the United States Government for Fiscal Year 1993*, Special Analysis G 2-26 (U.S. Gov. Printing Off., 1992). For a discussion of revenue loss estimates, see text accompanying notes 44-49.

6. The lock-in effect discourages gifts as well as sales. A lifetime gift does not trigger tax on the appreciation, but it prevents a step-up in basis upon the donor's death. I.R.C. § 1015.

7. Until 1921, no tax statute specified the basis of property received by gift or bequest. The administrative practice was to give such property a basis equal to its value at the date of transfer. Anita Wells, *Legislative History of Treatment of Capital Gains Under the Federal Income Tax, 1913-1948*, 2 Nat'l Tax J. 12, 16 (1949). In 1921, Congress enacted the predecessors of present I.R.C. §§ 1014 and 1015 (setting a fair market value basis for bequests and a carryover basis for gifts). One commentator has noted that the rationale for the Section 1014-type statute is unclear, and that it appears "to have been merely the legislative adoption of a consistent administrative practice." Louis M. Castruccio, *Becoming More Inevitable? Death and Taxes . . . and Taxes*, 17 UCLA L. Rev. 459, 460-61 (1970).

tute a realization of gain or loss on the property,⁸ and that fair market value basis for heirs was appropriate to prevent taxation of capital, because "'capital' was thought to refer to some tangible thing, whatever its value, rather than to a monetary account keeping track of what has been taxed."⁹

Defenders of the current system have justified it on the grounds that the step up in basis is "paid for" by the estate tax on the appreciation.¹⁰ It is true that appreciation that escapes income tax may not escape estate tax, and the estate tax rate may even be higher than the income tax rate.¹¹ Nevertheless, there are two problems with this argument. First, the step up in basis applies even to property that is not subject to estate tax (because of the unified credit¹² or the marital bequest deduction¹³). Second, and more important, the income and estate taxes are distinct, both conceptually and practically. Conceptually, there is no reason why appreciation transferred at death should not be subject to both taxes—to the income tax because it is gain, and to the estate tax because it is a gratuitous transfer. Practically, gratuitously transferred income is generally subject to both taxes. If a taxpayer sells appreciated property during life, the gain is subject to income tax, and if at death he transfers the proceeds of the sale (reduced by the income tax paid) to his beneficiaries, the estate tax will apply as well. The treatment of appreciation at death thus produces inequity between taxpayers who realize income during life, and those who transfer unrealized appreciation at death. The inequity is both horizontal (discriminating between different taxpayers of similar income and wealth) and vertical (favoring wealthy taxpayers because a greater portion of their income tends to be in the form of unrealized appreciation transferred at death).¹⁴

If Congress desires to eliminate the permanent forgiveness of capital gains tax at death, it could do so either by providing that the basis of property transferred at death carries over to heirs and beneficiaries, or by taxing gains at death. During the process that led to the enact-

8. The leading early case on realization, *Eisner v. Macomber*, 252 U.S. 189 (1920), indicated that gain was realized only when it somehow was severed from capital. Death, of course, does not produce any such severance.

9. Calvin Johnson, *The Undertaxation of Holding Gains*, 55 Tax Notes 807, 813 (1992).

10. Boris Bittker and Lawrence Lokken, 2 *Federal Taxation of Income, Estates and Gifts* 41-32 (Warren, Gorham & Lamont, 2d ed. 1989) (stating, but criticizing, the argument).

11. Under current law, the highest rate on capital gain is 28%, I.R.C. § 1(h), and the lowest estate tax rate (after application of the unified credit) is 37%, id. § 2001(c)(1).

12. Applied against the rate schedule of I.R.C. Section 2001(c), the unified credit of Section 2010 exempts \$600,000 from estate taxation.

13. I.R.C. § 2056.

14. Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options, Part 2* at 370 (U.S. G.P.O. 1990) ("*Reducing the Deficit*").

ment of the Tax Reform Act of 1986, virtually every base-broadening reform with significant support among tax policy experts was discussed by Congress and the administration.¹⁵ The one glaring exception was the forgiveness of gains tax at death.¹⁶ This omission would be astounding,¹⁷ but for some history.

As part of the Tax Reform Act of 1976, Congress enacted Section 1023 of the Internal Revenue Code, which generally provided a carry-over basis (rather than a Section 1014 fair market value at death basis) for inherited property.¹⁸ Congress added the carryover basis provision to the Act very late in the legislative process, with little opportunity for either input from interest groups or careful technical drafting.¹⁹ Affected taxpayers and their representatives harshly criticized it, on both technical and policy grounds,²⁰ and in 1980 it was repealed retroactively.²¹ Regardless of one's views on the merits of carryover basis, its short unhappy life was one of the greatest legislative fiascoes in the history of the income tax. This was recent history in 1986, and it is understandable that Congress lacked the fortitude to revisit the issue so soon.

In the past few years, interest in this area slowly has reawakened.²² As memory of Section 1023 recedes, as pressure to raise revenue with-

15. The two major administration documents are Office of the President, *The President's Tax Proposals to Congress for Fairness, Growth and Simplicity* (U.S. G.P.O. 1985); and Dept. of the Treasury, *1 Tax Reform for Fairness, Simplicity and Economic Growth* (Dept. of the Treasury, 1984) ("*The President's Tax Proposals to Congress*"). The Committee Reports are: Tax Reform Act of 1986, S. Rep. No. 313, 99th Cong., 2d Sess. (1986); Tax Reform Act of 1986 Conference Report, H.R. Rep. 841, 99th Cong., 2d Sess. (1986); and Tax Reform Act of 1985, H.R. Rep. No. 426, 99th Cong., 2d Sess. (1985).

16. The only mention was a sort of nonmention. The Treasury Department included "capital gains on appreciated assets transferred at death or by gift" in a list of "items not included in the tax reform proposal." *The President's Tax Proposals to Congress* at 147.

17. It is especially surprising because the 1986 Act repealed the so-called *General Utilities* doctrine, which allowed liquidating corporations permanently to avoid corporate level tax on the distribution (or, in some cases, even the sale) of their appreciated assets. Tax Reform Act of 1986, § 631, Pub. L. No. 99-514, 100 Stat. 2058 (1986). The *General Utilities* doctrine is the corporate analog of the forgiveness of gains at death, so it is strange that tax reform would repeal one and not even consider the other.

18. Tax Reform Act of 1976, § 2005, Pub. L. No. 94-455, 90 Stat. 1520, 1874, repealed by Crude Oil Windfall Profit Tax Act of 1980, § 401(a), Pub. L. No. 96-223, 94 Stat. 229, 299 (1980).

19. Howard Hoffman, *The Role of the Bar in the Tax Legislative Process*, 37 Tax L. Rev. 411, 441 (1982).

20. The criticisms are described by Hoffman. *Id.* at 448-68. The American Bankers Association and the American Bar Association were especially vocal in their opposition.

21. Crude Oil Windfall Profit Tax Act § 401(a), 94 Stat. at 229.

22. Recent indications of interest include the following: *Reducing the Deficit* at 315-17 (cited in note 14) (discussing the revenue effect of taxing gains at death); Charles O. Galvin, *To Bury the Estate Tax, Not to Praise It*, 52 Tax Notes 1413 (1991) (proposing repeal of the estate tax and its replacement with recognition of gains at death); J. Andrew Hoerner, *Panel Considers Capital Gains, Indexing, and Weeding Complexity*, 56 Tax Notes 839 (1992) (reporting a poll of members of the A.B.A. Tax Section's Tax Structure and Simplification Committee, in which five of nine

out raising rates increases, and as the remaining opportunities for significant base-broadening reform diminish, it becomes more likely that Congress eventually will revisit the area. And when Congress does, it seems much more likely (for reasons discussed below)²³ that it will tax gains at death, rather than revive carryover basis. In a recent interview with the Wall Street Journal, then President-elect Clinton remarked that taxing gains at death "probably should be looked at," and that he "wouldn't rule it out."²⁴

The purpose of this Article is not to argue for the taxation of capital gains at death,²⁵ but to provide a guide for legislators in considering the many policy and technical issues that would arise in designing and

respondents favored taxation of capital gains at death, if basis is indexed for inflation); J. Andrew Hoerner, *Frank Proposes Tax Increases to Fund Major New Public Housing Initiative*, 42 *Tax Notes* 1149 (1989) (reporting a proposal by Rep. Barney Frank to tax capital gains at death).

23. See text accompanying notes 26-43.

24. Jeffrey Birnbaum and Michael Frisby, *Democratic Agenda*, Wall St. J. A-6 (Dec. 18, 1992) (excerpts from the interview with President-elect Clinton). Opposition has surfaced quickly from lobbyists for small businesses and farmers. Rick Wartzman, *Clinton Suggestion of Possible Capital Gains Tax Upon Death Stirs Ire Among Powerful Interests*, Wall St. J. A-16 (Jan. 5, 1993).

25. The question of whether there are any constitutional impediments to a capital gains tax at death is beyond the scope of this Article. There would be an impediment if the doctrine of *Macomber*—that the government can tax constitutionally only realized income—is still good law, and if death does not satisfy the realization requirement. Although the Supreme Court has not overruled *Macomber*, later cases suggest that the Supreme Court no longer takes realization seriously as a constitutional requirement. See, for example, *United States v. Davis*, 370 U.S. 65 (1962) (holding that a husband realized gain upon the transfer of appreciated stock to his wife in satisfaction of her marital rights in connection with their divorce); *Helvering v. Bruun*, 309 U.S. 461 (1940) (holding that the government could tax a lessor on the value of the lessee's improvements to the premises, upon the forfeiture of the leasehold, despite the fact that the improvements were not severed from the land). Professor Chirelstein has remarked that "at present most tax commentators would be likely to feel that the congressional taxing power is not seriously restricted by such an implied [realization] requirement," and that "Congress could surely tax property appreciation at gift or death if it desired to do so." Marvin A. Chirelstein, *Federal Income Taxation: A Law Student's Guide to the Leading Cases and Concepts* 68-69 (Foundation Press, 5th ed. 1988).

Several provisions in the current I.R.C. impose tax on income no more realized than appreciation at death. For example: Section 1256 requires the value of certain contracts to be "marked to market" annually; Sections 551 to 558 tax United States shareholders on their proportionate shares of the undistributed income of foreign personal holding companies; and Sections 957 to 964 tax United States shareholders on certain categories of undistributed income of controlled foreign corporations. The foreign personal holding company rules were upheld against constitutional challenge in *Eder v. Commissioner*, 138 F.2d 27 (2d Cir. 1943). The controlled foreign corporation rules have been upheld in *Estate of Whitlock v. Commissioner*, 494 F.2d 1297 (10th Cir. 1974); *Garlock, Inc. v. Commissioner*, 489 F.2d 197, 202 (2d Cir. 1973) (stating that the constitutional challenge "borders on the frivolous"); *Doughtery v. Commissioner*, 60 T.C. 917, 927-30 (1973), supplemented 61 T.C. 719 (1974).

A number of commentators have concluded that a tax on appreciation at death would be constitutional. See, for example, President's 1963 Tax Message, Hearings Before the Comm. on Ways and Means, 88th Cong., 1st Sess. 596-602 (1963) ("*President's 1963 Tax Message*") (statement of General Counsel of the Treasury); Castruccio, 17 *UCLA L. Rev.* at 492-97 (cited in note 7); Phillip J. Hanrahan, *A Proposal for Constructive Realization of Gains and Losses on Transfers of*

implementing a gains tax at death. Part II of this Article explains why a death gains tax is a more attractive option than carryover basis and considers what Congress might do with the revenue raised by a death gains tax. Part III considers whether transition relief is required (either theoretically or politically) and some forms transition relief might take. Part IV then examines the problems of proving basis at death, which played a major role in the arguments over carryover basis in the late 1970s. Finally, Part V discusses a number of structural issues in designing a death gains tax, which require a balancing of simplicity, equity, and revenue concerns. Those structural issues include the treatment of marital and charitable bequests; the relation of the death gains tax to the estate tax; the need for anti-avoidance rules; the design of an exemption for small estates; problems presented by special types of assets (including collectibles, homes, life insurance, and ordinary income assets); the treatment of losses at death; and the need for liquidity relief provisions.

II. THE BASIC POLICY OPTIONS

A. *Choosing Between Carryover Basis and Taxing Gains at Death*

Either carryover basis at death or a death gains tax would prevent the permanent avoidance of gains tax that occurs under current law. At the theoretical level, the argument for carryover basis is that postponing tax until an actual sale of the property avoids the need to appraise the property²⁶ and imposes tax at a time when the taxpayer is likely to have cash available to pay the tax. The arguments for gains tax at death are that it appropriately limits the maximum deferral possibility to a single lifetime; it enforces the principle that income should be taxed to the person who earned it;²⁷ it imposes tax at an ideal time in terms of ability to pay (because the decedent has no use for the amount due as taxes, and whatever the heirs or beneficiaries receive is a wind-fall); and, unlike carryover basis, it solves the problem of lock-in.²⁸ Congress will not choose, however, between the two approaches based on

Property by Gift and at Death, 15 Kan. L. Rev. 133, 155-56 (1966); Philip Rubin, *Taxing Appreciated Property at Death: The Case for Reform*, 51 Or. L. Rev. 364, 371-75 (1972).

26. If Congress imposes a death gains tax only on estates subject to the estate tax, the gains tax will not involve any additional appraisal requirements. It does increase, however, the tax consequences of an inaccurate appraisal.

27. Charles O. Galvin, *Burying the Estate Tax: Keeping Ghouls Out of the Cemetery: A Reply to Professor Smith*, 56 Tax Notes 951, 953 (1992).

28. Carryover basis does lessen the problem of pre-death lock-in because elderly taxpayers know their assets will not receive a stepped-up basis at death. However, carryover basis creates a new problem of post-death lock-in: because the heirs inherit with low carryover basis, they are discouraged from selling the assets. Under either current law or a gains tax at death, the heirs take assets with a fair market value basis, so post-death lock-in does not occur.

such theoretical considerations. Rather, the key issues will be the complexity of administering the two approaches and the relative amounts of revenue they would raise.

The most serious administrative difficulty—proof of basis—would loom equally large under either system. In other respects, however, a death gains tax would be somewhat simpler to apply than carryover basis. Carryover basis would create a new problem for executors, because their fiduciary duties would require them to make not only an equitable distribution of *value* among beneficiaries, but also an equitable distribution of *basis*. A death gains tax does not present this problem, because all assets (other than assets going to a surviving spouse, if the system permits deferral of gains on such assets) receive a fair market value basis following the imposition of the tax at death. In addition, carryover basis requires the maintenance of basis records across unlimited numbers of generations; a death gains tax does not.

A major complication of carryover basis is the death tax basis adjustment. In order to make the consequences of carryover basis consistent with the tax consequences of selling appreciated property before death, it is necessary to increase the basis of appreciated carryover basis property by the death taxes (federal and state estate taxes, and state succession tax) attributable to the appreciation.²⁹ Although the principle is easy enough to state, applying it can be very complex. Section 1023(c) calculated the adjustment for each asset by multiplying the appreciation in the asset by the average tax rate for the entire estate. Since the average tax rate for an estate is a function of the value of every asset in the estate, the basis of every appreciated asset in the estate was uncertain as long as the value of even one asset was uncertain.³⁰

29. Suppose, for example, a 50% flat rate estate tax and a 28% flat rate capital gains tax, and a taxpayer with just two assets: \$1,000,000 cash, and stock with a basis of zero and a value of \$1,000,000. If the taxpayer sold the stock before his death for \$1,000,000, the gains tax would be \$280,000, and payment of the tax would reduce his estate to \$1,720,000. The 50% estate tax would be \$860,000, and the beneficiaries would receive \$860,000. In order to replicate this result if the taxpayer dies and the stock is then sold by the estate or by the beneficiaries, a death tax basis adjustment is needed. The estate tax liability is \$1,000,000 (50% of \$2,000,000), of which \$500,000 is attributable to the appreciation in the stock. The \$1,000,000 cash is used to pay the estate tax, and the beneficiaries receive the stock. The beneficiaries thus take the stock with a basis of \$500,000, after the death tax basis adjustment. The gain on a subsequent sale of the stock for \$1,000,000 is \$500,000, resulting in a tax of \$140,000. Reducing the \$1,000,000 proceeds by \$140,000 leaves the beneficiaries with \$860,000—the same amount they would have received if the decedent had sold the stock before death.

30. Background and Issues Relating to Carryover Basis, Hearings Before Joint Comm. On Taxation, 96th Cong., 1st Sess. 26 (U.S. G.P.O. 1979) ("*Background and Issues*"). According to Section 1023(c), the average tax rate was the total estate tax liability divided by the fair market value of all property subject to tax. The change in the value of any asset would change both of those numbers. Additional uncertainty was created by the rule, in Section 1023(f)(4) that no death

The leading clean-up proposal³¹ would have simplified the death tax adjustment by making it at the estate's marginal rate, rather than the average rate.³² This proposal would have reduced uncertainty, because in many cases an audit adjustment of an asset's value would not change the marginal rate.³³ In the interests of simplicity, clean up also would have allowed only a single adjustment based on the federal estate tax, rather than multiple adjustments for both federal and state death taxes.³⁴ The clean-up proposal would have created a new uncertainty, however, by providing that the total death tax adjustment could not exceed the marginal estate tax rate multiplied by the lesser of (a) the aggregate appreciation in the estate or (b) the taxable estate.³⁵ Thus, uncertainty in the amount of the taxable estate could leave the amount of the death tax basis adjustment unknown indefinitely.³⁶ Although the clean-up method of adjustment would not have been unworkable,³⁷ it would add a complication not involved in a death gains tax.

Another problem of carryover basis is the need for some method—whether by mechanical rules or executor election—of allocating whatever minimum basis adjustment is allowed. Allocation of the adjustment is necessary under carryover basis because gain on different

tax basis adjustment was allowed for property that was not subject to tax because of the marital or charitable deduction: "Thus, tax consequences may be uncertain for sales by an executor, or for distributions to a surviving spouse, during the estate's administration because at that time it may not be certain as to how much property will not be subject to the estate tax under the marital or charitable deduction." *Background and Issues* at 26-27.

31. Representative Fisher introduced the proposal with Treasury support.

32. H.R. Rep. No. 4694, 96th Cong., 1st Sess. § 2(a), in 125 Cong. Rec. H5491 (daily ed., Sept. 28, 1979) ("H.R. 4694") (proposed § 1023(c)(5)). The marginal rate was defined as the highest applicable rate, the amount subject to which is at least \$50,000. *Id.* § 2(a) (proposed § 1023(c)(5)(E)).

33. In addition, H.R. 4694 would have eliminated the rule of Section 1023(f)(4), that the adjustment was not available for marital deduction property. *Id.* § 2(a). This change simplified the administration of the adjustment, but arguably at the cost of some inequity.

34. Congress based the federal estate tax basis adjustment on the estate tax marginal rate, without a reduction to reflect the Section 2011 credit for state death taxes. This would result in inappropriately low adjustments in cases in which the state death taxes exceed the maximum Section 2011 credit. *Carryover Basis Provisions, Hearings Before the Comm. on Ways and Means, 96th Cong., 1st Sess. 51 (1979) ("Carryover Basis Provisions")* (statement of American Bankers Association).

35. H.R. 4694 § 2(a) (proposed § 1023(c)(5)(A)).

36. [T]he amount of the adjustment will not be "final" until (a) the federal estate tax is finally determined and the executor knows that the appreciation in such property is more than the decedent's taxable estate, or (b) the marginal federal estate tax rate is known and the executor knows that appreciation in appreciated carryover basis property is less than the decedent's taxable estate, in which case the basis of each such property will be increased by its appreciation times the marginal federal estate tax rate.

Carryover Basis Provisions at 51.

37. *Id.* at 230-33 (statement of American Institute of Certified Public Accountants); Richard B. Covey and Dan T. Hastings, *Cleaning Up Carryover Basis*, 31 *Tax Law.* 615, 641-52 (1978).

assets may be recognized at different times and by different taxpayers. By contrast, this is not an issue under a death gains tax because all gain is taxed at the same time to the same taxpayer.

Some commentators have argued that a death gains tax with carryover basis for marital bequests would be just as complicated as general carryover basis.³⁸ They are right that not having a marital exemption is simpler than having one, but they are wrong in arguing that a marital exemption involves all the difficulties of general carryover basis. A marital exemption would require keeping basis records, not over several generations, but only until the death of the surviving spouse. More important, the carryover basis for marital exemption property would be pure carryover basis, without any of the complicating adjustments. There would be no death tax adjustment because the marital bequest would not have been subject to estate tax. No minimum basis adjustment would be allowed for property passing to a surviving spouse, and no transition rule basis adjustment would be made to such property at that time; there would be no need to make either adjustment until the property is actually subject to tax at the death of the surviving spouse.

More important than the modest simplicity advantage of tax at death over carryover basis is the much greater revenue effect of tax at death. The Congressional Budget Office (CBO), for example, estimated that taxing capital gains at death would raise \$17.0 billion over four years (1994 to 1997), while carryover basis would raise only \$5.2 billion.³⁹ Part of the reason that Congress was unable to withstand the pressure to repeal carryover basis was that carryover basis did not raise very much revenue.⁴⁰ It is difficult to resist impassioned (and plausible) claims that the statute is too complex when the major argument in favor of the statute is that it closes a loophole offensive to some academics. It should be considerably easier to resist the claims that the statute is too complex when a major argument in favor of the law is that it raises very substantial and badly needed revenue.⁴¹

38. See, for example, Federal Estate and Gift Taxes, Public Hearings and Panel Discussions Before the Comm. on Ways and Means, 94th Cong., 2d Sess. 1211, 1218 (1976) ("*Federal Estate and Gift Taxes*") (statement of Richard Covey).

39. *Reducing the Deficit* at 315 (cited in note 14). How much revenue is raised by either a death gains tax or carryover basis will depend, of course, on the extent of relief given to smaller estates. At any given level of relief, however, a death gains tax will raise substantially more revenue than carryover basis.

40. In the long run, carryover basis (as enacted in 1976) was expected to raise \$1.08 billion annually. General Explanation of the Tax Reform Act of 1976, H.R. 10612, 94th Cong., 2d Sess. 597 (1976) ("*Tax Reform Act of 1976*"). Under the leading clean-up proposal, the revenue gain would have been even less. Jt. Comm. on Taxation, *Description of H.R. 13 and H.R. 4694 Relating to Carryover Basis*, 96th Cong., 1st Sess. 9 (U.S. G.P.O. 1979).

41. This is true whether the revenue is used for deficit reduction or reduction of capital gains or estate tax rates.

Although the revenue impact is by far the biggest advantage of the gains tax, it has two additional political advantages over carryover basis. First, it does not carry the historical baggage of carryover basis. The enactment and repeal of carryover basis was such a long and complete fiasco⁴² that carryover basis may never be given serious consideration again as long as anyone in Congress remembers that history. Legislators must feel strongly that it has been fully considered and conclusively rejected. Although that history also must color any consideration of a death gains tax, it should not have so conclusive an effect. Second, there are those (primarily academicians, but also some politicians and practitioners) who strongly believe in taxing gains at death. By contrast, almost no one considers carryover basis the best way of dealing with gains at death.⁴³

B. *Taxing Gains at Death: Revenue Implications and Policy Choices*

How much revenue would be raised by taxing capital gains at death is unclear, but it is clear that it would be significant. The Budget of the United States for Fiscal Year 1993 lists the failure to tax gain at death as the fourth largest item in the tax expenditure budget, with estimated revenue loss of more than \$24 billion in 1991, more than \$26 billion in 1992, and more than \$28 billion in 1993.⁴⁴ By contrast, the CBO has estimated the annual revenue gain from taxing capital gains at death at

42. For a thorough (and depressing) account of the history of carryover basis, see generally Hoffman, 37 Tax L. Rev. 411 (cited in note 19).

43. Id. at 442 (describing carryover as "the classic compromise that pleased no one"). He remarks that during consideration of repeal of carryover, many who favored taxing gains at death gave carryover little support. Id. at 442-43 n.121. During hearings held early in 1976 before the enactment of carryover basis, a panel of experts resoundingly rejected carryover basis. *Federal Estate and Gift Taxes* at 1435 (cited in note 38) (A. James Casner, stating that "the worst thing to do is . . . a carryover basis"); id. at 1444 (Edward C. Halbach, Jr., calling carryover "the worst of the possible alternatives"; Rep. Ullman, summarizing the testimony: "The carryover basis is obviously very difficult. No one seems to favor it very much.").

44. Office of the President, *Budget of the United States Government for Fiscal Year 1993* (cited in note 5). The exact figures are \$24.365 billion, \$26.8 billion, and \$28.14 billion. Id. at 2-26. The larger items in the tax expenditure budget are the expenditures for retirement savings, medical insurance, and home mortgage interest. The exemption of capital gains at death is unlike the three larger items in that it is unclear what Congress intended the exemption to accomplish. Whatever one may think of the other three expenditures, it is easy to understand why Congress might choose to subsidize retirement savings, medical insurance, and homeownership. It is much more difficult to understand the purpose of subsidizing the holding of appreciated property until death.

Jt. Comm. on Taxation, *Estimates of Federal Tax 1993-1997 Expenditures for Fiscal Years 1993-1997*, 102nd Cong., 2nd Sess. 14.0 (U.S. G.P.O. 1992), estimates the revenue loss from not taxing capital gains at death to be much lower (although still very large): \$11.6 billion in 1993, \$12.7 billion in 1994, \$14.0 billion in 1995, \$15.4 billion in 1996, and \$17.1 billion in 1997. Neither the Committee's report nor the Budget explains the discrepancy between the estimates.

\$5.3 billion by 1997.⁴⁵ Much or all of the difference in the estimates derives from the fact that the CBO estimate, unlike the budget estimate, is for a tax with substantial exemptions. The CBO estimate is for a tax with marital and charitable exemptions, with the option of using one-half an asset's date-of-death value as basis, with the availability of the \$125,000 exclusion for gain on a primary residence (if not used during life), and with a \$75,000 exclusion for any remaining gains.⁴⁶ The revenue from taxing gains at death would be substantial even by federal budget standards, but standing alone it would put only a small dent in the deficit. The size of that dent would be decreased, of course, by whatever exemptions from the tax Congress provides, whether based on particular types of assets, destination of assets, or size of the estate.⁴⁷

There are general points worth noting about the revenue effect of taxing gains at death. First, much of the revenue effect would be indirect. That is, without the lock-in effect of forgiveness of gains tax at death, elderly taxpayers would realize much more gain while still alive. Thus, much (perhaps most) of the revenue gain from the death tax would not result from assessing the tax at death, but from tax on dispositions during life which would not have occurred in the absence of a death gains tax.⁴⁸ Second, since the income tax liability created by the tax on gains at death logically should be deductible under the estate tax as a claim against the estate,⁴⁹ a complete analysis of the revenue impact of the gains tax must consider the partially offsetting reduction in estate tax receipts. Consider, for example, \$100 of appreciation held at death, with an applicable capital gains tax rate of twenty-eight percent and an applicable estate tax rate of fifty percent. Compared with no capital gains tax, the gains tax increases income tax revenue by \$28, but decreases estate tax revenue by \$14 (because the fifty percent estate tax is imposed on \$72 instead of \$100), for a net revenue gain of \$14.

45. *Reducing the Deficit* at 315 (cited in note 14). This compares with an estimate of \$2.0 billion to be gained from adopting carryover basis at death. A similar estimate is made in Alan J. Auerbach, *Capital Gains Taxation and Tax Reform*, 42 *Nat'l Tax J.* 391, 399 (1989).

46. *Reducing the Deficit* at 315-16. The Report also considered "levying an additional 10% estate tax on gains held at death." It estimated this would raise only \$0.6 billion in 1997. It explained the low estimate by the fact that the tax "could be offset by any unused credits allowed under the estate tax." *Id.* at 316.

47. Exemptions are discussed in text accompanying notes 150-83 (destination of assets), 223-53 (size of estate), and 243-95 (types of assets).

48. The President's 1963 proposal to tax capital gains at death estimated that annually the tax would raise \$300 million directly and \$450 million as "revenue effect due to increased turnover resulting from unlocking of asset holdings." *President's 1963 Tax Message* at 708 (cited in note 25).

49. I.R.C. Section 2053(a)(3) of the estate tax provides for a deduction for claims against an estate. See text accompanying notes 184-90 for discussion of the estate tax deductibility of the income tax liability.

Whatever the amount of revenue raised by the tax, there are three major options for what to do with that revenue: use it to reduce the deficit, use it to offset revenue lost from a decrease in the capital gains tax rate, or use it to reduce or even eliminate the estate tax. Congress also could devote the revenue to various combinations of the three uses.

The deficit reduction option is attractive. As a principled and perhaps politically feasible way of raising substantial additional revenue from the income tax without raising rates, it is a rarity. A death gains tax would result in a top combined income and estate tax burden of sixty-four percent on appreciation held at death, assuming a top capital gains rate of twenty-eight percent and a top estate tax rate of fifty percent.⁵⁰ From an historical perspective, that is not a particularly high federal death tax rate—as recently as 1981, the top estate tax rate was seventy percent.⁵¹ Nevertheless, it is questionable whether the current Congress would accept the sixty-four percent combined tax burden that would result if the gains tax were used entirely for deficit reduction.

One economist has estimated that a reduction in the capital gains tax rate to 12.5% and the taxation of gains at death would yield approximately the same revenue as the current twenty-eight percent capital gains rate and forgiveness of tax at death.⁵² This proposal is attractive in several ways. Both parts of the proposal would reduce lock-in: the lower rate would decrease resistance to recognizing gains during life, and the death tax would eliminate the incentive to hold assets until death. The proposal also would eliminate the horizontal inequity between taxpayers who sell appreciated assets during life and those who hold assets until death, by moving both groups of taxpayers to the same middle ground. It might fare well as a political compromise between those who feel strongly that there should be a significant reduction in capital gains rates and those offended by the forgiveness of capital gains tax at death. A closely related possibility would use the revenue raised by a death gains tax to pay for indexing of basis for inflation.

50. A top estate tax rate of 50% assumes Congress will allow the elimination of the 53% and 55% brackets to occur in 1993 as scheduled, I.R.C. § 2001(c)(2)(D), and ignores the five percent surtax caused by the phaseout of the graduated rates and the unified credit, I.R.C. § 2001(c)(3). A 28% tax on \$100 of capital gains held at death leaves \$72 subject to a 50% estate tax, which in turn leaves the estate with \$36. The combined tax burden is thus 64%.

51. Jt. Comm. on Taxation, *General Explanation of the Economic Recovery Tax Act of 1981*, 97th Cong., 1st Sess. 229 (U.S. G.P.O. 1981).

52. Donald W. Kiefer, *Lock-In Effect Within a Simple Model of Corporate Stock Trading*, 43 Nat'l Tax J. 75, 90 (1990). Strangely enough, Nicole Hollander proposed precisely the same capital gains tax rate in the following dialogue from her comic strip "Sylvia": "Why do you think George Bush has this obsession with capital gains?" "Probably some childhood thing." "You know I think it's the only thing he's ever really wanted? I say, let him have it. Let him bring the tax on capital gains down to 15.4%." "What the heck, let's go all the way. Give him 12.5%." Coincidence?

The estate and gift taxes raised approximately \$12.1 billion in 1992.⁵³ At least one commentator has suggested replacing the transfer taxes with a capital gains tax imposed on gifts and bequests of appreciated property.⁵⁴ As the above discussion indicates, it is unclear whether the revenue lost by repealing the transfer taxes could be replaced entirely by taxing capital gains at death. Assuming, however, that the change could be made revenue neutral, would it be a good idea? The change might appeal to an "academic desire for tidiness,"⁵⁵ because it rationalizes the income tax by eliminating perhaps its most glaring loophole.⁵⁶ In addition, it repeals a transfer tax system always objectionable for the many omissions from its base.⁵⁷

Notice, however, that the potential tax base for a capital gains tax on gratuitous transfers is substantially smaller than the potential tax base for a transfer tax system—smaller by the amount of the cost bases of the assets gratuitously transferred. Moreover, at current rates the capital gains tax (twenty-eight percent top rate) will raise less revenue from a given dollar amount of tax base than will the transfer taxes (rates ranging from thirty-seven to fifty percent).⁵⁸ Thus, for the capital gains tax to raise as much revenue as the transfer taxes, with a smaller potential base and lower rates, it must include in its actual base a much higher percentage of its potential base than do the transfer taxes. Although some of this might be done through loophole closing, the vast majority would have to be done by using much lower exemption amounts than the \$600,000 transfer tax exemption created by the unified credit.⁵⁹ Thus, assuming revenue neutrality, replacement of the transfer taxes with a capital gains tax on transfers would result in a major shift of tax burden away from the wealthy and the upper middle

53. Office of the President, *Budget of the United States Government for Fiscal Year 1993* at 2-3 (cited in note 5). Actual estate and gift tax receipts for 1991 were \$11.1 billion. *Id.*

54. Professor Galvin suggests repealing the transfer taxes and replacing them with either a capital gains tax imposed at the time of gifts and bequests, an accessions tax, or some combination of the two. Galvin, 52 *Tax Notes* at 1413 (cited in note 22).

55. *Commissioner v. Duberstein*, 363 U.S. 278, 290 (1960).

56. Surrey and Kurtz, 70 *Colum. L. Rev.* at 1381 (cited in note 4).

57. For discussion of this issue, see George Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance*, 77 *Colum. L. Rev.* 161 (1977).

58. I.R.C. § 2001(c)(1). This disregards the "phantom rates" offset by the unified credit, I.R.C. § 2010, the phase-in of the 50% maximum rate, I.R.C. § 2001(c)(2), and the phase out of the graduated rates and unified credit, I.R.C. § 2001(c)(3).

59. Galvin has reported that "Treasury representatives advise[d] Galvin informally that gift-time and death-time recognition of gain, standing alone, would probably make up the lost revenue [from repeal of the estate and gift taxes]." Galvin, 56 *Tax Notes* at 951 (cited in note 27). Galvin proceeds, however, to propose "a \$600,000 threshold below which gain or loss would not be recognized and basis would be stepped up," *id.* at 953, without recognizing that so high an exemption level makes impossible full replacement of the lost transfer tax revenue.

class, and onto the middle middle class.⁶⁰ I would oppose the regressivity inherent in a such a change, and it seems likely Congress would agree.⁶¹

In addition to its regressivity, the change would result in increased complexity. The need for valuation of gratuitous transfers would remain, and the need to determine the basis of all gratuitous transfers would arise. More significantly, these burdens would be imposed on many middle class transferors currently not subject to the transfer taxes.

As an alternative, of course, Congress could retain the transfer tax system, but use the revenue raised from the new capital gains tax to reduce the transfer tax burden, either by raising the exemption amount or by reducing rates. If Congress keyed the exemption to the new capital gains tax to the transfer tax exemption,⁶² it would impose no new tax burden (either in terms of tax liability or the compliance burden) on the middle class. Moreover, the exemption would improve horizontal equity among the affluent taxpayers above the exemption levels, because all of them now would be subject to tax on their capital gains.

III. OPTIONS FOR TRANSITION RELIEF

During both the enactment of carryover basis and the discussion of possible revisions, there was general agreement that it was not appropriate to apply carryover basis to appreciation occurring before the effective date of the statute.⁶³ In other words, there was agreement that appreciated property acquired before the effective date, and owned by a decedent dying after the effective date, should receive a basis equal to the fair market value of the property as of the effective date, rather than the decedent's cost.⁶⁴ The only disagreement was over how to implement this policy. In the case of marketable securities, whose fair market value as of the effective date could be determined reliably, Sec-

60. Despite the relatively small amount of revenue they raise, the transfer taxes supply a large part of the progressivity of the federal tax system. Michael J. Graetz, *To Praise the Estate Tax, Not to Bury It*, 93 Yale L. J. 259, 269-73 (1983). This contribution largely would be lost if the transfer taxes were replaced by a capital gains tax.

61. Robert B. Smith, *Burying the Estate Tax Without Resurrecting Its Problems*, 55 Tax Notes 1799, 1803-04 (1992), argues that the base broadening that would be necessary to replace the transfer taxes with capital gains taxes would not be feasible politically because of its impact on the middle class.

62. See text accompanying notes 224-53 for a discussion of how Congress could do this.

63. Nowhere in the hearings on carryover basis or in the legislative history is the possibility of adopting carryover basis without transition relief even considered.

64. This was also the approach taken in Canada in 1971, Income Tax Application Rule (I.T.A.R.) 26(3) (1991), and in the United States in 1913, currently reflected in Section 1053 of the Code. Both of those cases were different, however, in that under prior law in those cases capital gain would not have been subject to tax even if realized during life.

tion 1023(h)(1) implemented the policy in the pure form described above. In the case of other property, the difficulty in determining effective date fair market value led to the use of other approaches, including pro rata apportionment of appreciation between the time of acquisition and the decedent's death (the primary approach of Section 1023, reflected in Section 1023(h)(2)) and determining basis by discounting back from the date of death value to the effective date at a prescribed rate of interest.⁶⁵

A. *Arguments for Transition Relief*

The same issue of transition relief for appreciation accrued before the effective date of the new law arises under a tax on capital gains at death. If Congress considers such transition relief appropriate, there are a number of different ways to provide it, reflecting various compromises between theoretical correctness and administrative practicality. Before the evaluation of those alternatives, however, comes the question of whether *any* transition relief is appropriate. There are both substantive and procedural arguments in favor of transition relief. The substantive argument is based on concerns of equity and reliance: that it is unfair to tax appreciation which, under the law as it existed at the time the appreciation occurred, would not be taxed if the owner held the property until death. According to this argument, the owner reasonably relied on the forgiveness of capital gains tax at death in acquiring and retaining the appreciated property. To change the rules now, to tax pre-effective date appreciation, would violate reliance by retroactively imposing a tax.

The procedural argument focuses on the availability of cost records for property acquired before the effective date. A taxpayer may have failed to keep adequate basis records of such property because he reasonably anticipated holding the property until his death, at which time the basis would be irrelevant. Without transition relief, his executor would be unable to prove any basis (the decedent is, of course, unavailable to help reconstruct basis records), and the entire fair market value at death would be taxed as gain. This would be unfair to the extent of

65. This is the approach of Section 1023 for personal and household effects, and the primary approach of the leading clean up bill. I.R.C. § 1023(h)(3), added by the Revenue Act of 1978, § 702(c)(2), Pub. L. No. 95-600, 92 Stat. 2763, 2926 (1978), repealed by Pub. L. No. 96-223, § 401(a) (1980), provided for an elective discount back formula for "tangible personal property." H.R. 4694 § 2(a) (cited in note 32) (proposed § 1023(d)(2)(a)) would have made the discount back formula the general rule (except for marketable securities).

the decedent's actual—but unprovable—cost. Transition relief could ameliorate the harshness of that result.⁶⁶

B. Arguments Against Substantive Transition Relief

There are, however, serious objections to the substantive arguments for transition relief. First, no taxpayer could know with certainty that he actually would hold any particular asset until death. Even if he did not anticipate selling the asset, changed circumstances might lead to a sale. Thus, even under current law the appreciation in every asset of every taxpayer potentially is subject to tax, if there is a lifetime disposition. This potential for tax under current law arguably means that taxpayers had no legitimate reliance interest in tax-free appreciation, and that taxing pre-effective date appreciation at death would not be unfair. The counterargument is that, despite the theoretical potential for tax on all appreciation under current law, as a practical matter it is inevitable that as long as the law remains unchanged, large amounts of appreciation—perhaps the majority of all appreciation⁶⁷—will escape taxation. The claim that all appreciation is taxable under current law is, therefore, somewhat out of touch with economic reality. Moreover, many taxpayers had good reason to expect, regarding particular assets, that they could hold those assets until death. And for every asset for which transition relief becomes an issue, hindsight will have proven that taxpayer's expectation correct. The potential for tax on all appreciation under current law weakens, but does not destroy, the substantive argument for transition relief.

There is, however, another argument against transition relief, which does not depend on the possibility of taxation under existing law. This argument begins by examining the claim that taxing pre-effective date appreciation would be a retroactive, and therefore unfair, change in the law. As a matter of semantics, it is debatable whether applying a change in the law to income economically accrued before the change, but realized after the change (sometimes referred to as a carryover

66. The pro rata apportionment method of Section 1023 required proof of the decedent's basis in the property (in addition to proof of acquisition date), and so at first glance appears to have been aimed only at the substantive argument for transition relief. On the other hand, assuming the executor can prove or at least estimate the acquisition date, pro rata apportionment may result in a substantial basis for an asset even starting from a cost basis of zero. Thus, pro rata apportionment is somewhat responsive to the procedural argument for transition relief.

67. The literature concerning what percentage of gain escapes tax by reason of I.R.C. Section 1014 is reviewed in Johnson, 55 Tax Notes at 811-12 (cited in note 9). Johnson reports that "the variation in the estimates is surprisingly wide," but many of the estimates suggest that half or more of all gain permanently escapes the income tax. *Id.*

problem)⁶⁸ should be characterized as retroactive. Such an application occupies a middle ground between nominal retroactivity (applying the change to income realized before the enactment of the new law) and nominal pure prospectivity (applying the change only to income both accrued and realized after enactment).

In the leading analysis of transitions in tax law, Michael Graetz has argued that nothing is gained by arguments over whether a particular change is retroactive, because *all* changes in tax law, even if nominally purely prospective, are retroactive in the sense that they have an economic impact on the value of existing assets.⁶⁹ Suppose the tax on capital gains at death is designed to exempt gains accruing before the enactment of the tax. The fact that future appreciation in assets held at enactment can no longer escape ultimate taxation will reduce somewhat the value of those assets. This would be true even if assets held at enactment were holder-grandfathered, rendering even post-enactment appreciation untaxable if the holder at enactment continued to hold until death. The change in the law still would reduce the value of those assets, because anyone acquiring an asset from the original owner would not be eligible for the grandfather rule. The decrease in value of existing assets caused by a nominally prospective change in the law is commonly referred to as a price change.⁷⁰ Graetz observes that carryover problems and price changes are "similar in their broadest economic effects,"⁷¹ and should be analyzed in the same fashion, as reductions in the wealth of asset holders caused by a change in the law.⁷²

Under that general analysis, Graetz concludes that neither fairness nor efficiency concerns mandates transition relief. On the fairness issue, he notes that a taxpayer who buys a tax-favored asset buys it at a price that reflects the possibility that Congress may some day repeal the favorable treatment. In other words, he buys at a discount because of

68. David Bradford and U.S. Dept. of Treasury, *Blueprints for Basic Tax Reform* 163-64 (U.S. G.P.O., 2d ed. 1984).

69. Michael J. Graetz, *Legal Transitions: The Case of Retroactivity in Income Tax Revision*, 126 U. Pa. L. Rev. 47, 49-63 (1977). Graetz reiterates this point in *Retroactivity Revisited*, 98 Harv. L. Rev. 1820, 1822-23 (1985).

70. Bradford and Dept. of Treasury, *Blueprints for Basic Tax Reform* at 163 (cited in note 68).

71. Graetz, 126 U. Pa. L. Rev. at 51.

72. Louis Kaplow, *An Economic Analysis of Legal Transitions*, 99 Harv. L. Rev. 509, 612-13 (1986), takes issue with Graetz's claim that carryover problems and price changes should be subjected to the same transition analysis. He reasons that special transition rules for certain kinds of accounting-related carryover problems may be necessary to avoid inappropriate nontaxation or double taxation of income. (His example involves a required tax accounting change from a calendar year to a fiscal year.) The taxation of accrued but unrealized capital gain does not present this problem.

the possibility the tax law may change. The taxpayer is gambling that the law will not change as long as he holds the property, but he knows he may lose. If he happens to lose—if Congress does change the law—no principle of fairness requires relief for one who knowingly assumed the risk.⁷³ On the efficiency issue, Graetz argues that if the change in the law is itself an efficient change, it is inefficient to limit the scope of that change by providing transition relief.⁷⁴

My own view is that the two objections to the substantive argument for transition relief are persuasive. But the unanimity with which Congress accepted transition relief for carryover basis suggests that the political reality is that Congress will accept unquestioningly the substantive argument. One might draw a different conclusion from the history of the 1986 Tax Reform Act, in which Congress raised the top rate on capital gains from twenty percent to twenty-eight percent without providing any relief for gain which accrued under the twenty percent tax but was realized under the twenty-eight percent tax.⁷⁵ There is, however, a long (albeit not particularly sensible) tradition of concern about transitions when Congress adopts a new tax, but not when it increases the rate of an existing tax.⁷⁶

73. Graetz, 126 U. Pa. L. Rev. at 63-79. The argument is well summarized in J. Mark Ramseyer and Minoru Nakazato, *Tax Transitions and the Protection Racket: A Reply to Professors Graetz and Kaplow*, 75 Va. L. Rev. 1155, 1159-60 (1989).

74. Graetz remarks that transition rules "often significantly delay and sometimes permanently reduce the benefits that are expected to be realized from the change in the law." Graetz, 98 Harv. L. Rev. at 1825 (cited in note 69). Ramseyer and Nakazato disagree with Graetz in part. Their analysis indicates that it may improve efficiency for Congress to bind itself, *at the time it enacts a tax incentive*, not to repeal the incentive without transition relief. Ramseyer and Nakazato, 75 Va. L. Rev. at 1161-62 (cited in note 73). They concede, however, that there is no efficiency advantage to transition relief if Congress did not promise it at the time of enactment. *Id.* at 1162. Since Congress has not bound itself to transition relief if it repeals stepped up basis at death, their analysis does not apply here. In addition, their analysis depends on Congress having intended the tax preference as an incentive to invest in the tax-favored asset type. Neither history nor logic makes a good case for Congress having intended the basis step up as incentive to buy appreciating assets and hold them until death. See text accompanying notes 7-9. If Congress lacked that intent, the analysis of Ramseyer and Nakazato is irrelevant here for that reason as well.

75. Tax Reform Act of 1986, §§ 301-02, Pub. L. No. 99-514, 100 Stat. 2085, 2217-19.

76. Kaplow, 99 Harv. L. Rev. at 610 (cited in note 72).

The implicit theory behind this view is that once a tax has been implemented, taxpayers can expect changes (that is, they are on notice), whereas new taxes cannot reasonably be anticipated. . . . The distinction's relevance, if any, lies in its suggestion that these groups of reforms typically have different probabilities of enactment—a difference of degree that is of limited significance. This assumed difference also does not hold in many contexts.

Id.

C. Transition Relief Limited to Proof of Basis Concerns

Even in the rather unlikely event that Congress rejected substantive transition relief, the procedural argument for relief would deserve attention. Of course, one can argue that the possibility of a lifetime sale or the enactment of a tax on capital gains at death means that taxpayers should have kept meticulous cost records for all assets, but that is a counsel of perfection with too little allowance for human frailty.

If transition relief is only for the purpose of accommodating understandable failure to keep good cost records, the relief should be quite limited. This is especially true if rules of general applicability—that is, applicable to assets acquired before or after the effective date—permit reasonable estimates of basis and provide for basis equal to fair market value at acquisition when cost cannot be determined.⁷⁷

As for the assets held on the date of enactment, however, it would be sensible for a transition rule to isolate the assets for which failure to keep basis records is particularly understandable. The most obvious class of such assets is nonbusiness tangible personal property. The non-business context of the acquisition and the unlikelihood (in most cases) of a lifetime disposition at a gain make the lack of cost records particularly likely in their case. Most of these assets probably would be exempt from tax anyway, under a limited exemption for non-business tangible personal property regardless of acquisition date,⁷⁸ but some would be too valuable to qualify for that exemption. Transition relief for those assets could take the form of either determining basis by discounting back from date of death value to the effective date,⁷⁹ or simply a rule providing that the basis is some stated percentage of the date of death value of the property. Under either approach, the decedent's actual cost would govern if higher than the basis determined under the special rule. Similar relief could be provided to any number of other classes of assets held on the effective date,⁸⁰ but the justification for failing to keep basis records for any other asset type seems much weaker.⁸¹

77. For a discussion of these rules, see text accompanying notes 137-40.

78. See text accompanying notes 253-68 for discussion.

79. This method is described at text accompanying notes 100-06.

80. The leading carryover basis clean-up bill would have applied the discount back approach to *all* assets (other than marketable securities) held as of the effective date. H.R. 4694 § 2(a) (cited in note 32) (proposed § 1023(d)(2)). This, however, was intended to be responsive to the substantive claim for transition relief, as well as to the procedural claim.

81. Another category of assets for which transition relief might seem appropriate is assets acquired when the decedent was older than some specified age, such as 70. The argument would be that acquiring an asset at an advanced age makes it more likely that the decedent will hold it until death, thus making the failure to keep cost records more understandable. One objection is that there are some business and investment assets for which failure to keep cost records is never reasonable, regardless of age. Another objection is that relief for such assets is not needed because, by

The Congressional Budget Office has estimated the revenue effect of a death gains tax that would allow, as transition relief, use of a basis equal to one-half the date-of-death value of an asset.⁸² As a response solely to proof of basis problems, this is too generous, since it would apply even to business assets and other assets for which poor basis records would not be excusable.⁸³

Another possible response to the problem of proof of basis would be to enact the tax with a delayed effective date—for example, to be effective beginning with decedents who die three years after the date of enactment.⁸⁴ If a taxpayer had failed to keep basis records in anticipation of the benefit of Section 1014 at death, the delayed effective date would give him at least three years before his death to work on establishing the basis of significant assets.⁸⁵ Although this would no doubt help in some cases, overall it seems both wildly underinclusive and wildly overinclusive. It is underinclusive because in many cases the basis records simply are lost in the mists of history and cannot ever be recovered, whether the taxpayer is alive or dead. It is overinclusive because during the deferral period it would forgive tax on billions of dollars of gain for which there was little or no problem of basis determination.⁸⁶ Moreover, the history of the delayed effective date of carryover basis suggests that during the delay period the efforts of taxpayers and their advisers will be focused on repealing the law, rather than preparing to comply with it. On balance, the disadvantages of a delayed effective date outweigh its rather limited advantage on the proof of basis problem.

definition, they will have been acquired not long before the decedent's death, thus making the problem of basis determination relatively simple.

82. *Reducing the Deficit* at 315-18 (cited in note 14). The Report is somewhat vague as to whether this is intended as permanent or transition relief, but it appears to be only transitional. *Id.* at 318.

83. As a response to the alleged need for substantive transition relief (i.e., the need not to tax pre-effective date appreciation), it would be incoherent, since it does not attempt even to approximate the value of assets as of the effective date of the tax.

84. This possibility is mentioned in Michael J. Graetz, *Taxation of Unrealized Gains at Death—An Evaluation of the Current Proposals*, 59 Va. L. Rev. 830, 854-55 (1973). Graetz rejects this possibility because it assumes the deceased person retained basis records.

85. This justification for the delayed effective date suggests some special accommodation should be made for taxpayers who are incompetent throughout much or all of the time between the date of enactment and their death, and who die after the effective date. It seems unlikely, however, that any accommodation would be worth the difficulty of administering it.

86. If Congress paired the new tax with a decrease in the capital gains rate or the estate tax rates, Congress also would have to give the decrease a delayed effective date, in order to keep the revenue effects in balance.

D. *Methods of Providing Substantive Transition Relief*

If, as seems likely, Congress chooses to provide substantive transition relief, there are a number of ways it could do so. The most likely options are discussed below.

1. National Appraisal Date

In theory, the purest method would be to step up the bases of all appreciated assets to their fair market values on the effective date of the capital gains at death tax, so that no pre-effective date appreciation would be subject to the tax. This stepped-up basis would apply for purposes of the death tax, but not for purposes of computing gain on dispositions during life. This national appraisal date approach was used both when the income tax was introduced in 1913, and when the Canadian capital gains tax was introduced in 1971.⁸⁷

The basic problem with a national appraisal date, of course, is that for most assets (marketable securities being the important exception), determining value as of an appraisal date is difficult, expensive, uncertain, and contentious. Consider, for example, the question of when the appraisals would be done. Appraisals performed at or about the time of the effective date are more likely to be accurate than appraisals performed years later (after the taxpayer's death), but the appraisal industry could not possibly handle the job. It would be wasteful even to try, since appraisals of any assets not held until death would be for naught. And, even in a case in which the taxpayer did obtain a contemporaneous appraisal, the IRS could not be expected to review that appraisal until the taxpayer's death years later. As a practical matter then, the vast majority of effective date appraisals would have to be performed years after the fact, thus adding one more element of uncertainty and contention.⁸⁸

Additional complexity comes from the fact that a national appraisal date would *not* make the actual cost of pre-effective date assets irrelevant for purposes of the death tax. Fairness requires that an executor be allowed to use actual cost as basis, rather than appraisal date value, if the actual cost is higher.⁸⁹ Thus, the difficulties inherent in

87. I.R.C. § 1053; I.T.A.R. 26(3) (1991).

88. A retrospective valuation date appraisal, made upon a taxable disposition of property, is the standard practice in Canada. Interviews by the author with Revenue Canada officials in Ottawa (July 16 and 17, 1992).

89. This was the approach of Section 1023(h). It is also the rule in Canada for purposes of computing gain. I.T.A.R. 26(3). In Canada, if cost basis exceeds appraisal date value, appraisal date value must be used for purposes of computing loss. Adoption of the same rule in the United States would be consistent with the rationale of substantive transition relief: if pre-effective date increases in value should not be subject to capital gains tax when realized upon a post-effective

determining the cost of assets acquired before the effective date can arise under an appraisal date system.⁹⁰ In many cases, however, it will be clear that appraisal date value is greater than basis, so that no attempt to prove basis will be needed.

There is one important respect in which use of a national appraisal date actually might reduce disagreements between taxpayers and the IRS. If a taxpayer dies owning property eligible for an appraisal date basis, then both its appraisal date value and its death date value will be at issue. The taxpayer's incentive is to argue for a high appraisal date value and a low death date value; the government's incentive is the reverse. But to a large extent, arguments in favor of a high (or low) value at one date also will tend to support a high (or low) value at the other date. In some cases, this tendency may cause both parties to be more reasonable in their claims than under a system in which only the date of death value is at issue.⁹¹

Canada's experience of more than two decades with a national appraisal date system indicates such a system can work, although at considerable administrative expense.⁹² That does not mean, however, that it necessarily is worth the trouble. The supposed advantage of the appraisal date over other forms of transition relief is its theoretical appropriateness, but in practice an appraisal date system is only suitable to the extent the appraisals it produces are accurate. Given the difficulties in obtaining accurate appraisals, especially years after the fact, the ability of an appraisal date system to supply precisely the appropriate transition relief is largely illusory. Weighing this largely illusory advantage

date death, then pre-effective date declines in value should not be deductible when realized at death.

90. A related policy question is whether, if the appraisal date value exceeds cost basis, the executor can use the appraisal date value only for computing gain, or also for computing loss. Since the purpose of the appraisal date system is simply to prevent the taxation of pre-effective date appreciation, the logical answer is that cost basis should be used for computing loss (and if the date of death value is greater than cost basis but less than appraisal date value, there should be neither gain nor loss). This is the Canadian rule, I.T.A.R. 26(3), and it was also the approach of Section 1023(h). The proposed clean up of Section 1023 would have changed this rule to allow use of appraisal date value for computing both gain and loss, but this was in response to the argument that it was unduly burdensome to require heirs and beneficiaries to maintain dual basis records for inherited assets over many years—an argument not applicable if the gain is taxed at death. H.R. 4694 § 2(a) (proposed § 1023(d)).

91. This point is made by Graetz, 59 Va. L. Rev. at 857 (cited in note 84). Revenue Canada officials confirmed the existence of this effect. Interviews by author (cited in note 88).

92. Revenue Canada officials told the author that few, if any, appraisals were actually done on or near the valuation date. Rather, appraisals as of the valuation date were done retrospectively upon taxable dispositions of assets. Retrospective valuation of real estate has worked fairly well because Revenue Canada constructed a massive data base of real estate sales near the valuation date. Valuation of closely-held stock has been much more difficult. The officials thought, however, that this would be less of a problem in the United States, because of the greater number of comparable businesses. Interviews by author (cited in note 88).

against the very real administrative costs, an appraisal date system does not seem worthwhile.

2. Pro Rata Apportionment of Appreciation

The 1976 carryover basis legislation provided transition relief for appreciated assets (other than marketable securities and personal and household effects) by apportioning the appreciation in the property evenly over the total time the taxpayer owned the property, and stepping up the basis by the amount of the appreciation apportioned to the time before the effective date of the legislation. Suppose, for example, the following facts: A taxpayer died four years after the effective date, owning property he had acquired six years before the effective date; the cost of the property was two dollars, and its value at death was \$12. Of the \$10 appreciation, six dollars (sixty percent) would be apportioned to before the effective date, and basis would be stepped up to eight dollars.⁹³ Following the enactment of carryover basis, the apportionment method was criticized severely for failing to address the problem of proof of basis for pre-enactment assets.⁹⁴ Since the method requires knowledge of cost basis, it was said not to ease the need for difficult-to-find records of old transactions.⁹⁵ It even may have made the problem worse, by requiring knowledge of acquisition date as well as cost. In response to these criticisms, the defenders of carryover basis abandoned apportionment and proposed replacing it with transition relief based on the discount back method.⁹⁶

The objections to apportionment were overstated, given that it would provide substantial transition relief, even if no cost basis could be established, as long as an approximate acquisition date was known. Still, the relevance of cost basis meant that executors would be obliged to make the effort to ascertain it. In any event, the universal disfavor with which apportionment ultimately was viewed, by both attackers and defenders of carryover basis, indicates it would not be a politically feasible form of transition relief for a capital gains death tax.

Although history suggests the proof problems alone are enough to doom apportionment, there are also substantive objections. It is, of course, arbitrary to assume that assets appreciate as apportionment

93. This method was optional with the taxpayer under the British capital gains at death tax, for most types of assets. Graetz, 59 Va. L. Rev. at 855 (cited in note 84).

94. See, for example, Estate and Gift Tax Carryover Basis and Generation-Skipping Trust Provisions and Deductibility of Foreign Convention Expenses, Hearings Before the House Comm. on Ways and Means, 95th Cong., 1st Sess. 10 (1977) ("*Estate and Gift Tax Carryover Basis and Generation-Skipping*") (statement of John S. Pennell).

95. *Id.*

96. H.R. 4694 § 2(a) (proposed § 1023(d)(2)).

deems. The law could assume, instead, that assets appreciate in a compound manner, in the same way that interest accrues under the original issue discount rules,⁹⁷ with the taxpayer-unfavorable result that less appreciation would be allocated to early years and more to later years. This probably would be more accurate in the aggregate, but it still would be arbitrary with respect to particular assets.

As a response to the problem of arbitrariness, the law could give executors the option of using either the greater of the basis determined under apportionment or the actual value of the property as of the effective date.⁹⁸ In order to exercise the option wisely, however, the executor would need to know actual cost, date of acquisition, and appraisal date value. In terms of administrative burden, then, such an option would be the worst of all possible transition rules. Moreover, if there is an election provision, there will be ill-advised elections, which will mean unfairness if they cannot be revoked or administrative complexity if they can.⁹⁹

3. Discount Back

The final proposal of the proponents of carryover basis was to provide transition relief by giving property a basis determined by discounting back from the death value to the effective date at a statutorily provided rate of interest.¹⁰⁰ Suppose, for example, the following situation: The taxpayer died one year after the effective date, owning an asset which he owned as of the effective date; the asset was worth \$104 at his death, and the applicable interest rate was four percent. The discount back would produce a basis of \$100. The proposal also provided that the basis determined under the discount back method could not be less than twenty-five percent of the date of death value.¹⁰¹ This method would apply to all assets except marketable securities, which would be given a basis equal to their trading price as of the valuation date.¹⁰² Preferred stock ineligible to participate in corporate growth was treated

97. I.R.C. § 1272(a).

98. This was suggested by representatives of shopping center owners in the hearings on cleaning up carryover basis. *Estate and Gift Tax Carryover Basis and Generation-Skipping* at 129-31 (statement of the International Council of Shopping Centers). This option was available under the British capital gains death tax. Graetz, 59 Va. L. Rev. at 855-56.

99. Graetz reports that both the need to compute two different bases and the problem of ill-advised elections proved to be serious difficulties under the British tax. 59 Va. L. Rev. at 856.

100. H.R. 4694 § 2(a) (cited in note 32) (proposed § 1023(d)(2)).

101. *Id.* (proposed § 1023(d)(2)(B)).

102. Canada, which used value as of the national appraisal date as the transition rule for all assets, see note 89, nevertheless treated marketable securities somewhat differently from other assets. Although the valuation date for other assets (December 31, 1971) was announced in advance, the exact valuation date for marketable securities (December 22, 1971) was announced only after the end of the year. This secrecy was intended to prevent manipulation of the value of thinly

as a marketable security for this purpose because it was unreasonable to assume such stock would have appreciated over time.¹⁰³ In addition, the proposal would have created regulatory authority to treat "certain other property" like marketable securities, if as of the effective date the property "had a value which was readily ascertainable (whether because of a buy-sell agreement, a redemption value, or otherwise) by a method other than appraisal."¹⁰⁴

Under the discount back method there still would be the option of establishing a cost basis greater than the discount back basis, so even this approach would not eliminate totally problems of determining historical basis.¹⁰⁵ But the method enables the executor to establish a substantial basis in every case (assuming there is a percentage floor provided by the statute), without the need for any evidence of historical cost or acquisition date (except that the acquisition date must be before the effective date). In addition, as the proponents of the method (including the Treasury) pointed out, in most cases an executor can easily make an educated guess as to whether it is worth the trouble of trying to determine the cost basis (that is, as to whether there is a serious possibility that the cost basis significantly exceeds the discount back basis).¹⁰⁶

The method is undeniably somewhat arbitrary, both in its basic approach and in the choice of discount rate and minimum basis (if any). But it is also undeniably administrable, and it provides significant transition relief. If Congress is to provide substantive transition relief at all, discount back is the least objectionable means of doing so.

4. Complete Grandfathering

The most taxpayer-favorable transition relief would be complete grandfathering of any asset that a taxpayer owned on the effective date and continued to own until his death. Such assets would not be subject to the tax on gains at death, and would receive a fair market value basis at death. Some opponents of carryover basis suggested this when it ap-

traded shares through sales at artificial prices on the valuation date. Even with this technique, determining the appraisal date values of thinly traded marketable securities has been difficult.

103. H.R. 4694 § 2(a) (proposed § 1023(d)(4)).

104. *Id.* (proposed § 1023(d)(5)).

105. The method also could be combined with an option to use appraisal date value as basis, if higher than discount back basis. However, for the reasons discussed in text accompanying notes 98-99 (concerning an option to use either pro rata apportionment or appraisal date), that would not be a good idea.

106. Carryover Basis, Hearings Before the Subcomm. on Taxation and Debt Management, Comm. on Finance, 96th Cong., 1st Sess. 24 (1979) ("*Carryover Basis*") (statement of Donald C. Lubick, Assistant Secretary of Treasury for Tax Policy).

peared that carryover basis would survive in some form,¹⁰⁷ but it was adopted by proponents only as an unsuccessful last-minute desperation alternative to complete repeal.¹⁰⁸ It is, of course, extremely responsive to both the substantive and procedural claims for transition relief.¹⁰⁹

It is almost impossible, however, to imagine a convincing argument that *post*-effective date appreciation deserves to escape the tax, merely because the asset was acquired before the law was enacted. The horizontal inequity between the holders of grandfathered and non-grandfathered assets would be glaring. In fact, the proponents of complete grandfathering did not seriously attempt to justify such a sweeping exemption on any grounds other than simplicity of administration. Discount back transition relief is nearly as easy to administer, however, without being so bizarrely generous. In addition, grandfathering creates a severe lock-in effect for the grandfathered assets.¹¹⁰ Finally, grandfathering invites the abuse of "aging" assets to exploit the loophole. For example, a taxpayer might transfer (in a nonrecognition transaction) an appreciated nongrandfathered asset to a corporation controlled by the taxpayer, the stock of which is a grandfathered asset.¹¹¹ Absent effective anti-abuse rules, this would convert the non-grandfathered asset into a grandfathered asset. It might not be impossible for Congress to write and for the IRS to enforce anti-aging rules, but it certainly would not be easy.

A strong believer in taxing capital gains at death might accept complete grandfathering as the only way of getting the reform enacted,¹¹² and an opponent might accept it as the next best thing to no reform at all. As a political compromise, it is not unlikely. On the merits, however, it is significantly inferior to the discount back approach.

107. *Estate and Gift Tax Carryover Basis and Generation-Skipping* at 22 (cited in note 94) (letter of Frederick S. Lane); *id.* at 84 (statement of Frank S. Berall).

108. 126 Cong. Rec. H12149 (daily ed. Dec. 18, 1979) (statement of Rep. Fisher).

109. However, as explained in text accompanying notes 68-72, it does not eliminate the price change issue.

110. The lock-in would be worse than under current law, because one could not sell the grandfathered asset and replace it with another asset whose future appreciation would be eligible for a tax-free basis step-up at death.

111. The abuse is most apparent if the asset is appreciated when it is transferred to the corporation, but even if the asset is not appreciated at that time, the transfer makes future appreciation in the asset eligible for grandfathering, which it should not be.

112. Of course, it would decrease significantly the revenue from taxing gains at death for many years. If the tax were part of a revenue neutral package (including a decrease in the capital gains rate or in the estate tax), grandfathering would mean the taxpayer-favorable part of the package would be much less favorable.

5. Phased-in Implementation

The new tax could be implemented gradually—for example, only 20% of gain realized at death might be taxed during the first year after enactment, 40% during the second year, and so on. The 1963 Treasury proposal to tax gains at death included a proposal for phased-in implementation.¹¹³ Whatever may be the merits of this form of transition relief in other circumstances,¹¹⁴ it makes little sense here. It is unresponsive to the procedural claim for transition relief, because it requires proof of basis in every case.¹¹⁵ It also is unresponsive to the substantive argument that pre-enactment appreciation should not be taxed, because it makes no attempt to distinguish between pre- and post-enactment appreciation. To the extent the tax has been phased in, it taxes both.

IV. HOW SERIOUS ARE PROOF OF BASIS PROBLEMS?

A. *The Flow of the Argument*

During the hearings that led to the repeal of carryover basis, many opponents of Section 1023 cited the need to determine a decedent's basis in his assets as the single biggest practical problem with carryover basis—even for assets acquired after the effective date of the legislation.¹¹⁶ Many argued the problem was so serious as to make carryover basis impractical. If they were right, then taxing capital gains at death—which also requires determination of a decedent's asset basis—is impractical for the same reason.

The obvious response to this argument is that dispositions of assets during life always have required proof of basis,¹¹⁷ and that the system has proved workable. If determining basis on dispositions during life is practical, determining basis at death also must be practical.

This response was met in turn with several responses. Some argued that determining basis of assets disposed of during life was practical only because the taxpayer was available to help reconstruct basis

113. *President's 1963 Tax Message* at 140 (cited in note 25).

114. For examples of its use, see the 1986 Tax Reform Act's transition rules for the disallowance of passive losses and investment interest expense. I.R.C. §§ 469(m)(2), 163(d)(6).

115. Graetz, 59 Va. L. Rev. at 854-55 (cited in note 84). It does lessen the consequences of failure to prove basis for deaths during the phase-in period, however.

116. The most complete development of this argument was by the American Bankers Association. See, for example, *Carryover Basis Provisions* at 79-101 (cited in note 34) (giving the results of a survey of banks on the difficulties of proving basis).

117. In the case of most dispositions, proof of basis is needed to compute gain or loss realized under Section 1001. In the case of gifts, proof of basis is needed to inform the donee of his basis under Section 1015.

records, and that determining basis after the taxpayer's death thus would be impractical.¹¹⁸ This is not persuasive. It is not plausible that taxpayers can keep large quantities of complex basis records in their heads, so that the information is available during their lives, but disappears at death.¹¹⁹ The overwhelming bulk of important basis information is in forms that do not die with the taxpayer.

There are, however, three somewhat more persuasive responses. First, it may be that taxpayers take proof of basis problems into account in deciding which assets to hold until death, so that the assets which pass at death tend to be those with the worst proof of basis problems.¹²⁰ Second, proof of basis problems that may be manageable when only a few assets are disposed of in any given year during life, may become overwhelming when all assets are deemed to have been disposed of at death. Third, a taxpayer who sells an asset with an unprovable basis during life can choose to accept gracefully a zero basis, but an executor faced with a deemed disposition of the same asset at death might be under a fiduciary obligation to attempt to establish a basis.¹²¹

There is a reply to these responses: that most of the proof of basis problems that would be encountered by executors of decedents dying today, if those executors were required to prove basis, would be due to decedents having failed to keep adequate basis records in reliance on Section 1014. One can criticize such reliance, because a taxpayer can never be certain he will be able to hold a particular asset until death. Still, it is understandable that in many cases a taxpayer would expect to hold certain assets until death, and therefore would fail to keep basis records for those assets. But if a gains tax were enacted, this reason for failing to keep basis records (for significant assets acquired after the effective date of the new law) would disappear, with two consequences: most taxpayers would begin to keep good basis records for all significant assets, and those who did not would deserve the consequence of a zero basis upon a deemed disposition at death.¹²²

118. *Carryover Basis Provisions* at 161, 173 (statements of the American Bar Association).

119. Further, even if a taxpayer claimed to remember such information, it is unlikely that the IRS or the courts would believe him.

120. The case of taxpayers holding assets until death in order to avoid proof of basis problems is a seldom-noted aspect of the lock-in effect of Section 1014.

121. It may be true that a fiduciary could not give up as quickly as the taxpayer himself might, but there would come a point (probably fairly quickly) at which it is obvious that basis could not be established without unreasonable expense. At that point, it would be the executor's fiduciary duty *not* to attempt to establish basis.

122. Although they would merit that result, they still might avoid it under a rule allowing a basis equal to fair market value at acquisition date.

B. Some Comments on the Arguments

After having read hundreds of pages of wildly conflicting testimony on the proof of basis problems of carryover basis under Section 1023, it still is difficult to judge the seriousness of the problem. Some witnesses claimed proof of basis problems were manageable; others claimed the problems made the system unworkable. It is true, as some legislators enjoyed pointing out, that most of the assertions that the problems were not serious did not come from the workers in the trenches.¹²³ Rather, they came mostly from academics and from elite practitioners (especially former high-ranking government tax officials) who did not deal with such mundane problems on a regular basis.¹²⁴

By contrast, the claims that proof problems were severe were better documented and came more from those with first-hand experience. Particularly impressive in scope was the American Bankers Association's survey of its members, which generated 200 replies representing experience with more than 5000 estates.¹²⁵ The survey summary indicated that proof of basis problems were not limited to esoteric assets or careless taxpayers, and that proof of basis was difficult or impossible for a substantial part of the assets in between one-third and two-thirds of all estates.¹²⁶ Problems tended to be most severe in smaller estates.¹²⁷ The survey revealed that bases of chattels, intangibles, and improvements to real estate were especially problematic, but that even marketable securities frequently presented difficulties.¹²⁸ The survey summary estimated that carryover basis increased the total bank time required to administer estates by twenty percent.¹²⁹

There are reasons, however, to treat the survey results with some skepticism. First, they relate primarily to assets acquired before Section 1023 was enacted.¹³⁰ Therefore, they do not indicate whether record-

123. During the 1979 hearings, Rep. Frenzel pointedly asked three former government tax officials, who had testified that proof of basis problems were manageable, how many farmers they represented in their practice. *Carryover Basis Provisions* at 144 (cited in note 34). Rep. Conable remarked that their testimony "illustrat[ed] the old principle, once a taxman always a taxman." *Id.*

124. Witnesses in this category included Donald C. Alexander, *id.* at 143; Sheldon S. Cohen, *id.* at 24; James B. Lewis, *id.* at 133; and John S. Nolan, *id.* at 102. There were, however, a few other witnesses in private practice who said that proof of basis problems were exaggerated. These included Bernard Barnett, *id.* at 267, and David E. Watts, *id.* at 249.

125. *Id.* at 79-101.

126. *Id.* at 80.

127. *Id.*

128. *Id.* at 47 (discussing intangibles and marketable securities); *id.* at 80 (discussing chattels and real estate improvements).

129. *Id.* at 96.

130. The pro rata allocation transition rule of Section 1023(h)(2) required knowledge of the cost basis of pre-1976 assets.

keeping would have improved for assets acquired after the effective date. Second, the information came from an organization strongly opposed to carryover basis, thus raising the question of whether the information had been slanted to support the organization's agenda.¹³¹

A fair overall evaluation of proof of basis problems at death probably would be along the following lines. Certainly the need to establish basis at death will raise significant problems in some cases, but it should be possible to muddle through satisfactorily, especially with respect to the investment assets containing most of the appreciation. Even if the twenty percent of additional estate administration time claimed by the American Bankers Association was not inflated, it is not horrendous for the early experience with proving basis at death. That figure could be expected to drop substantially over time, as more and more assets held at death were acquired after the effective date of the new legislation. (It would not be so high even at the beginning, if the transition rule did not require proof of basis for pre-effective date assets.) The bankers nevertheless claimed that anyone who thought record-keeping would improve dramatically after the change in the law was living in a "dream world."¹³² The most basic response is that tax policy should not be held hostage to taxpayers' refusal to comply with reasonable record-keeping rules. If taxing gains at death makes good policy sense, and if the record-keeping burden is not unreasonable, then the refusal of some taxpayers to keep records should not be a bar to changing the law. If decedents do not leave their executors adequate basis records, even after notice that records will be required, there is nothing wrong with computing their gain using zero bases. It also is worth noting the great improvements since the late 1970s in the availability, cost, and user-friendliness of computer technology; software could be developed quickly to make basis record-keeping much easier than it would have been in the carryover basis era.

The Canadian experience over the past two decades with taxing capital gains at death has been that establishing basis is simply not a major problem. The Treasury reported this experience to Congress dur-

131. It is interesting that the American Bankers Association's position on the AET changed from grudging acceptance in 1977 as "the most satisfactory change in the basis rule if a change from prior law must continue in the future," *Estate and Gift Tax Carryover Basis and Generation-Skipping* at 50 (cited in note 94), to outright opposition in 1979, *id.* at 77. The opposition in 1979 to any proposal requiring proof of basis at death *might* have been due to unexpectedly bad experience with proof of basis problems under carryover basis, *id.* at 80 (stating problems were worse than anticipated), but it also might have been a response to a change in the political climate. That is, the bankers may have accepted reluctantly the AET when they thought some sort of change in the treatment of gains at death was inevitable, but they may have opposed it in 1979 because they saw a real opportunity to return to total forgiveness of gains tax at death.

132. *Id.* at 42.

ing the hearings on carryover basis,¹³³ and Revenue Canada officials confirmed this account to the author in 1992.¹³⁴ The officials reported significant asset valuation problems, of the sort common in the United States in the administration of the estate tax, but they stated that proof of basis problems were trivial in comparison. In fact, they found it difficult to believe that alleged proof of basis problems played a leading role in the repeal of carryover basis.¹³⁵ In light of the history of the death gains tax administration in Canada, it is difficult to take seriously the argument that problems of basis determination make a death gains tax impractical.

C. Limited Responses to Proof of Basis Problems

Although proof of basis problems do not make a death gains tax impractical, they do call for certain limited legislative responses, noted below.

1. Value at Acquisition Alternative

Revenue Canada officials indicated that it was sometimes necessary to arrive at a basis figure by estimating the value of an asset as of its acquisition date.¹³⁶ This confirms the desirability of allowing value at acquisition as basis, when cost cannot be established.¹³⁷

2. Allowing Estimates

An executor's inability to establish cost basis to the exact dollar should not lead to a zero basis if he can establish approximate cost with reasonable accuracy. One would hope the IRS would administer the law in this way even without explicit guidance, but it could not hurt to include a statement in the legislative history, or even in the statute itself, that the IRS and the courts must accept reasonable estimates of basis.¹³⁸ One way of making this point would be to say that the spirit of the *Cohan* rule¹³⁹—allowing taxpayers to deduct estimated business en-

133. *Id.* at 12-13 (statement of Donald C. Lubick).

134. Interviews by author (cited in note 88).

135. *Id.*

136. *Id.*

137. I.R.C. Section 1023(g)(3) provided for this alternative, and I.R.C. Section 1015(a) has long included a similar rule for determining the basis of property acquired by gift.

138. Consider the following comment of Rep. Conable and the response of James B. Lewis, in *Estate and Gift Tax Carryover Basis and Generation-Skipping* at 243 (cited in note 94): "My impression is, if we were relying on the goodwill of the IRS to assume a reasonable basis for something, we would be relying on something that was ephemeral indeed."

"I think that is right unless you get a real statutory foundation there."

139. *Cohan v. Commissioner*, 39 F.2d 540, 543-44 (2d Cir. 1930).

tainment expenses despite the absence of detailed records—applies with respect to proof of basis at death.¹⁴⁰

3. Nonbusiness Tangible Personal Property

This is probably the area in which the greatest proof problems can be expected. As discussed elsewhere in this Article,¹⁴¹ a liberal exemption (either aggregate, or item-by-item) should obviate most of these problems. As a practical matter, in any case in which: (a) the fair market value at death is great enough to exceed significantly the exemption amount, and (b) basis cannot be established, basis is likely to be very low. This is due to the fact that even for nonbusiness tangible personal property, taxpayers are likely to keep records of expensive purchases. Inability to prove a trivially low basis has, of course, no significant tax consequences. In the hearings on carryover basis, one witness lamented the fact that his executor probably would be unable to prove his \$50 basis in a highly appreciated painting.¹⁴² Neither the witness nor any of the legislators noted that the tax difference between a zero basis and a \$50 basis is trivial (\$14, under a twenty-eight percent capital gains tax).

4. Farms and Closely-Held Businesses

The proof of basis issues for farms and small businesses differ somewhat, depending on the form of ownership of the business. If it is in C corporation form, there is probably little at stake in proof of basis, because stockholders will tend to have very low bases in closely-held C corporations financed with retained earnings over many years.¹⁴³ In addition, as witnesses on carryover basis noted, generally basis can be “backed out” from corporate books (kept on an historical cost basis) and perhaps old income tax returns.¹⁴⁴

If the farm or business is a sole proprietorship, most basis information should be readily available. The basis of depreciable assets must be known in order to claim depreciation deductions, and the basis of inventory must be known in order to compute income from anticipated sales. Given the generous expensing rules for farms,¹⁴⁵ the basis of most other assets will be zero.

140. Note, however, that the *Cohan* rule was overruled in the context in which it was developed. I.R.C. § 274(d).

141. See text accompanying notes 254-68.

142. *Carryover Basis Provisions* at 260 (cited in note 34) (statement of Billy R. Carter).

143. Basis may not be low if the stock recently was inherited by the decedent, but in that case records of the previous estate tax value of the stock should be readily available.

144. *Carryover Basis Provisions* at 106 (statement of John S. Nolan).

145. Treas. Reg. § 1.162-12 (1992) (all Treasury Regulation citations are to the current Treasury Regulations).

If the farm or business is owned as a pass-through entity (partnership or S corporation), partner or shareholder basis records must be maintained in order to determine the tax consequences of distributions to the owners.¹⁴⁶ Ordinarily basis can be determined easily from the information on the owner's K-1 forms.

In short, any argument against taxing gains at death, grounded on basis record-keeping difficulties for farms and small businesses, is completely unpersuasive. It is unacceptable for any *business* to argue it should not be expected to keep adequate cost records. The real argument against taxing farm and small business appreciation at death is substantive; the alleged record-keeping problems are a smokescreen.

5. Basis Allocation for Related Assets

In some cases involving a set of related assets, such as a stamp or coin collection, it may be practical to determine the total basis of the set (that is, the taxpayer may have kept track of the total amount spent on the collection), but it may be difficult or impossible to determine the basis of individual assets within the set. The same problem can arise with investments in stocks or mutual funds under a dividend reinvestment plan. This was a significant problem under carryover basis. Elective averaging of basis among related assets was suggested as a relief measure,¹⁴⁷ but even then a conscientious fiduciary would have to attempt actual cost allocations (when that would serve to allocate higher basis to assets likely to be sold first). This is one of the situations in which taxing gains at death is easier to administer than carryover basis. As long as all capital gain at death is treated as long term,¹⁴⁸ and all gain or loss is recognized at death, it makes no practical difference how the total basis of a group of assets is allocated within the group. Whatever the allocation, the net capital gain or loss will be the same. Thus, taxing gains at death eliminates the problem of allocating basis within a group of related assets.¹⁴⁹

146. I.R.C. §§ 731, 1368.

147. *Background and Issues* at 22 (cited in note 30); H.R. 4694 § 2(a) (proposed § 1023(e)(1)).

148. All capital gains and losses at death should be treated as long term, regardless of the actual holding periods. This was a feature of the 1969 Treasury proposal. Ways and Means Comm., *Tax Reform Studies and Proposals*, 91st Cong., 1st Sess., 340 (1969) ("*Tax Reform Studies and Proposals*").

149. This would not be true if some of the assets went to the surviving spouse (thus qualifying for carryover basis) while other assets were taxed at death. It is always, however, within the power of the decedent or the executor to avoid this problem simply by providing that the surviving spouse receive either all or none of the assets within the group.

V. THE STRUCTURE OF A GAINS TAX AT DEATH

This Article now considers a number of important policy choices and technical issues that will arise in designing a gains tax at death.

A. Exemptions Based on Destinations of Assets

1. Should There Be a Marital Exemption?

During hearings on the adoption of carryover basis, a number of witnesses advised Congress that taxation of capital gains at death with an exemption for marital bequests would be as complicated as—or even worse than—carryover basis.¹⁵⁰ Much of the alleged complexity of carryover basis came from the fact that asset bases would remain uncertain until a bequest to a surviving spouse had been fully funded. This is because assets that qualified for the estate tax marital deduction were not entitled to share in the basis increase on account of death taxes.¹⁵¹ A tax on capital gains at death with a marital exemption—in effect a hybrid system, with tax at death for some assets and carryover basis for others—would generate complexity and uncertainty in the same way. Until the funding of the marital bequest was completed, the income tax liability generated by the death could not be calculated.¹⁵² And because the income tax liability would be deductible under the estate tax, this uncertainty also would delay the determination of the estate tax liability.¹⁵³ In order to avoid this complication, the “additional estate tax”

150. *Federal Estate and Gift Taxes* at 1211, 1218-19 (cited in note 38) (statement of Richard Covey); *Estate and Gift Tax Carryover Basis and Generation-Skipping* at 237 (cited in note 94) (statement of James B. Lewis).

151. I.R.C. §§ 1023(c), (f)(4), repealed by the Windfall Profit Tax § 401(a), Pub. L. No. 96-223, (1980). Clean up would have addressed this problem by allowing marital deduction property to share in the death tax basis increase. H.R. 4694 § 2(a) (proposed § 1023(c)(4)). This solution was criticized on equity grounds—i.e., that property which did not bear a death tax burden did not deserve a death tax basis increase. *Carryover Basis Provisions* at 50-51 (cited in note 34) (statement of American Bankers Association).

152. Although the estate tax marital deduction also depends on what is actually transferred from the estate to the surviving spouse, only the *values* of the assets transferred are relevant to the tax liability, not their bases. Thus, under present law estate tax liability can be computed without knowing precisely which assets will go to the surviving spouse, as long as the total value going to the surviving spouse is known.

153. If the marital bequest is to be determined under a zero-estate tax formula, a marital exemption from the gains tax is somewhat complex even if all assets have a uniform basis. The complication is that of interdependent calculations: the amount bequeathed to the surviving spouse depends on the amount of the gains tax liability, and the amount of the gains tax liability depends on the amount bequeathed to the surviving spouse. For an example of this criticism, see *Estate and Gift Taxes, Hearings Before the Comm. on Ways and Means, 94th Cong., 2d Sess. 100 (1976) (“Estate and Gift Tax Hearings”)* (statement of American Bankers Association). In fact, however, the computation required is not particularly difficult. Suppose, for example, the following: the estate consists of capital assets with a total value of \$1,000,000 and a basis of zero; the

(AET) reluctantly advanced by the American Bankers Association¹⁵⁴—really a low-rate income tax (not deductible against the regular estate tax) imposed on capital gains at death—did *not* provide for a marital exemption.¹⁵⁵

In light of the unlimited marital deduction in the estate and gift taxes,¹⁵⁶ and the nonrecognition rule of Section 1041 on lifetime transfers between spouses,¹⁵⁷ it appears there is a robust political consensus that transfers between spouses—either inter vivos or testamentary—are not appropriate occasions for the imposition of tax.¹⁵⁸ If this consensus exists, then a tax on capital gains at death is politically possible only if the administrative complexities of a marital exemption can be overcome.¹⁵⁹ Even putting politics aside, the idea that transfers between

estate tax exemption amount is \$600,000; the capital gains rate is 20%; and the bequest to the surviving spouse is the minimum amount necessary to reduce the estate tax liability to zero, taking into account the estate tax exemption amount and the estate tax deduction for the capital gains tax liability created by death. The amount of the marital bequest depends on the capital gains tax, and the amount of the gains tax depends on the amount of the bequest. The formula to determine the amount of the bequest is: $\$1,000,000 - 0.20(\$1,000,000 - X) - X = \$600,000$. This reduces to $X = \$250,000$. A marital bequest of \$250,000 results in a capital gains tax of \$150,000 on gain of \$750,000, and together the marital deduction and the gains tax liability deduction reduce the taxable estate to the \$600,000 exemption amount.

Of course, it would not be quite that simple in real life. Complications could arise for various reasons, including the strong probability that the assets in an estate will not have a uniform basis (unless the law requires basis reallocation). Even with complications, however, this is hardly calculus. Although the calculations may be daunting to some executors (and even some lawyers), they should not be challenging to any competent accountant. Moreover, it is likely that computer software to make the task easier would appear quickly.

154. For details of the proposal, see *id.* at 62-63, 90-113. The tax rate under the AET would have been significantly lower than the rate imposed on capital gains realized during life. This difference was intended to compensate for the fact that the AET was not deductible against the regular estate tax, rather than to compensate for the lack of a marital exemption. *Id.* at 105-07.

155. Michael Graetz proposed a system with a marital exemption for inter vivos spousal transfers, but not for bequests. Graetz, 59 Va. L. Rev. at 845 (cited in note 84). As with the AET, this conflicts with the consensus that has developed since the 1970s that transfers between spouses, during life or at death, are not appropriate occasions for tax. In addition, it would require some sort of anti-avoidance provision to deal with transfers in contemplation of death, which could be a substantial complication.

156. See I.R.C. §§ 2056, 2523.

157. Or even between former spouses, if incident to a divorce. I.R.C. § 1041(a)(2).

158. A marital exemption is assumed by the Congressional Budget Office in *Reducing the Deficit* at 315 (cited in note 14).

159. A possible response to the conclusion that allowing a marital exemption is theoretically proper but too difficult to administer, would be to enact the tax without a marital exemption, but with a lower rate than for other capital gains to compensate for the lack of an exemption. (This lower rate thus would be conceptually different from the lower rate under the AET, which was designed to compensate for the nondeductibility against the estate tax of the AET tax.) This response is unappealing. If one believes that allowing a marital deduction is conceptually correct, this trade-off may be fair from the government's standpoint, but it is not fair to individual estates: the detriment of no exemption is borne entirely by estates with surviving spouse beneficiaries, while the benefit of the lower rate goes largely to other estates.

spouses should be ignored for tax purposes—i.e., that a married couple (or a surviving spouse and an estate) generally should be treated as a single entity for tax purposes—has considerable appeal.¹⁶⁰

There is, of course, significant revenue loss generated by the deferral caused by a marital exemption. The median time that widows survive their husbands is about eleven years.¹⁶¹ If, however, one believes that allowing a marital exemption is conceptually correct, one views this deferral as simply part of the proper structure of the tax, rather than as a revenue loss. In any event, the revenue loss is basically a transition issue, since eventually the tax deferred on transfers to surviving spouses will be roughly offset by gains realized on the deaths of other widows and widowers.

The crucial question, then, is whether the critics were right in claiming that a capital gains death tax with a marital exemption would be unworkably complex. At the outset, it is important to note that a capital gains death tax with a marital exemption certainly would not involve *all* the complexities of carryover basis under Section 1023. Property passing to a surviving spouse under the capital gains death tax would receive a pure carryover basis, without any minimum basis adjustment,¹⁶² with no death tax adjustment,¹⁶³ and with no fresh start adjustment.¹⁶⁴ In addition, the carryover basis records would need to be maintained only until the death of the surviving spouse, rather than over many generations, as could be required under Section 1023.

In many ways, then, a marital exemption to the tax on gains at death would be much less complex than universal carryover basis. There remains, however, the one important complication that the two systems do share: the inability to determine the tax consequences of the decedent's death until the marital bequest has been fully funded. Even as to this problem, there is an important difference between Section

160. However, the fact that property passing at death to a surviving spouse receives a fair market value basis under current law is inconsistent with the premise that a married couple should be treated as a single entity. This point is made in Harry L. Gutman, *Reforming Federal Wealth Transfer Taxes After ERTA*, 69 Va. L. Rev. 1183, 1235-36 (1983).

161. *Tax Reform Studies and Proposals* at 360 (cited in note 148). At a discount rate of seven percent or higher, deferring a tax for 11 years reduces the present value of the tax burden to less than half of the stated amount (at a seven percent discount rate, the present value of a dollar due in 11 years is 47.5 cents).

162. Whatever minimum basis or similar relief was provided by the tax with respect to the exempt property should be determined when and if the surviving spouse died owning the property. See text accompanying notes 250-53.

163. The property passing to the surviving spouse would have generated no estate tax, and so would receive no basis adjustment.

164. A fresh start adjustment would be appropriate upon the death of the surviving spouse, if the two spouses together had held the property since before the effective date of the tax. There would be no need to make the adjustment, however, until the surviving spouse's death.

1023 and a tax at death. The problem under Section 1023 was that of a "suspended basis" when an asset was sold during the administration of the estate. The sale was clearly an event triggering recognition of gain or loss, but the amount of gain or loss could not be computed because the basis of the asset depended on events yet to occur (the funding of the marital bequest). This created two problems. First, it was difficult for the executor to make an informed decision about which assets to sell when the bases of the assets were unknown. Second, the fact that later events would affect the bases of assets sold made numerous amended returns and refund claims inevitable.¹⁶⁵

By contrast, under a capital gains tax at death with a marital exemption, the uncertainty is not as to the basis of assets sold, but as to which assets are subject to gain (or loss) recognition at death.¹⁶⁶ As long as the marital bequest is fully funded before the income tax and estate tax returns are due, there is no problem. This differs from Section 1023, under which there was a problem any time an asset was sold before the marital bequest was funded.

This suggests two possible approaches. The first approach would permit a decedent's return to claim the exemption only for assets actually distributed to the surviving spouse by the time the return is filed, but with the return date late enough that distribution by the due date is practical. The final income tax return, and the estate tax return, should be due long enough after death that in the vast majority of cases the marital bequest can be fully funded by the time the returns are due. If (as seems likely) the current estate tax return due date of nine months after death¹⁶⁷ is inadequate for that purpose, practitioner groups should present the evidence of that inadequacy to Congress and suggest what due date would be appropriate. In the unusual case in which funding cannot be completed before the due date, a reasonable

165. The funding of the marital bequest was not the only later event that could affect the basis of assets sold. Because of the statute's rules for the allocation of the death tax basis adjustment among assets, a change on audit in the estate tax value of *any* asset could change the Section 1023 basis of every asset. See I.R.C. § 1023(c),(e).

166. James B. Lewis remarked that taxation of gains at death, with a marital exemption, would present executors with the problem of "unknown basis" of assets prior to the funding of the marital bequest. *Estate and Gift Tax Carryover Basis and Generation-Skipping* at 237 (cited in note 94). If he meant that executors would not know the basis of any assets sold during the administration of the estate, he was not correct (at least with respect to the marital exemption proposed in this Article). The marital exemption would apply only to property received *in kind* by the surviving spouse (or a qualifying spousal trust). Any asset sold by the executor during the administration of the estate will have been subject to the gains tax at death (even if the proceeds of the sale are used to fund the marital bequest), and so will have a basis equal to fair market value at death for purposes of determining gain or loss on the executor's sale. Thus, the very fact of the sale by the executor determines that the property does not qualify for the marital exemption.

167. I.R.C. § 6075(a).

extension of time to file should be granted. A first extension might be granted automatically, with additional extensions granted upon a showing of reasonable cause. If the six month limitation on extensions imposed by Section 6081 is considered inadequate for this purpose, Congress could enact a special longer limitation. Interest would run, of course, from the original due date of the returns. As an alternative to the above, Congress could address the problem entirely with extension provisions, rather than with a change in the basic due date of nine months after death. Under this alternative, interest would begin to run after nine months, rather than at some later point.

Under either of the above variations, there seldom should be a case in which the returns must be filed before the marital bequest is fully funded. If such a case nevertheless should arise, the income and estate taxes both should be computed by exempting from the income tax only those assets actually distributed to the surviving spouse by the time the return is filed. If additional assets are distributed before the expiration of the statute of limitations, amended returns could be filed.¹⁶⁸

The other possible approach would be to permit returns to claim tentative exemptions for assets that the executor reasonably anticipates eventually will be distributed to the surviving spouse (within some specified time, such as three years after the date of death). If the actual distribution differs from that anticipated by the return, an amended return would be required. This technique—of allowing returns to be filed in anticipation of an act qualifying a gain for nonrecognition—is already in use with respect to involuntary conversions and replacements of personal residences.¹⁶⁹

Under either of these approaches—delayed return filing or filing based on anticipated distributions—a death gains tax with a marital deduction seems workable. Moreover, such a system has proven itself workable in twenty years of Canadian experience. The Canadian tax on capital gains at death exempts appreciation in marital bequests, and uses a “wait and see” approach to determine what property qualifies for the exemption.¹⁷⁰ The exemption applies to property that has become “indefeasibly vested” in the surviving spouse within thirty-six months

168. Distribution of additional appreciated property to the surviving spouse would increase the income tax liability and (by a lesser amount) decrease the estate tax liability.

169. With respect to involuntary conversions, see I.R.C. § 1033(a)(2)(C) and Treas. Reg. § 1.1033(a)-2(c)(2). With respect to personal residences, see I.R.C. § 1034(j), and instructions for I.R.S. Form 2119. See also I.R.C. § 302(c)(2)(A) (concerning the consequences of acquiring a prohibited interest in a corporation within 10 years of a stock redemption for which family attribution was waived).

170. Since Canada does not have an estate tax, only the determination of the income tax liability is suspended until the funding of the marital bequest.

after the death of the taxpayer.¹⁷¹ Revenue Canada officials report the system works without significant difficulty, although there has been some dispute as to the meaning of "indefeasibly vested" under particular circumstances.¹⁷²

In short, the need to wait until the estate's assets have been distributed to determine the income tax and estate tax liabilities does not seem to be an insuperable objection to allowing a marital exemption to the gains tax. There is, however, another possible objection: a gains tax with a marital exemption inappropriately gives the executor incentive to transfer low basis assets to the surviving spouse and high basis assets to other beneficiaries, in order to defer as much gains tax as possible.

This incentive could be considered inappropriate for two reasons. First, of course, there is the revenue loss. Although the loss would not be trivial, the tax avoided is deferred only until the death of the surviving spouse. Second, tax considerations might encourage funding of the marital bequest with low basis assets, when some other method of funding the bequest would make better nontax sense. The 1969 Treasury proposal took this second concern seriously enough to include a complicated method of addressing it.¹⁷³ Under the proposal, if a decedent left some but not all of his estate to his surviving spouse, his total basis in all his assets was allocated among all his assets in accordance with their relative fair market values. Thus, every asset would bear the same ratio of appreciation to value, and funding a marital bequest at any given dollar amount would result in a marital exemption not dependent on the particular assets used to fund the bequest.

Reallocation would be tremendously complex in practice. The reallocated basis of every asset would depend on the *basis and value* of every other asset. Uncertainty concerning either the basis or the value of even one significant asset in the estate would create uncertainty as to the gain or loss recognized on every nonmarital bequest asset and uncertainty as to the basis of every marital bequest asset. Amended returns and claims for refund—both income tax and estate tax—would become the norm. The complexity and uncertainty would far exceed that under a system with a marital exemption but without basis reallocation.

171. Revenue Canada, upon written request, may extend the time period as it deems reasonable. Income Tax Act, § 70(6) (1992). For deaths before 1985, the normal period for vesting was 15 months. IT-444R § 3(b) (1987).

172. The issue is addressed in IT-449R (1987).

173. *Tax Reform Studies and Proposals* at 338, 344-46 (cited in note 148). The proposal justifies its basis reallocation rules solely on the grounds of not distorting the distribution of assets among beneficiaries; it does not mention revenue concerns.

Canada has chosen not to require basis reallocation. Apparently Canadian executors have been able to balance the tax and nontax considerations in deciding how to fund marital bequests.¹⁷⁴ American executors should be equally capable of handling such situations. As for the revenue loss from the deferral opportunities, it seems an inevitable part of a workable gains tax at death with a marital exemption.

In sum, a tax on capital gains at death should include an exemption for gain in assets actually used to fund marital bequests, basis reallocation should not be used, and return dates and extensions should be designed keeping in mind the time required to fund marital bequests (or returns should be allowed to anticipate future funding).

2. How Should Charitable Bequests of Appreciated Property Be Treated?

Under current law, a taxpayer who makes a charitable donation during life of appreciated property generally may take an income tax deduction for the fair market value of the property, despite not having to recognize gain on the disposition.¹⁷⁵ The rule permitting deductibility of an amount never taken into income is inconsistent with general income tax principles, but has survived as an incentive for charitable donations.¹⁷⁶ Under current law, a charitable bequest generates no income tax deduction, but is deductible under the estate tax.¹⁷⁷ If the property bequeathed to charity is appreciated, the appreciation is not, of course, subject to income tax.

If capital gains are to be taxed at death, the issue arises as to whether gain should be taxed on property left to charity.¹⁷⁸ The resolution of this issue should be consistent with the treatment of lifetime charitable gifts of appreciated property. If the gain is not taxed when the property is donated by a living taxpayer, it also should not be taxed when the donation is made at death. On the other hand, in those situations in which present law denies a charitable deduction for lifetime donations of appreciation (the equivalent of allowing a deduction for the appreciation, but at the tax cost of taking the appreciation into in-

174. If there is any question under applicable state law concerning the executor's discretion to balance these tax and nontax considerations, the will might specifically confer such discretion.

175. Section 170(e) contains exceptions to the general rule of fair market value deductibility.

176. However, Section 57(a)(6) treats the charitable deduction of unrecognized appreciation as an item of tax preference for purposes of the alternative minimum tax.

177. I.R.C. § 2055.

178. A charitable exemption is assumed by the Congressional Budget Office in *Reducing the Deficit* at 315 (cited in note 14).

come)¹⁷⁹ the appreciation in a charitable bequest should be taxed at death.¹⁸⁰

In those situations in which gain is not recognized on charitable bequests, issues arise analogous to those created by a marital exemption: (a) the problem of what, if anything, should be done about the incentive the charitable exemption gives the executor to satisfy the charitable bequest with low basis assets, and (b) the administrative problem of needing to wait and see what assets fund the charitable bequest (in the case of a nonspecific bequest) before the income tax and estate tax liabilities can be determined.

The problem of selection of low basis assets might be viewed as more serious in terms of revenue loss than the equivalent problem under the marital exemption, because gain that escapes tax under the charitable exemption is permanently forgiven, rather than merely deferred. On the other hand, it is less serious in the sense that total charitable bequests are far smaller than total marital bequests.¹⁸¹ The basic point, however, is that Congress is willing to permit the revenue loss caused by donor selection of low basis assets in the case of lifetime contributions, and as long as that remains true there is no good reason for policing basis selectivity by executors. The other concern about basis selectivity in the marital exemption context (that it might lead to transfers of inappropriate assets to the surviving spouse) has little relevance to the charitable exemption. Whatever may be the appropriate level of congressional solicitude for the needs of widows, presumably the appropriate level for charities is considerably lower. As for the problem of having to wait and see how the charitable bequest is funded before calculating the tax liabilities, any liberalization of the time to file rules (or permission to file in anticipation of bequest funding) that is adequate to deal with the equivalent problem under the marital exemption would be adequate to deal with this problem.

If Congress concludes (contrary to the above analysis) that special provisions are needed to limit selection of low basis assets for charitable

179. Actually, if the appreciation would be taxed at a low capital gains rate, and the deduction would be against income taxed at a high ordinary income rate, simply denying a deduction for the appreciation is harsher to taxpayers than taxing the appreciation and then allowing the deduction.

180. Assuming current law regarding lifetime charitable contributions remains unchanged, this means that gain should be recognized on a bequest of ordinary income property, I.R.C. § 170(e)(1)(A), on a bequest of tangible personal property to a donee whose use of the property is unrelated to its exempt purposes, I.R.C. § 170(e)(1)(B)(i), and on a bequest to a private foundation, I.R.C. § 170(e)(1)(B)(ii). In addition, gain should be recognized at death for purposes of the alternative minimum tax. I.R.C. § 57(a)(6).

181. Estate tax returns filed for 1986 decedents claimed marital deductions totaling \$20.9 billion and charitable deductions totaling \$4.1 billion. Barry Johnson, *Estate Tax Returns, 1986-1988*, 9 SOI Bull. 27, 50 (Spring 1990).

bequests, it nevertheless should avoid the complexities of basis reallocation. Rather, it should adopt the much simpler approach suggested by Professor Graetz.¹⁸² First, he would allow the deduction only for specific bequests, eliminating both the problem of executor selectivity and the need to wait and see how the bequest is funded. This would be simple enough, but it seemingly has little point. It is not apparent, as a matter of policy, why selectivity by the decedent should be permitted but selectivity by the executor should not. And nothing of significance is gained by eliminating the need to wait and see for charitable bequests, as long as the need to wait and see for marital bequests remains.

The second Graetz suggestion is to require that charitable bequests include, in cash or unappreciated property, the tax saved by the estate by donating appreciated property to charity. The effect would be to require that the benefit of the exemption go to the charity, rather than to the taxpayer. It is an interesting idea, but if it is appropriate for charitable bequests, it is equally appropriate for charitable contributions during life.

In sum, the rules concerning exemption of gain on bequests to charity should be consistent with the rules governing contributions during life, and no special rules are needed to limit an executor's ability to fund bequests with low basis assets.¹⁸³

B. The Structural Relation of the Death Gains Tax to the Estate Tax

1. Should the Death Gains Tax Be an Estate Tax Deduction?

If a taxpayer pays a capital gains tax during life, the tax paid depletes his potential taxable estate. In order for a capital gains tax at death to have an equivalent effect on estate tax liability, the capital gains tax would have to be deductible in computing the taxable estate. In fact, it would not even be necessary to amend the estate tax to

182. See Graetz, 59 Va. L. Rev. at 846-47 (cited in note 84).

183. Canada treats charitable contributions and bequests of appreciated property as triggering recognition of gain. A special rule permits a taxpayer making a contribution or bequest of capital gain property to designate any amount between the basis of the property and its fair market value as both the proceeds of disposition and the amount of the contribution. Income Tax Act § 118.1(6) (1992). When the gain will be taxed at a lower rate than the income against which the contribution is deducted, a taxpayer will select the highest permissible basis. Unlike the U.S. Revenue Code, Canadian law permits an income tax deduction for charitable bequests (whether or not of appreciated property) to be taken in the taxation year of the taxpayer's death. Income Tax Act § 118.1(5). Whether such a deduction should be permitted is a question analytically unrelated to the treatment of appreciation in donated property. Congress likely will continue to disallow an income tax deduction for charitable bequests as long as there is an estate tax, but it probably would consider allowing the deduction if the estate tax were eliminated.

achieve that result, since Section 2053(a)(3) already provides a deduction for "claims against the estate," and the capital gains tax liability would be such a claim.

When Congress was considering taxing capital gains at death during the 1970s, however, a number of witnesses testified that any gains tax should not be deductible, because allowing a deduction would have a regressive effect.¹⁸⁴ Suppose, for example, that two taxpayers die, each owning \$100,000 appreciation subject to a twenty-eight percent capital gains tax. Decedent A's estate, which is the smaller of the two, is subject to a marginal estate tax rate of forty percent; B's estate is subject to the highest marginal estate tax rate of fifty percent. Compared with the result if the gains tax did not exist, the deductible gains tax increases the total death tax burden on B's \$100,000 appreciation from fifty percent to sixty-four percent: the \$28,000 income tax leaves \$72,000 subject to a \$36,000 estate tax, with the result that the combined tax liability is \$64,000. Again compared with no gains tax, A's total death tax burden is increased from forty percent to 56.8%: the \$28,000 income tax leaves \$72,000 subject to a \$28,800 estate tax, resulting in a combined tax liability of \$56,800. Thus the introduction of the deductible gains tax can be called regressive, in that it increases the effective combined tax rate on the smaller estate more than it increases the rate on the larger estate. In order to avoid this effect, the American Bankers Association proposed a nondeductible additional estate tax¹⁸⁵ to be imposed on appreciation at death. The tax would be imposed at a flat rate equal to the increase in effective combined rate that a deductible capital gains tax at the generally applicable capital gains rate would impose on an estate in the highest bracket. Using the numbers in the above example, this would result in a fourteen percent flat rate nondeductible AET, applicable to both A's and B's estates.¹⁸⁶

184. See, for example, *Estate and Gift Tax Hearings* at 120-22 (cited in note 153) (statement of American Bankers Association). To state the obvious, this issue does not arise if there is no estate tax. Thus Canada, which repealed the estate tax at the same time it enacted the capital gains tax, did not have to consider this question.

185. *Id.* at 129. Since the tax base for the AET is determined using income tax concepts, the name Additional *Estate Tax* is a misnomer. The American Bankers Association made the improbable suggestion that labeling the tax an estate tax would put it on firmer constitutional footing than if it were considered to be an income tax. *Id.* at 130. For a brief explanation of the constitutional issue, see note 25.

186. The proposed AET, unlike most proposals to tax capital gains at death, provided for no marital exemption. The marital exemption question is, however, entirely separate from the estate tax deductibility question. (The marital exemption issue is discussed in text accompanying notes 150-74.) There could be a nondeductible AET with a marital exemption, or a deductible gains tax without a marital exemption. The issue with respect to the marital exemption is complexity; the issue with respect to estate tax deductibility is alleged regressivity. Estate tax nondeductibility is *not* a significant simplification per se.

The argument that a deductible gains tax is regressive is fundamentally misguided. The supposed regressivity is caused by the fact that any given dollar amount of deduction always will reduce the tax liability of a higher bracket taxpayer more than it will reduce the liability of a lower bracket taxpayer. If an estate-tax deductible gains tax is considered unacceptably regressive for this reason, then the income tax deduction for business expenses and the estate tax deductions for expenses, indebtedness, and taxes would be unacceptable as well. Also unacceptable would be the fact that the reduction in estate tax liability caused by any given amount of capital gains tax paid during life is greater for a high bracket estate than for a low bracket estate. For that matter, the failure to tax income never earned and the failure to tax wealth never transferred would be objectionable because those failures are more valuable the higher one's tax bracket.

The regressivity analysis that resulted in the AET proposal reflects a misunderstanding of Stanley Surrey's argument that tax expenditures in the form of deductions are unwarranted "upside-down subsidies," because for any given dollar amount of deduction such tax expenditures give the largest subsidy to the wealthiest (highest bracket) taxpayer.¹⁸⁷ That criticism applies, however, only when the deduction functions as a subsidy. When the deduction is not a subsidy, but rather an integral part of the logical structure of the tax base, the criticism makes no sense.¹⁸⁸ The estate tax deductibility of gains tax liability is a basic part of the structure of the estate tax base: the tax base is wealth gratui-

There is one way, however, in which the estate tax deductibility and marital exemption issues may be related significantly: a nondeductible AET might result in a tax rate low enough to make the imposition of the tax on marital bequests politically feasible, thus simplifying the administration of the tax considerably. If, however, one considers both estate tax nondeductibility and the taxation of marital bequests bad policy decisions, this would be a very high price to pay for ease of administration.

In any event, the justification for applying an AET rate lower than the capital gains rate—as compensation for the nondeductibility of the AET against the estate tax—would not apply in the case of a marital bequest not subject to estate tax. Suppose, for example, a surviving spouse (SS) receives property with a basis of zero and a value of \$100, and the property is subject to a 14% AET and no estate tax. SS sells \$14 of the property to pay the tax (the sale generates no tax, because basis was increased to \$100 after imposition of the AET) and dies owning the rest of the property, which is still worth \$86. The 50% estate tax on the property at SS's death is \$43. The total tax burden on the property is thus only 57%, despite the fact that the combined AET/estate tax burden on top bracket taxpayers is ordinarily 64% (14% AET plus 50% estate tax). What has happened, of course, is that the SS received the equivalent of an estate tax deduction for the AET by paying the AET. This occurred despite the fact that the lower rate of the AET was supposed to be compensation for the estate tax nondeductibility of the AET.

187. Stanley S. Surrey, *Pathways to Tax Reform* 134-38 (Harvard, 1973).

188. In addition to its major flaw of being premised on a misunderstanding, the AET also is subject to the criticism that for many taxpayers (those who anticipate having estates not subject to the highest marginal rate) it will be less burdensome than a capital gains tax during their lifetime, thus continuing the lock-in effect.

tously transferred at death, and wealth that must be used to pay taxes cannot be so transferred.¹⁸⁹

If the combined effect of a deductible gains tax at death and the estate tax strikes Congress as insufficiently progressive (a rather unlikely event), the obvious solution is to build greater progressivity into the estate tax rates, the capital gains rates, or both—not illogically to deny an estate tax deduction for the capital gains tax.¹⁹⁰

2. The Estate Tax Basis Credit Proposal

A study paper accompanying the Report by the American Bar Association Tax Section on Transfer Tax Restructuring explains an interesting proposal for dealing with the treatment of unrealized appreciation at death.¹⁹¹ The proposal is in the context of a proposed fifty percent flat rate estate tax,¹⁹² which eliminates the substantive difference between a twenty-eight percent deductible gains tax and a fourteen percent nondeductible AET (assuming neither tax applies to estates not subject to the estate tax). The study paper, however, goes beyond this equivalency, to note that there is also an equivalency between a nondeductible AET on appreciation and an estate tax with a credit for basis.¹⁹³ For example, consider (a) a fifty percent estate tax and a fourteen percent AET, and (b) a sixty-four percent estate tax and fourteen percent credit against the estate tax for the value included in the estate that does not constitute unrealized appreciation. Under either system, the effect is that appreciation included in the estate is taxed at sixty-four percent, and other value included in the estate is taxed at fifty percent.

189. For the same reason, the exclusion from the tax base of capital gains taxes paid during life is entirely appropriate and cannot sensibly be called regressive. The same is true, of course, of the Section 162 income tax business expense deduction and the Section 2053 estate tax deduction for claims and expenses.

190. Note, however, that the issue is of limited relevance under the current compressed estate tax rate structure. A 28% gains tax increases the tax burden on a 50% bracket estate by 14% (from 50% to 64%), and on a 37% bracket estate (the lowest bracket not entirely sheltered by the unified credit) by 19.64% (from 37% to 56.64%). The difference between the 19.64% increase and the 14% increase the 37% bracket estate would experience under an AET is not overwhelming. And the difference would disappear entirely, of course, under a flat rate estate tax.

On the other hand, the difference between a 14% AET and a 28% capital gains tax would be very significant to an estate subject to the appreciation tax but too small to be subject to the estate tax. The crucial issue concerning such estates, however, is whether it is appropriate to subject them to any form of death gains tax. On that question, see text accompanying notes 215-19.

191. A.B.A. Section of Taxation, *Report on Transfer Tax Restructuring*, 41 *Tax Law* 395, 446-48 (Winter 1988). The study paper includes a note that it "reflects various individual views, but does not reflect the position of the task force or a majority of its members." *Id.* at 446.

192. *Id.* at 397, 446.

193. *Id.* at 446.

Having noted this equivalency, the study paper proposes using a credit system, rather than an AET system. A minor objection to the credit system is that it is somewhat more confusing and less straightforward than an additional tax on appreciation. Much more important, however, is the way in which the study paper uses the credit proposal as a disguised way of reducing death tax rates. The study paper proposes not a sixty-four percent estate tax and a fourteen percent credit, but rather a fifty percent estate tax and a ten percent credit. Thus, the proposal disingenuously leaves unchanged the present treatment of unrealized appreciation at death, and *reduces* the tax on other value passing at death. It is quite a sleight of hand: to claim to be taxing unrealized appreciation at death, while actually reducing overall death tax revenues. This tax reduction effect is not, of course, inherent in the credit proposal, as the possibility of a sixty-four percent estate tax with a fourteen percent credit indicates.

The other interesting aspect of the proposal is how it deals with the problem of marital bequests. Unlike the AET, it in effect exempts appreciation in marital bequests from tax.¹⁹⁴ The mechanism for the marital exemption is very simple: the estate tax rate before credit (e.g., sixty-four percent) in effect incorporates both the true estate tax rate (e.g., fifty percent) and the hidden appreciation tax rate (e.g., fourteen percent). When the marital bequest is exempted from the estate tax by the estate tax marital deduction,¹⁹⁵ it thus is exempted automatically from the appreciation tax as well.

The proposal avoids the need to "wait and see" what assets are used to fund the marital bequest in order to compute the appreciation tax, and gives the executor no incentive to fund the marital bequest with low basis assets. It computes the credit as a percentage (e.g., fourteen percent) of "X", where $X/\text{taxable estate} = \text{nonappreciation portion of gross estate/gross estate}$.¹⁹⁶ Although this formula depends in part on the *value* of the marital bequest (because that value affects the amount of the taxable estate), it does not depend in any way on the *basis* of the assets used to fund the marital bequest. In effect, it conclusively presumes that the assets used to fund the marital bequest have the same basis to value ratio as the gross estate as a whole. That assumption is the equivalent of the 1969 Treasury proposal to require reallocation of basis in computing the marital exemption, in terms of its effect on the amount of appreciation taxed at death.¹⁹⁷ As with realloca-

194. This is not, however, an inherent difference between the credit and AET approaches; as noted above, an AET could be designed with a marital exemption. See note 186.

195. I.R.C. § 2056.

196. A.B.A. Section of Taxation at 446 (cited in note 191).

197. See text accompanying note 173.

tion of basis, it involves the complication that the amount of gain taxed (or the amount of gain effectively not taxed by reason of the credit) depends on the value and basis of every asset in the gross estate. A change on audit of the value or basis of any asset would change the amount of the credit.

The proposal provides that the basis of appreciated property in the gross estate would be increased (from the decedent's basis)¹⁹⁸ by the amount of "X", with the increase allocated among appreciated assets in proportion to their relative amounts of appreciation.¹⁹⁹ There appears to be a technical mistake in the proposal. The logical result would be to permit a basis increase for the appreciation in the taxable estate subject to tax (by virtue of not being eligible for the credit). Such appreciation is represented not by "X", but by taxable estate minus "X". Presumably this is what the study paper intended.

Assuming that was the intent, is the basis proposal attractive? Notice that the effect is an odd combination of basis reallocation and basis tracing: for purposes of determining the amount of gain recognized (i.e., the amount of the taxable estate not eligible for the credit) the proposal uses reallocation, but for purposes of determining subsequent basis of the assets the proposal uses the actual basis of each asset plus an adjustment. This combination produces unappealing results. The pro rata allocation of the available basis increase means that the post-death basis of every appreciated asset included in the estate depends on the basis and value of every other asset. If there is a marital bequest, no appreciated asset will receive a fair market value basis in the hands of a beneficiary of the estate²⁰⁰ (nor will any appreciated asset receive a pure carryover basis). This is more complex than the 1969 Treasury proposal for reallocating basis, which would have simply given a fair market value basis to nonmarital property following the application of the gains tax at death.²⁰¹ In addition, the study paper proposal has the arguably unfair result of giving a basis increase to appreciated marital bequest property, even though the appreciation in the property was not taxed.²⁰²

198. Actually, the proposal is not explicit as to whether the increase would be from the decedent's basis or from fair market value at death, Section 1014 basis, but it must mean decedent's basis, since there could be no valid reason for increasing basis *above* fair market value at death.

199. *Tax Reform Studies and Proposals* at 448 (cited in note 148).

200. In fact, this problem exists even if there is no marital bequest, because the proposal also disallows a basis increase for appreciation deemed not subject to tax by reason of the basic estate tax exemption (\$600,000) and the deduction for debts and charges against the estate.

201. *Tax Reform Studies and Proposals* at 345 (cited in note 148). The Treasury proposal would have provided for no step up in the reallocated basis of marital bequest property. *Id.*

202. Another objection to the proposal is that if the appreciation tax is built into the estate tax, there never will be any appreciation tax if there is no estate tax, and that means there is no

To sum up, (a) a basis credit has no substantive advantage over AET, is harder to understand, and could be used to disguise a tax decrease; and (b) the study paper's treatment of marital bequests involves a strange combination of reallocated basis and actual basis, less attractive than either standing alone.

C. Special Avoidance Concerns

1. Taxation of Gain on Gifts During Life

Most plans to tax capital gains at death have included taxation of gains on gifts made during life.²⁰³ The reason is apparent: the premise of the tax at death is that gains should be taxed at least once a generation, but gains tax can be deferred indefinitely if appreciated property is transferred from one generation to another by gift and gain is not taxed at that time. A rule taxing gain on assets gifted in contemplation of death, or within a specified time before death, is not adequate to prevent avoidance because many wealthy taxpayers will be willing and able to transfer much of their appreciation well before their deaths.²⁰⁴ Such avoidance will be most practical for the very wealthy, thus reducing the vertical equity of the death gains tax.

It is clear, then, that gifts generally should trigger the recognition of gain (subject perhaps to some unified exemption amount²⁰⁵ and a limited exemption for nonbusiness tangible personal property). The major complication concerns incomplete lifetime transfers: transfers (typically, but not necessarily, in trust) in which the donor retains some control over or interest in the transferred property. Under what circumstances should an incomplete transfer be deemed sufficient to impose an immediate gains tax, and under what circumstances should the tax be postponed until the retained interest or control is terminated (which may be during life or at death)? The problem is not that current law

limit to the amount of appreciation that may escape tax in the case of debt-laden estates. This point is discussed in text accompanying notes 235-36.

203. See, for example, *Tax Reform Studies and Proposals* at 348; *President's 1963 Tax Message* at 24 (cited in note 25); *Income Tax Act* § 69(1)(b) (1991) (Canada).

204. The AET proposal would have continued current law—no recognition of gain and carry-over basis—for all lifetime gifts other than those made within two years of death. *Estate and Gift Tax Hearings* at 104 (cited in note 153). This opportunity for unlimited deferral of gain across generations is a major weakness in the AET. It also is inherent in the concept of an AET. The AET is imposed at a relatively low rate because it is not deductible against the estate tax, but any gains tax imposed during life automatically functions as the equivalent of an estate tax deduction (by reducing the size of the potential estate). Thus, a gains tax on gifts, designed to complement an AET, would have to be imposed at a higher rate than the AET.

205. Designing a unified exemption for gains tax on gratuitous transfers during life or at death involves certain difficulties, which are discussed in text accompanying notes 234-37.

provides no help in designing rules to deal with this issue; rather current law provides too much help. There is one set of rules for determining whether a grantor will continue to be taxed on the income from incompletely transferred property,²⁰⁶ a different set of rules for determining whether a gift is complete for gift tax purposes,²⁰⁷ and a third set of rules for determining whether incompletely transferred property is includable in a decedent's gross estate.²⁰⁸

Without delving into the intricacies of the different rules, does it inherently make more sense to apply the rules from one tax than from another? One commentator has stated, without explaining his reasoning, that the income tax grantor trust rules should be used.²⁰⁹ The idea that existing income tax rules concerning the ownership of property should be used in the context of a new income tax problem certainly has intuitive appeal. As a practical matter, however, it is more important to coordinate the new gains taxes with the transfer taxes. Planning for these taxes will be a part of estate planning, where the gift and estate tax incomplete transfer rules govern. And using the transfer tax rules will mean that the new gains taxes will never impose a new valuation requirement—gains tax will be imposed only when valuation already is required by the transfer tax rules.

In some cases, a transfer is considered complete for gift tax purposes but incomplete for estate tax purposes, so that a transfer tax is imposed both upon the initial transfer and at the transferor's death.²¹⁰ In such a case, both the initial transfer and the death would trigger a capital gains tax. This would not involve double taxation, because the basis of the property would be increased by the amount of gain taxed at the time of the initial transfer.

2. Generation-Skipping Transfers

But for the generation-skipping transfer tax, a taxpayer could avoid one level of transfer tax by transferring (during life or at death) property to a trust, giving his child a substantial interest in the prop-

206. I.R.C. §§ 671-79.

207. Treas. Reg. § 25.2511-2.

208. The most important of those provisions are Sections 2036, 2037, and 2038.

209. Victor Thuronyi, *Tax Reform for 1989 and Beyond*, 42 *Tax Notes* 981, 989-90 (1989).

210. The classic example is a transfer of property to a trust, with the transferor retaining an income interest for life. The value of the remainder is subject to gift tax, Treas. Reg. § 25.2511-2(b), and the entire value of the property is subject to the estate tax, I.R.C. § 2036.

There is considerable dissatisfaction with the inconsistencies between the gift and estate tax rules concerning incomplete transfers, and proposals have been made to apply a single set of rules to both taxes. See, for example, *The President's Tax Proposals to Congress* at 378-80 (cited in note 15). If such reform is enacted, it also should apply for purposes of the gains tax at gift and death.

erty during the child's life (such as an income interest for life), with the remainder to his grandchild at the child's death. The property would not be subject to estate tax at the child's death, despite the fact that the child received the income from the property for as long as he lived.²¹¹ Under current law, however, a generation-skipping transfer tax generally will be imposed at the child's death, to compensate for the avoided estate tax.²¹²

The same kind of generation-skipping trust also could be used to frustrate the congressional intent to impose a tax on unrealized appreciation once every generation.²¹³ To prevent this avoidance, rules are needed that will treat the termination of interests such as the child's income interests for life as events triggering the gains tax. For the most part, the rules in Chapter 13 of the Revenue Code defining a generation-skipping transfer also should be used for purposes of the gains tax. In the interest of simplicity, the gains tax also should follow the generation-skipping transfer tax in not attempting to base the rate of tax on the financial circumstances of the skip person (e.g., the child).²¹⁴ When the tax is triggered, it should be imposed at the top capital gains rate (or ordinary income rate, if it is ordinary income), rather than at the rate it would be subject to if included in the income of the skip person.

There are, however, two important issues concerning the scope of the gains tax: whether the tax should apply to direct skips and whether there should be a gains tax exemption for transfers under some specified dollar amount.

Under the terminology of the generation-skipping transfer tax, a direct skip (as contrasted with a taxable distribution or a taxable termination) is a generation-skipping transfer in which the skipped generation is *completely* skipped—for example, an outright gift or bequest to a grandchild, with the skipped child never receiving an interest of any kind in the property.²¹⁵ Such a gift or bequest is, of course, already a taxable event under a capital gains tax on gratuitous transfers. The question is whether something more than the normal tax should be imposed, because a direct skip may result in an unusually long deferral period until the next capital gains tax is imposed on the property. For

211. Section 2036(a) includes in the gross estate property in which the decedent had a life estate, only if the decedent originally had owned the property outright and then transferred it retaining a life estate.

212. The tax is imposed by Chapter 13, Sections 2601-63. The text states that the tax "generally" will be imposed, because Section 2631 grants every individual transferor a \$1,000,000 exemption from the tax.

213. This was not an issue under Section 1023, because unlimited deferral of gain across generations was consistent with a carryover basis regime.

214. I.R.C. § 2641.

215. *Id.* § 2612.

example, a bequest to a twenty-five-year-old grandchild instead of a fifty-year-old child increases the potential deferral period, assuming the property is held until death, by twenty-five years.

What is the magnitude of the benefit of this deferral? Suppose the property bequeathed to the twenty-five-year-old grandchild is currently worth \$100. Since what is being deferred is a tax on *future* appreciation, a forecast is needed of how much appreciation there will be. Assuming the property appreciates at a compound annual rate of four percent, in twenty-five years it will be worth \$267. A gains tax of twenty-eight percent imposed at that time (on the death of the child) would be \$46.76, and would have a present value (discounted at four percent) of \$17.54. If, however, that tax is deferred until the death of the grandchild in fifty years, the present value of the tax is only \$6.59. Under these assumptions, the present value of deferring the next gain recognition for fifty years instead of only twenty-five years is $\$17.54 - \$6.59 = \$10.95$, or about eleven percent of the value of the transferred asset.

The tax benefit from the generation-skipping transfer is sufficiently small, and sufficiently conjectural, that the best legislative response probably is to do nothing—not to impose any gains tax other than the basic tax at the time of the original transfer. If, however, Congress disagrees and decides to impose a special tax on direct skips, the best approach would be to impose an additional tax at the time of the original transfer. Any “wait and see” alternative, such as taxing the appreciation in the property if it is still owned by grandchild at child’s death, would be too difficult to administer.

Using the assumptions in the above example, the appropriate amount of the additional tax would be \$17.54—the present value of the tax that would be due in twenty-five years, upon child’s death, had child not been skipped. When gain on the property eventually is recognized, appropriate allowance should be made for the additional tax paid. There are various ways of making that allowance. For example, if gain is recognized within the next twenty-five years, the taxpayer could be allowed a credit against the gains tax of \$17.54 plus interest; if the property is disposed of after twenty-five years, the basis could be stepped up to \$267. The gains tax avoidance potential of direct skips, however, does not seem sufficient to justify this complexity.

The generation-skipping transfer tax allows every individual to make generation-skipping transfers of up to \$1,000,000 free of the tax, and to choose how to allocate that exemption among his transfers.²¹⁶ This exemption is based on the value of the property at the time of the

216. *Id.* § 2641.

original transfer. If an original transfer of \$1,000,000 is exempted, and the property appreciates to \$4,000,000 (for example) by the time the taxable distribution or taxable termination occurs, the entire \$4,000,000 is exempt.²¹⁷ It would be possible to apply the same rule for purposes of the gains tax, thus exempting the \$3,000,000 gain in the example. Alternatively, the same exemption mechanism could be used, but the amount of the exemption could be smaller.²¹⁸ An exemption might be justified on the following reasoning: that in theory any unused portion of the skip person's own minimum basis (or other form of gains tax exemption) should be available, but that coordinating the generation-skipping gains tax with the skip person's actual tax circumstances is too complicated, so a special gains tax exemption should be allowed instead. The problem with this argument is that, in a family with enough wealth to merit the sophisticated planning involved in generation-skipping trusts, the skip person is likely to have little or no unused gains tax exemption. At most, a special generation-skipping gains tax exemption should be relatively small—certainly no more than \$100,000—and a tax with no exemption would be entirely justifiable.²¹⁹

3. Estate Freezes

Since both the estate tax and the capital gains tax at death depend on asset values as of the decedent's death, a death gains tax creates the same incentive for "freezing" the value of assets the taxpayer expects to hold until death, which always has existed under the estate tax. This typically is attempted when an elderly person divides his interest in an enterprise into a senior interest and a junior interest. He then gives away the junior interest, which is entitled to most or all of the potential growth in the enterprise, while retaining the senior interest (whose value is more or less frozen because of its limited or nonexistent interest in growth). The history of the attempts of Congress and the IRS to deal with estate freezing is not a happy one.²²⁰ It may be, however, that

217. *Id.* § 2642.

218. It is crucial, however, to the administration of any such exemption that the exemption be based on and allocated among the value of the original transfers, rather than the appreciation at the time the generation-skipping events occur.

219. Canada has a generation-skipping gains tax provision that provides for a deemed disposition of trust property every 21 years, rather than focusing on taxable distributions and terminations. Income Tax Act § 104(4) (1992). This would be an acceptable alternative to the system of Chapter 13, but given that Chapter 13 is already in place and familiar to American practitioners and taxpayers, it would be better to model the generation-skipping gains tax provision on the Chapter 13 approach.

220. Saddest of all was Section 2036(c), which was enacted in 1987, Omnibus Budget Reconciliation Act of 1987, § 10402, Pub. L. No. 100-203, 100 Stat. 1330, 1330-1431, and repealed retroactively (in response to intense criticism) in Omnibus Budget Reconciliation Act of 1990, § 11601, Pub. L. No. 101-508, 104 Stat. 1388, 1388-1490.

the most recent legislative effort—the Chapter 14 special valuation rules,²²¹ enacted in 1990—will bring order to this troubled area. The basic approach of Chapter 14 is to require the use of valuation rules that assign to a gifted junior interest substantial value, relative to the retained senior interest, thus assuring that the implementation of the freeze will result in a substantial taxable gift.

In keeping with the general principle of using the same valuations for transfer tax and for gains tax, and in recognition of the identity of the estate freeze issues under both tax systems, whatever estate freeze rules finally are settled on for gift and estate tax purposes can and should be used to value assets subject to the gains tax at gift or death.²²² The gains tax, however, does involve an issue not present under the transfer taxes: the gains tax requires an allocation not only of *value* between transferred and retained interests, but also of *basis*. The law should provide that basis is allocated between the interests in the same proportions as value. Otherwise taxpayers would attempt to make unrealistically high allocations of basis to transferred interests, resulting in deferral of tax until a later transfer of the low basis retained interest.

D. A Small Estate Exemption

It seems clear that there should be an exemption from a capital gains death tax for small estates. At some point, estates are small enough that the revenue gained from taxing their appreciation does not justify imposing the complexities of a capital gains tax (or, for that matter, of carryover basis). The difficult question is finding that point. One obvious and attractive possibility is designing the exemption to track (so far as possible) the estate tax exemption provided by the unified credit, so that estates not subject to the estate tax also would not be subject to the gains tax, and estates subject to the estate tax also would be subject to the gains tax.²²³ For estates not subject to the gains tax, current law—no realization of gain or loss at death, and fair market value basis for inherited property—would continue to apply. This

221. I.R.C. §§ 2701-04, enacted by the Omnibus Budget Reconciliation Act of 1990 § 11602, 104 Stat. at 1388-491-500.

222. Even if the transfer taxes are repealed, if a statutory approach to estate freezes has proven satisfactory under the transfer taxes, it should be retained to deal with the same problem under the gains tax. None of the previous proposals for a capital gains tax at death has included anti-estate freeze provisions; but at the time of those proposals, the transfer taxes themselves also lacked explicit rules for estate freezes.

223. However, this is not the approach assumed by the Congressional Budget Office in *Reducing the Deficit* at 315-16 (cited in note 14). That approach would allow a general exclusion of only \$75,000 gain. (The Congressional Budget Office's alternative of a 10% supplemental estate tax on appreciation, of course, would equate the estate tax and gain tax exemptions.)

would limit the application of the death gains tax to a small portion of the decedent population.²²⁴

Would it be appropriate to equate the estate tax and death gains tax exemptions? In considering this question, the current \$600,000 exemption amount need not be viewed as unalterable. One may favor a higher or lower estate tax exemption amount, quite apart from considerations related to a new death gains tax. Or the revenue gained from the death gains tax could be used to raise the exemption amount for both taxes. Whatever the precise exemption amount, there are strong arguments for using the same amount for both taxes. Perhaps most important, equating the exemptions would mean that the death tax would not impose any additional valuation requirements: death gains tax would be imposed only on property that already had to be valued for the estate tax. Estates large enough to exceed the exemption amount should have the necessary resources to handle the administrative burdens of the gains tax. And despite affecting only a small percentage of all estates, the tax still would reach much of the appreciation passing at death, since that appreciation is concentrated in larger estates.²²⁵ Finally, equating the exemptions may be the only way to make the death gains tax politically feasible. The 1976 carryover basis statute was strongly criticized for applying to many estates not subject to the estate tax,²²⁶ and the proponents of carryover basis agreed that the law should be revised to equate the exemption levels.²²⁷

There are also arguments against equating the exemptions, all of which are based on the fact that a gains tax exemption tied to the estate tax exemption will mean huge amounts of appreciation escaping the tax. Most obviously, the revenue lost by not taxing that appreciation would be in the billions of dollars. In addition, exempting the vast majority of the population from the tax invites the argument that the

224. An estimated 45,800 U.S. citizens who died in 1986 had gross estates over \$500,000 (the exemption amount for that year). They represented about 2.2% of all U.S. decedents. Slightly fewer than half (about 22,000) of those estates were taxable, after deductions. Johnson, 9 SOI Bull. at 27 (cited in note 181).

225. The leading carryover basis clean-up proposal would have equated the carryover basis exemption with the existing estate tax exemption, by providing an exemption from carryover basis for estates having \$175,000 or less of carryover basis property. H.R. 4694 § 2(a) (proposed § 1023(a)(3)). Raising the minimum basis from \$60,000 to \$175,000 was estimated to reduce the number of estates subject to carryover basis (from 9.4% of all decedents to 2.7%) much more than it reduced the revenue effect of carryover basis (from \$833 million to \$560 million). *Background and Issues* at 35 (cited in note 30).

226. Section 1023(d) provided a minimum basis of \$60,000, but the estate tax exemption amount at that time (computed by applying the \$47,000 unified credit of Section 2010 to the rate schedule of Section 2001(c)) was \$175,625.

227. H.R. 4694 § 2(a) (proposed § 1023(a)(3)).

tax is really just another excuse to soak the rich.²²⁸ It is also arguable that a high exemption may do little to alleviate record keeping burdens for middle class taxpayers, because one cannot be certain that one's estate will be under the exemption level until one is dead. Finally, to the extent taxpayers anticipate their estates will be eligible for the exemption, their assets will continue to be subject to lock-in.

I find the arguments for equating the estate and death tax exemptions persuasive, and I suspect Congress would as well. Assuming that is to be done, the next question is what mechanical form of exemption would best achieve that goal. There are three basic forms an exemption might take: a minimum basis exemption, an exemption based on the amount of gain, and an exemption based on value.

To understand the mechanics of the three alternatives, imagine an estate with a single asset valued at \$800,000, with a basis of \$200,000. The minimum basis approach (which was used in carryover basis) would give every estate a total basis²²⁹ of at least some stated minimum amount. If the estate's actual total basis is greater than the minimum basis, actual basis is used. If actual basis is less than minimum basis, basis is increased by the difference between the two amounts.²³⁰ Assuming that the estate tax exemption is \$600,000, and no estate of less than that amount is subject to the death gains tax, the minimum basis allowance must be \$600,000. Thus, the basis of the estate's asset is increased from \$200,000 to \$600,000, and the gain subject to tax at death is only \$200,000. As the example illustrates, the minimum basis sometimes will benefit estates large enough to be subject to estate tax, but that is necessary in order to avoid an inappropriate "cliff effect" (i.e., a situation in which a trivial difference in economic circumstances makes a major difference in tax consequences). Imagine two estates, each with a single

228. The response, of course, is that it makes good sense for the government to tax the appreciation of only the wealthy for the same reason it made good sense for Willie Sutton to rob only banks—that is where the money is. Nevertheless, the assertion that a high exemption was unfair to the rich was prominent in the arguments of those who wanted carryover basis repealed, rather than cleaned up. For example, Senator Bentsen remarked:

I look on this [the proposed increase in the minimum basis] as a political move to try to gain support. If there is inequity for one, there is inequity for the other. If it is a complex thing for the small estate, it is also a complex thing for the very large estate and we ought to try to get some uniform application.

Estate and Gift Tax Carryover Basis and Generation-Skipping at 12 (cited in note 94).

The argument that a high exemption was unfair was somewhat ironic, coming largely from the same people who had argued that a low exemption imposed an unreasonable burden on small estates.

229. For purposes of computing gain, but not for the purpose of artificially creating a deductible loss.

230. This basis calculation is subject to the limitation that no asset's basis shall be increased above its estate tax value.

zero-basis asset, one valued at \$600,000 and the other valued at \$600,001. If the first estate were entitled to the \$600,000 minimum basis and the second were entitled to none, the cliff effect would be dramatic and grossly unfair. The other two approaches also provide benefits to estates larger than \$600,000 for the same reason.

What if the value of the asset were only \$500,000? Then the minimum basis rule would increase the asset's basis by \$300,000, to \$500,000, and it would not be subject to gains tax. The same result could be achieved more easily, by providing that estates whose assets are valued at less than \$600,000 simply are not subject to the gains death tax, but rather continue to be governed by Section 1014 and the nonrecognition of gains at death.²³¹

On the same facts—an \$800,000 asset with \$200,000 basis—the gains exemption approach would exempt the entire \$600,000 gain from tax. The gains exemption approach is used in the Canadian gains tax²³² and was used in the former British tax on gains at death.²³³ Like a minimum basis exemption, a gains exemption could provide that Section 1014 and nonrecognition would continue to apply to estates no larger than \$600,000.

A value-based exemption would provide that \$600,000 of value could pass at death, exempt from the death gains tax. Applying a value-based exemption to the same facts, \$600,000 of value (with an allocated basis of \$150,000) would be exempt from tax; \$200,000 of value (with an allocated basis of \$50,000) would generate a taxable capital gain of \$150,000.

One way of comparing the effects of the three methods is to note that each starts with a potential maximum benefit of \$600,000 of “free” basis or exempted gain. Minimum basis reduces that potential benefit by the basis of all assets in the estate; a gains exemption does *not* reduce the benefit (except in the sense that it is limited by the amount of the appreciation in the estate); and a value exemption reduces the benefit by the basis of the assets passing under the exemption.

231. This was the approach taken by the leading carryover basis clean-up proposal. H.R. 4694 § 2(a) (proposed § 1023(a)(3)). This approach is discussed in more detail at text accompanying notes 238-41.

232. Income Tax Act § 110.6 (1992). The general rule is a \$100,000 unified exemption for capital gain, regardless of whether the gain is realized by sale, gift, or bequest. This is increased to \$500,000 for gain on the transfer of farms and small businesses.

233. Graetz, 59 Va. L. Rev. at 842 (cited in note 84).

1. The Exemption Methods Evaluated

a. Minimum Basis

Perhaps the most attractive feature of the minimum basis method is that it tends to phase out its benefit for wealthy estates, which do not need an exemption designed to simplify the rules for small estates, and it accomplishes that phase-out without any cliff effect. The phase-out follows naturally from the fact that the minimum basis rule confers no benefit on estates with at least \$600,000 actual basis, and the larger the estate the more likely it will have at least that much actual basis.

Assuming the gains tax allows a marital exemption, the minimum basis method coordinates easily with the estate tax marital deduction: the \$600,000 minimum basis is allowed with respect to the estate's assets other than those passing to the surviving spouse (or to charity). This coordination fails if there is no marital exemption from the gains tax, but that problem is not peculiar to the minimum basis method: allowing an estate tax marital deduction but not allowing a gains tax marital exemption necessarily rejects the idea that the gains tax should be designed not to apply when the estate tax does not apply.

At first glance, it appears that one disadvantage of the minimum basis method is that it does not coordinate well with the application of the transfer tax unified credit to gifts during life. In order to insure that no gains tax is imposed on a gift sheltered from gift tax by the unified credit, the minimum basis exemption would have to be unified—available for use on gifts as well as bequests. But allowing *any* minimum basis for gifts, at a time when the total actual basis of gifts and bequests is unknowable, creates the possibility of allowing an inappropriate basis increase under the minimum basis rules. The increase may be inappropriate because the total actual basis of all gifts and bequests ultimately may exceed the minimum basis amount. There is, however, a simple solution to this problem: allow the minimum basis adjustment for gifts, but reduce the basis of assets transferred at death to the extent that the previously allowed deduction was excessive, viewed with the benefit of hindsight. For example, a gift of an asset with a basis of \$100,000 and a value of \$500,000 results in an increase in basis of \$400,000 under the minimum basis rule. Suppose that this is the taxpayer's only gift, and his estate consists of assets with a value of \$700,000 and a basis of \$450,000. With hindsight, he had actual total basis of \$550,000, so he should have been permitted a basis increase of only \$50,000. The \$350,000 excess portion of the basis increase allowed

on the gift would be "recaptured" by decreasing the basis of the estate's assets by \$350,000, to \$100,000.²³⁴

There is a situation in which minimum basis will not completely exempt an estate from gains tax, despite the fact that the estate is not subject to estate tax: when the estate's assets are appreciated, and their value exceeds \$600,000, but there is no estate tax because indebtedness²³⁵ reduces the taxable estate to less than \$600,000. Suppose, for example, the estate's only asset has a value of \$800,000, a basis of zero, and is subject to a \$300,000 debt.²³⁶ After application of the minimum basis rule, the gains tax will apply to \$200,000 of gain, even though there is no estate tax liability. This results in less than perfect coordination of the gains tax with the estate tax, but any solution would be worse than the problem. Complete coordination of the gains tax exemption with absence of estate tax liability is possible (as this example demonstrates) only at the cost of giving some estates "free basis" of more than the intended minimum basis amount. In fact, a rule that the gains tax never applies if the net value of the estate is less than \$600,000 would mean no ceiling would exist at all on the potential amount of gain that could be exempted.

b. Gain Exemption

The most important difference between the minimum basis method and the gain exemption method is that the gain exemption method does not tend to phase out its benefits for larger estates. In fact, since larger estates will tend to have more gain than smaller estates, larger estates generally will receive the greatest benefit from the gain exemption method. Given the primary purpose of any exemption—to give small estates relief from the burdens of a death gains tax—this is an ironic result. I therefore prefer the minimum basis method.

The application of a gains exemption to gifts, however, does not require the recapture rules necessitated by minimum basis. The first \$600,000 of gain on gifts would be exempt; there would be no additional exemption for any gain on later gifts or at death. It would be appropri-

234. An alternative would be simply to allow no minimum basis increase for lifetime gifts. This could be justified on the grounds that the voluntary nature of gifts makes special exemptions unnecessary. But the resulting discontinuity between the gains tax and the transfer taxes would be unfortunate, and also unnecessary, given the solution described in the text.

235. Indebtedness is deductible under Section 2053.

236. A liability in excess of basis could result from the decedent's having borrowed against the appreciation in the property (and having consumed the borrowed funds before his death). It also could result from accelerated depreciation deductions. The availability of the small estate exemption against depreciation recapture is discussed in text following note 295.

ate to reduce, however, any net loss at death by the amount of gain exempted during life.²³⁷

The effects of a gains exemption are the same as the effects of minimum basis, with respect to marital bequests and liabilities of the estate.

c. Value Exemption

Since the transfer taxes and the transfer tax exemption (provided by the unified credit) are based on the value of transferred assets, a value-based gains tax exemption would provide the closest coordination between the transfer tax and gains tax exemptions. There are, however, two serious objections to a value-based exemption.

First, a value exemption requires, in the case of an estate larger than the exemption amount, some mechanism for determining which assets pass under the exemption and which assets are subject to gains tax. This could be done by a mechanical rule (including the possibility of a rule requiring basis reallocation, thus making identification of particular assets unnecessary) or by giving the executor the power to identify exempt assets. But either a mechanical rule or an election would involve considerable complexity. More serious is the problem already noted in the discussion of minimum basis—that an exemption based on the amount of the taxable estate imposes no limit on the amount of gain that may exist in an exempt estate. The estate tax deduction for liabilities creates the possibility that a taxable estate of less than \$600,000 may contain appreciation of much more than \$600,000. Allowing such an unlimited gains exemption is unacceptable. The exemption could be limited by providing that gain must be recognized to the extent it exceeds the exemption amount, but that is nothing more than a convoluted way of using a gain exemption rather than a value exemption.

2. Issues in Implementing a Minimum Basis Rule

The remainder of this discussion assumes that the small estate exemption will take the form of a minimum basis allowance and considers some issues involved in designing a minimum basis exemption. Many of the comments are equally applicable, however, to a gain exemption.

237. This is required by Canadian law. Income Tax Act § 111(2) (1992).

a. Treatment of Estates Smaller Than the Minimum Basis Amount

What should be done when an estate contains assets that would be subject to the death gains tax but for the minimum basis rule,²³⁸ and the total value of the assets is less than the minimum basis amount? The simplest approach would be to take such estates entirely out of the realization at death system and to provide that the current system—no realization at death and fair market value basis under Section 1014—continues to apply to those estates. This has the major advantage of making proof of basis entirely irrelevant for small estates.²³⁹

This approach, however, does result in an unfortunate cliff effect with respect to losses. Imagine an estate with just one asset, with a value of \$600,000 and a basis of \$1,000,000. Under the proposal, the estate is just small enough that it remains subject to current law, with the result that the \$400,000 loss is not realized. By contrast, if the value of the asset were \$600,001, the loss (\$399,999) would be realized at death. This cliff effect not only seems unfair, it also creates the potential for some rather bizarre valuation controversies. The alternative is to permit estates with net losses to realize those losses, no matter how small the estates. But this means that proof of basis may be required for any estate, no matter how small.²⁴⁰ Although the cliff effect on the denial of losses is certainly disturbing, on balance it is an acceptable price to pay for simplification, especially given the fact that taxpayers generally can plan for lifetime dispositions to avoid the cliff effect.²⁴¹

b. Allocation of the Minimum Basis Adjustment

Critics of the carryover basis law complained that considerable complexity was created by the need to allocate the allowable minimum

238. This excludes assets exempt under the special rules for nonbusiness tangible personal property, income in respect of a decedent (if current Section 691 is retained, as discussed in text accompanying notes 284-93), and marital and charitable bequests. It includes, however, lifetime taxable gifts.

239. This was the approach of the leading carryover basis clean-up proposal. H.R. 4694 § 2(a) (proposed § 1023(a)(3)).

240. It also would create the potential for the minimum basis adjustment inappropriately creating or increasing a net loss (rather than reducing or eliminating a net gain). Suppose an estate consists of Asset A, with a basis of zero and a value of \$300,000, and Asset B, with a basis of \$400,000 and a value of \$100,000. The estate has no actual net gain or loss, but a \$200,000 minimum basis adjustment to Asset A would create an artificial net loss of \$200,000. It should be easy enough, however, to draft a rule providing that the minimum basis adjustment cannot be used to create or enlarge a net loss.

241. In any event, the denial of losses at death is a feature of the law taxpayers have dealt with for many years.

basis increase among the various assets of the estate.²⁴² Since different assets would go to different beneficiaries and would be disposed of at different times, how the basis was allocated had significant tax consequences. In this respect, taxation of gains at death is simpler than carryover basis. Since all the capital gains and losses realized at death will be netted against each other, it makes no difference how the minimum basis adjustment is allocated among the estate's capital assets. The allocation of the adjustment could matter only if there was a question of whether it should be allocated to capital gain assets or ordinary income assets.²⁴³ As discussed below,²⁴⁴ the adjustment might be made available only to capital assets. But even if it is available for ordinary income assets, the allocation rule would be simple: the allowable adjustment is allocated to capital assets to the maximum extent possible (i.e., up to their estate tax values), and any remaining allowable adjustment is allocated to ordinary income assets (how it is allocated among those assets makes no difference).

c. Ordinary Income Items

It is questionable whether ordinary income should be eligible for the minimum basis adjustment.²⁴⁵ Three different forms of ordinary income merit separate consideration: income in respect of a decedent (IRD), gain on Section 1221(1) inventory-type assets, and depreciation recapture.²⁴⁶ Issues relating to IRD—the most important of which is whether IRD items should be taxed at death or when they are collected—are discussed elsewhere in this Article.²⁴⁷ That discussion concludes that the minimum basis allowance should not apply to IRD, regardless of how the timing issue is resolved. Inventory items raise the same timing issue, and therefore are discussed in connection with IRD. Again, the conclusion is that minimum basis should not apply.²⁴⁸ The better policy on recapture income is not to allow the minimum basis adjustment: the price of taking an artificial depreciation deduction against ordinary income should be the recapture of the deduction no later than at death. Moreover, the fact that depreciation deductions

242. *Background and Issues* at 27 (cited in note 30).

243. All capital assets held at death would be deemed to give rise to long-term gain or loss, regardless of the actual holding period. See *Tax Reform Studies and Proposals* at 340 (cited in note 148).

244. See text accompanying notes 245-49.

245. Section 1023 did not disqualify ordinary income property (other than income in respect of a decedent) from its minimum basis adjustment. I.R.C. § 1023(d). By contrast, the Canadian \$100,000 gain exemption applies only to capital gains. Income Tax Act § 110.6 (1992).

246. I.R.C. §§ 1245, 1250.

247. See text accompanying notes 284-93.

248. See text accompanying notes 294-95.

have been claimed on the property eliminates any argument that the estate cannot be expected to know the basis of the property.

Not allowing the minimum basis adjustment against ordinary income items does create limited potential for imposing gains tax at death (or after death, depending on how the timing issues are resolved) in cases in which the estate tax would not apply, but the reasons for taxing such income justify the discontinuity. Incidentally, the discontinuity exists under current law in the case of IRD.²⁴⁹

d. The Post-Transfer Basis of Exempt Assets

When appreciated property transfers free of gains tax under the minimum basis exemption, the question arises whether the property should take a carryover basis or a fair market value basis in the hands of the transferee. I think the best answer is a bifurcated approach: exempt gifted property should receive a carryover basis and exempt estate property should receive a fair market value basis—in other words, present law (Sections 1015 and 1014) should continue with respect to exempted transfers. This approach can be criticized for its seeming logical inconsistency, and for perpetuating a limited lock-in effect. The alternative to carryover basis for exempted gifts is offering taxpayers \$600,000 of tax-free basis increase on voluntary lifetime gifts. That is, of course, much more generous than current law, and there does not seem to be any good reason for such generosity. Stepped-up basis at death, by contrast, serves an important simplification purpose by avoiding proof of basis problems for small estates—which the history of carryover basis suggests is a political necessity. In addition, stepped-up basis at death is not available for voluntary transfers, and it is not more generous than current law.

A closely related question is whether property passing under the marital exemption, which ordinarily would receive a pure carryover basis, should be entitled to any otherwise unused minimum basis.²⁵⁰ Suppose, for example, that the estate has two assets, each with a zero basis. Asset A, valued at \$400,000, goes to the decedent's child, who takes it with a \$400,000 basis under the minimum basis rule. Asset B, valued at \$300,000, goes to the decedent's spouse. Should the spouse take it with a zero carryover basis, or a \$200,000 basis (representing the portion of the minimum basis not applied to the other property)? The argument for allocating "left over" minimum basis to a marital bequest is that

249. IRD items always are subject to income tax, I.R.C. § 691, even if the estate is too small to be subject to estate tax.

250. Essentially the same issue is considered, in a different context (a proposal generally not to apply Section 1014 to marital bequests), in Gutman, 69 Va. L. Rev. at 1237 (cited in note 160).

such an allocation is necessary to avoid discrimination against marital bequests. If such an allocation is not permitted, the nonmarital bequests of a small estate get a tax-free basis step-up, but the marital bequest gets only a carryover basis.

Although there is some merit to that argument, I favor not permitting the allocation. Only the zero basis (in the example) is consistent with the fundamental premise of the marital exemption—that transfers between spouses should be treated as nullities for tax purposes. Moreover, pure carryover basis (with no adjustments whatsoever) is very simple²⁵¹ and avoids the difficulties of allocating the minimum basis allowance among the various assets received by the surviving spouse.²⁵²

e. Coordination With the Gift Tax Annual Exclusion

Complete coordination of the gains tax exemption with the gift tax would require ignoring any appreciation in property transferred under the \$10,000 gift tax annual exclusion of Section 2503(b), just as the gift tax ignores the transfer. This could be done, of course; but given sufficient donees, sufficient years to work with, and highly appreciated property, it would constitute a major loophole in the gains tax. Perhaps the loophole should be acceptable, because basis will carryover and gain will merely be deferred. Still, the loophole has the potential to defer tax for a generation (or for two generations, if the gift is to a grandchild), and such deferral normally is not permitted under a gains tax on gifts and bequests. A possible solution would be to apply the annual exclusion to both taxes, but to narrow significantly the scope of the exclusion—for example, by limiting it to gifts of cash and tangible personal property.

f. Coordination With the Nonbusiness Tangible Personal Property (TPP) Rules

As discussed later in the Article, there should be a special rule giving each item of nonbusiness tangible personal property a minimum basis (perhaps \$5,000) for computing gain at death.²⁵³ The general minimum basis adjustment and an item-by-item TPP \$5,000 minimum basis allowance (for purposes of computing gain) should be coordinated in the following way. A TPP item valued at \$5,000 or less should be ignored entirely—treated as if it did not exist—in determining the gen-

251. Even with pure carryover basis, there will never be a need to establish the basis of the assets, if the surviving spouse holds them until death, and the surviving spouse's estate does not exceed the minimum basis amount.

252. As explained in text accompanying notes 242-44, minimum basis in a carryover system requires allocation, whereas minimum basis in a recognition system generally does not.

253. See text accompanying notes 253-68.

eral minimum basis adjustment. A TPP item valued at more than \$5,000 should be treated like any other asset for purposes of computing the general minimum basis adjustment (regardless of whether the item's basis is the \$5,000 minimum basis or some higher actual basis). Ignoring low value TPP items in computing the general minimum basis adjustment creates some potential for entirely exempting an estate from the gains tax, even though the estate is large enough to be subject to the estate tax. The potential is limited, however, and should be tolerated in the interests of simplicity.

E. Issues Associated With Particular Types of Assets

1. The Treatment of Nonbusiness Tangible Personal Property

Nonbusiness tangible personal property (TPP) presents special administrative problems for a capital gains tax at death. Such assets tend to be numerous and of relatively low value. Moreover, these are the assets for which adequate basis records most likely do not exist. Taxpayers may fail to keep basis records for TPP because the costs are often trivial, because they do not expect the assets to appreciate,²⁵⁴ because they know a loss would be nondeductible,²⁵⁵ and simply because the nonbusiness context of the acquisition makes business-type records seem unnecessary.

One could argue that whatever allowances must be made for taxpayers who fail to keep basis records for TPP in reliance on Section 1014, taxpayers must keep records or bear the consequences for assets acquired after the effective date of a death gains tax. But that argument expects too much of people; special rules for TPP are clearly needed.

At the other extreme from no special rules, a capital gains death tax simply could exempt all TPP from the tax, and continue to give those assets a basis equal to fair market value at death. Even total exemption would not have a major revenue impact. Professor Shakow has estimated that TPP (referred to by him as "consumer durables") constitute only 8.6% of the total value of all assets owned by individuals.²⁵⁶ The vast majority of these assets fall into categories involving no signif-

254. Consumer durables, such as cars, furniture, and appliances, almost always decline in value over time, unless they fall into the special category of collectibles (such as antique cars).

255. Individuals may deduct losses only if they are incurred in a trade or business, in a transaction entered into for profit, or as a result of casualty or theft. I.R.C. § 165(c). A loss on the sale of a personal use item falls into none of those categories.

256. David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. Pa. L. Rev. 1111, 1125 (1986). Shakow's figure is based on data compiled by the Federal Reserve Board as of the end of 1984.

icant chance of appreciation. Shakow estimates that potentially appreciable TPP ("collectibles", such as art, antiques, and jewelry) constitute at most one percent of the value of all assets held by individuals, and probably closer to half that.²⁵⁷ Despite the relative insignificance of TPP in the overall picture, two concerns counsel against total exemption. One is equity: a small number of taxpayers will have very large gains in art and antiques, and it is unfair to exempt those gains when other taxpayers are taxed on much more modest gains. The other is tax avoidance: although collectibles are not now of great significance, their significance will increase if wealthy taxpayers are led to invest in them as the only means of avoiding the death gains tax for large amounts of gain.²⁵⁸

A limited exemption is needed. There are two issues concerning the exemption: whether it should apply on an asset-by-asset basis (versus an aggregate basis), and what should be the dollar amount of the exemption. Section 1023 used an aggregate exemption: \$10,000 (by estate tax value) of "personal and household effects" were exempted from carryover basis and given a fair market value basis under Section 1014.²⁵⁹ Proposed clean-up legislation would have increased the exemption amount and would have extended the exemption to all nonbusiness tangible personal property.²⁶⁰ Canada, by contrast, provides a \$1,000 minimum basis for each item of "personal use property" for purposes of computing gain on its disposition (whether by sale, gift, or bequest).²⁶¹ A special rule treats "properties ordinarily disposed of as a set" as a single item of personal use property for purposes of the minimum basis allowance.²⁶²

257. *Id.* at 351.

258. For the same reason, Shakow argues against totally exempting consumer durables from the accrual taxation system he proposes: "If policymakers removed these assets from the system, taxpayers would be encouraged to invest in them because of their tax-favored status. The potential for tax shelters and tax planning revolving around exempted consumer durables is too strong to ignore." *Id.* at 1152.

259. I.R.C. § 1023(b)(3).

260. H.R. 4694 § 2(a) (proposed § 1023(b)(3), providing for a \$25,000 exclusion).

261. Income Tax Act § 46(1) (1992). An interesting refinement of the Canadian law is its identification of "listed personal property" as a subset of personal use property. Listed personal property refers to certain classes of personal use property with significant investment potential—art, jewelry, rare books, stamps, and coins. *Id.* § 54(e). The significance of the distinction is that losses on personal use property are totally nondeductible, whereas losses on listed personal property are deductible against gains on other listed personal property. *Id.* § 41. This limited deductibility of losses on TPP with significant investment elements makes good sense. The list is, however, somewhat underinclusive (antique cars and furniture, for example, are not included).

262. *Id.* § 46(3). Technically, Section 46(3) of the Canadian Act applies only to a disposition that breaks up a set, but the clear implication is that a set disposed of as a set also is entitled to only \$1,000 of minimum basis. Graetz reports that the British capital gains tax at death, in force between 1965 and 1973, also used an item-by-item exemption and treated a set of articles as a

In choosing between the asset-by-asset and aggregate approaches, it is important to keep in mind the goal of simplifying the administration of the system with respect to assets of small value. An asset-by-asset exemption is truly simple: in the vast majority of cases involving TPP, it will be clear immediately that the asset is worth less than the exemption amount, and nothing more will need to be done. By contrast, under an aggregate exemption, the executor must value every asset and must choose which assets to apply the exemption against. Moreover, if the value of any exempted asset is raised or lowered on an estate tax audit, an adjustment will be required in the identification of exempted assets.²⁶³

Concern with ease of administration suggests a TPP exemption should apply to gratuitous transfers during life, as well as at death.²⁶⁴ Of the two exemption methods, asset-by-asset is simpler to apply to lifetime gifts. Under the asset-by-asset method, whether the exemption applies to a particular gift depends only on the value of that gift. But under the aggregate method, the exemption must be applied cumulatively, which means that whether the exemption applies to a particular gift depends on the total value of exempt gifts made in all prior years. (This cumulation also, of course, would affect the amount of exemption remaining to be used at death.) The need for record keeping, and the possibility of disputes over the value of prior years' gifts, are at odds with the goal of simplification. The aggregate method also leads to results that are questionable in terms of substance: until the exemption amount is exhausted, very substantial gains on lifetime transfers can escape tax; and after the exemption is exhausted, even trivial gains (whether on gifts or bequests) are at least theoretically taxable. But the asset-by-asset method means that substantial gains always are taxable and trivial gains always are exempt.²⁶⁵

single item. Graetz, 59 Va. L. Rev. at 843 (cited in note 84). Although there were some cases of disagreement over whether related articles constituted a set, practitioners "experienced very few doubtful cases and did not consider this problem to be particularly important." *Id.* at 843 n.37. Revenue Canada officials also stated that the set rule has not created any serious problems. Interviews by author (cited in note 88).

263. If the value of an asset is lowered, the executor should be allowed to exempt other assets in order to fully utilize the exemption amount. If the value of an asset is raised, the executor should be allowed to choose which assets to remove from the list of exempt assets.

264. However, in order not to create a tax avoidance incentive to make lifetime transfers of appreciated TPP, an exempted lifetime gift should result in a carryover basis, rather than the fair market value basis given to exempted transfers at death. In other words, the distinction of present law between Sections 1014 and 1015 of the U.S. Code should continue to apply to exempted gratuitous transfers of TPP.

265. An asset-by-asset exemption could go one step further, as Canada has done, and make the exemption available even for sales and other dispositions taxable under current law. Income Tax Act § 46(1) (1992). To a significant extent, the legitimate concerns about basis record-keeping

On the other hand, if controlling the total amount of gain exempted (whether during life or at death) is a major concern, only the aggregate method provides that control. The concern here is that the asset-by-asset method could be abused by a taxpayer who acquires a great many assets of small value taken individually, but of considerable value in the aggregate,²⁶⁶ and who thereby exempts an inappropriately large amount of gain. I tend to discount this concern, because the method is both too cumbersome and too uncertain (there is no guarantee the assets will appreciate after their acquisition) to appeal to many taxpayers.

Although on balance I prefer the asset-by-asset method, either method is workable,²⁶⁷ and the choice between them is not one of the more important issues in implementing a gains tax at death. There is, of course, no right answer as to what the amounts of the exemptions should be, but \$5000 should strike about the right balance as an asset-by-asset exemption,²⁶⁸ and perhaps \$100,000 as an aggregate exemption.

2. Issues Relating to Personal Residences

Should a special exemption from a death gains tax be provided for appreciation in the decedent's personal residence? The 1969 Treasury proposal argued it should not, on the premise that a marital exemption and a minimum basis allowance made it unnecessary.²⁶⁹ I agree with the Treasury position: if the residence does not go to the surviving spouse, and if the gain would not be exempt under the generally applicable minimum basis rule (or other small estate exemption), there is no good reason to allow a special exemption.

This having been said, several subsidiary points are worth noting. First, proposals occasionally have been made for a general exemption

apply even to such dispositions. Moreover, this is an area in which enforcement is almost impossible and compliance is presumably very low. Officially providing an exemption in such cases would bring the law in line with practice. By contrast, allowing an aggregate exemption to apply to currently taxable dispositions would make very little sense. It would exempt substantial gains (and, once the exemption is exhausted, tax trivial gains), and it would complicate rather than simplify the rules (by requiring taxpayers to report all gains and claim the exemption).

266. A stamp or coin collection would be a good example, assuming it is not treated as a single asset under a "set" rule.

267. The aggregate method does have one advantage: unlike the asset-by-asset method, it does not involve the problem of determining whether an asset is part of a set. However, this does not appear to be a significant problem. See text accompanying note 262.

268. Revenue Canada officials told the author they thought the Canadian \$1000 exemption should be increased significantly. Interviews by author (cited in note 88).

269. *Tax Reform Studies and Proposals* at 342 (cited in note 148).

from gains tax on any disposition of a personal residence.²⁷⁰ Whatever one's view of the merits of such an exemption, if it is adopted it certainly should apply at death as well as during life.²⁷¹

Second, if a capital gains tax is enacted without a general marital exemption, there should be a special marital exemption for gain in a personal residence left to a surviving spouse who continues to live in the residence. A tax on the gain in the house in that situation is clearly inappropriate, given its potential to evict the surviving spouse by forcing a sale to pay the tax.

Third, there was concern in connection with the carryover basis legislation that taxpayers understandably would fail to keep good records of the basis of home improvements. To address this concern, the leading clean-up proposal would have permitted, without proof, an automatic basis increase for home improvements of \$250 per year.²⁷² A gains tax at death could permit a similar adjustment—perhaps for a larger amount, such as \$1000, to reflect inflation since the 1970s. The appropriateness of such an automatic adjustment, however, is debatable. Taxpayers arguably should be expected to keep adequate cost records for major improvements, and minor improvements generally should be characterized as repairs not giving rise to basis. If an automatic adjustment is permitted, a question arises as to whether it should be permitted only in connection with gains realized at death, or also in connection with taxable dispositions during life. The carryover basis adjustment would have applied only at death, but the argument in favor of the adjustment seems to have equal force regardless of when the taxable event occurs.

Finally, there is an issue of how (if at all) to coordinate a gains tax at death with the one-time exclusion of \$125,000 of gain on the sale of a personal residence by a taxpayer at least 55 years old. Section 1023 provided no coordination; if the exemption was not used during life, it was lost. In the clean-up discussions, some argued the estate should be able to sell and take advantage of Section 121 if the decedent could have

270. See, for example, Lee Sheppard, *Should Sales of Personal Residences be Exempt from Tax?*, 50 Tax Notes 1433 (1991). Canada has such a general exemption, which applies to dispositions both during life and at death. Income Tax Act § 40(6) (1992).

271. Note, however, that elimination of the tax-free step up in basis at death would weaken the argument for having a general exemption in the first place. A major argument for a general exemption is that the combination of the tax-deferred rollover provision, I.R.C. § 1034, the one-time \$125,000 exclusion, and the forgiveness of tax at death, results in personal residence gain being taxed to relatively few taxpayers. The argument concludes that those few hapless taxpayers should not be taxed when all others are not. That argument would be weakened seriously by the introduction of a tax on gains at death. On the other hand, Canada has chosen to exempt personal residence gain despite the taxation of gains at death.

272. H.R. 4694 § 2(a) (proposed § 1023(e)(2)). The adjustment would have been permitted only at the time of the homeowner's death.

done so immediately before death.²⁷³ The Treasury supported only a more limited coordination to permit a surviving spouse to take advantage of the exclusion on a subsequent sale if the decedent had been older than fifty-five and the surviving spouse was not.²⁷⁴ A gains tax at death with a marital exemption (resulting in carryover basis) could provide the same limited coordination.²⁷⁵

In the context of a gains tax at death and a personal residence *not* left to a surviving spouse, the major options concerning the \$125,000 exclusion would be: not allowing the exclusion at all; allowing the exclusion any time the decedent would have been eligible for the exclusion immediately before death; and allowing the exclusion in any case in which the decedent had not used it while alive, even if the decedent was younger than fifty-five. The choice depends on one's view of the purpose of the exclusion. It could be viewed as personal to the taxpayer: as designed to enable a taxpayer to use residence appreciation to finance his retirement, undiminished by a capital gains tax.²⁷⁶ So viewed, the justification for the exclusion dies with the taxpayer, and no exclusion should be allowed against the death gains tax.²⁷⁷ Alternatively, the exclusion might be viewed as an extremely rough inflation adjustment, or as a reflection of a policy that only unusually large gains—major windfalls—in personal residences should be taxed. If so, the exclusion should be available to the estate as long as the decedent had not used it already, regardless of the decedent's age at death. Under neither view would the middle approach—allowing the exclusion only if the decedent were over fifty-five—make particularly good sense, but it nevertheless might have appeal as a compromise solution. And it does have the arguable virtue, unlike the other two choices, of treating death neutrally—i.e., neither eliminating nor creating a tax benefit by reason of the taxpayer's death.

273. This would require that the decedent have been at least 55 years old and not previously have taken advantage of the exclusion.

274. *Carryover Basis* at 192 (cited in note 106) (letter of Donald C. Lubick to Senator Dole).

275. It could be objected that Congress thought special relief was justified only for relatively elderly persons moving their wealth out of housing, so that the relatively young widow should not inherit her older spouse's exemption. But allowing her the exemption might have major public relations value for the tax laws, while resulting in only very modest revenue loss.

276. This view is supported by the legislative history of the exclusion, which notes that an elderly person selling his home may "require some or all of the funds obtained from the sale of the old residence to meet his and his wife's living expenses," and which concludes that imposing a tax in such a case "is an undesirable burden on our elderly taxpayers." H.R. Rep. No. 749, 88th Cong., 1st Sess. (1963), reprinted at 1964-1 (Part 2) C.B. 125, 169.

277. The Congressional Budget Office assumed a death gains tax under which "the existing \$125,000 exclusion on the gain from sale of a principal residence could be claimed if it had not already been used." *Reducing the Deficit* at 315 (cited in note 14). It is not clear whether this means the second or third option described in the text.

3. Life Insurance

Under current law, Section 101 generally excludes from gross income life insurance proceeds payable by reason of the death of the insured. This can be viewed as a special instance of the forgiveness at death of tax on appreciation. Thus, if a tax is to be imposed on gains at death, the exclusion for life insurance proceeds should be reconsidered.

The carryover basis legislation explicitly indicated that it did not affect the life insurance exclusion.²⁷⁸ However, the conversion of life insurance to cash at death meant that the carryover basis compromise was not available for life insurance. Congress was faced with the choice of either taxing it at death or not taxing it at all, and it was unwilling to tax at death.

In a system in which taxation of gains at death is the general rule, should life insurance proceeds be subject to that general rule? Logic and consistency suggest they should. On the other hand, a major concern with a gains tax at death is liquidity,²⁷⁹ and life insurance is an important means of providing liquidity at death. Not taxing insurance proceeds would encourage the use of insurance to fund death tax liabilities.²⁸⁰ If an exemption is retained for this reason, it should be limited in accordance with its rationale. Rules should be designed to limit the exclusion to the excess of death tax liabilities over other liquid assets in the estate.

As an alternative to either completely removing the exemption, or removing it subject to special liquidity-related relief, Congress could distinguish between the investment gain (inside build-up) in life insurance and the mortality gain (or loss), taxing the former but not the latter.²⁸¹ The investment gain could be taxed either annually on an accrual basis,²⁸² or only at death. Taxation of inside build-up is justified by its similarity to taxable interest income. Ignoring mortality gains and losses could be explained on the grounds that the beneficiaries of one who dies early (and thus has a mortality gain) are likely to suffer serious financial hardship from the death, and so deserve a tax subsidy.²⁸³

278. Section 1023(b)(2)(B) provided that "property described in section 2042 (relating to proceeds of life insurance)" was not carryover basis property.

279. See text accompanying notes 304-30.

280. See Graetz, *Federal Estate and Gift Taxes* at 1295 (cited in note 38).

281. Graetz argues that, at the very least, a death gains tax should include taxation at death of the investment gain in life insurance. Graetz, 59 Va. L. Rev. at 845 (cited in note 84).

282. This is a reform that has been seriously proposed independently of the taxation of gains at death. A proposal to tax the inside build-up on life insurance annually on an accrual basis was included in *The President's Tax Proposals to Congress* at 254-57 (cited in note 15).

283. Moreover, if both mortality gains and losses are ignored for tax purposes, in the aggregate the gains and losses cancel out, and the revenue effect should be close to neutral. This would

4. Income in Respect of a Decedent and Other Ordinary Income Items

Income in respect of a decedent (IRD)²⁸⁴ is, in general, income that has accrued before death, but that was not taxable before death under the tax accounting rules applicable to the decedent. Important examples include compensation for services rendered, accrued dividends and interest, amounts in qualified retirement plans, and amounts due on installment sales. IRD items are usually, but not always, ordinary income.²⁸⁵ Under current law, the benefit of Section 1014 does not apply to IRD.²⁸⁶ Instead, the item is taxable to the estate or beneficiary at the same time and in the same manner that it would have been taxed if the decedent had lived.²⁸⁷ Generally, this means the item will be taxed to the estate or beneficiary when payment is received. Thus, under current law, tax on IRD is not forgiven at a taxpayer's death.

In the context of a proposal generally to tax gains at death, the issue with respect to IRD is whether to continue current law (a carryover basis approach) or to tax IRD at death.²⁸⁸ The 1969 Treasury proposal to tax gains at death would have repealed the special rules for IRD and required recognition of IRD at death.²⁸⁹ The stated rationale was that the IRD rules "were designed to avoid bunching of ordinary income in the decedent's final return," and that bunching could be dealt with instead by the use of averaging rules.²⁹⁰

Treasury was correct in stating that avoiding bunching was the historical explanation for the carryover basis treatment of IRD.²⁹¹ If it is also the only reason to continue current treatment, then it is not a good enough reason. Under the current nearly flat income tax rate structure, bunching is not an important issue; if rates should change to make it an important issue, it can be addressed with averaging provisions.

But bunching is not the only possible reason for not taxing IRD at death. There is also the problem of valuing IRD items, which is necessary if tax is imposed at death, but not if tax is deferred until payment

not be the case, however, if mortality losses were permitted to offset investment gains. In that case, some mortality losses would produce a tax benefit, but no mortality gains would produce a tax detriment.

284. I.R.C. § 691.

285. For example, capital gain deferred under Section § 453 (relating to installment sales) would be income in respect of a decedent. I.R.C. § 691(a)(4).

286. I.R.C. § 1014(c).

287. Treas. Reg. § 1.691(a)-3.

288. The issue does not arise under a general carryover basis at death system, such as Section 1023, because carryover basis applies the current treatment of IRD to *all* assets held at death.

289. *Tax Reform Studies and Proposal* at 338-39 (cited in note 148).

290. *Id.*

291. H.R. Rep. No. 2333, 77th Cong., 2d Sess. 84-85 (1942).

is received. David Westfall has stated that classic IRD items (such as accrued salary, interest, and dividends) are not hard to value, and must be valued anyway for the estate tax.²⁹² But neither of his claims is entirely accurate. Most classic IRD items may not be unusually difficult to value, but valuation is not as simple as determining the amount ultimately due. Those amounts would have to be discounted to reflect the expected delay in the receipt of cash and doubts as to the payors' creditworthiness. Moreover, under current law, items of IRD are taxable upon receipt of payment, even when the estate is not subject to estate tax, and one would not expect Congress to change this rule upon adoption of a gains death tax. Assuming there continues to be no small estate exemption from the taxability of IRD, taxing IRD at death *would* require valuation in many cases in which the estate tax does not require valuation. In short, the treatment of IRD under current law is better than a tax at death for avoiding valuation problems and for avoiding the need for a later tax adjustment if the amount ultimately received does not equal the amount included in income at death.

In addition, since IRD items generally are received within a reasonably short time after death, any deferral obtained from retention of current law would be minor and would be a reasonable price to pay in order to obtain the advantages of matching the imposition of the tax with the receipt of cash—i.e., avoiding the need for valuation and avoiding liquidity problems.

On balance, it seems that the present treatment of ordinary income items of IRD works reasonably well, is neither too harsh nor too generous, and should be retained even under a system that generally taxes gains at death. Thus, such items should continue to be given carryover basis treatment, and should not be eligible for any small estate exemption to the death gains tax. On the other hand, capital gains IRD items—such as deferred gain on installment sales—have more in common with other capital gains than with other IRD. The similarities are both in terms of the typical length of the delay between death and the receipt of payment, and in terms of the nature of the income. Like other capital gains, capital gain IRD items should be subject to the death gains tax, but should be eligible for the small estate exemption.

Closely related to the question of the treatment of IRD under a death gains tax is the question of how other items of ordinary income should be treated. The two most important categories are appreciation in inventory and other Section 1221(1) assets, and depreciation recapture. The issues are whether any small estate exemption should be

292. General Tax Reform: Panel Discussions Before the Committee on Ways and Means, 93d Cong., 1st Sess. 1528 (1973) (statement of David Westfall).

available against gain on such assets, and whether that gain should be recognized at death or subject to carryover basis.²⁹³

With respect to inventory, basis records generally are good and taxpayers expect to pay tax on gains from sales in the ordinary course of business, so there is neither an administrative nor an equitable argument for allowing such gain to escape tax through a small estate exemption. As for timing, the same arguments that favor carryover basis for IRD items also favor carryover basis here.²⁹⁴ Carryover basis avoids valuation and liquidity problems, and the resulting deferral is limited because the inventory normally will be sold not long after death.²⁹⁵

With respect to depreciation recapture, there is no serious issue of timing. The rule clearly should impose a tax at death, rather than carryover basis. The asset with the recapture potential must be valued at death anyway for purposes of the capital gains tax, and carryover basis could result in deferral of unlimited duration. The closer question is whether the small estate exemption should apply against recapture income. This is basically a question of how generous Congress decides to be, but certainly Congress could conclude that it is one thing to forgive tax on a limited amount of unrealized appreciation, and quite another never to require taxpayers to account for artificial deductions taken against ordinary income. If Congress generously allowed the small estate exemption to apply against recapture, it could impose an ordering rule requiring the exemption to be used first against capital gain, to the extent thereof.

F. Treatment of Losses on Gifts and Bequests

Under current law, a taxpayer may deduct capital losses only against capital gains and a very limited amount of other income (\$3,000 per year).²⁹⁶ Capital losses disallowed under this rule may be carried forward indefinitely.²⁹⁷

The standard rationale for this limitation is to prevent taxpayers with large portfolios of capital assets from selectively realizing losses to shelter ordinary income, while not realizing gains. The rule functions as a conclusive presumption that capital losses in excess of capital gains

293. The Canadian \$100,000 exemption is for capital gains only, Income Tax Act § 110.6 (1992); but the Section 1023(d) minimum basis allowance was not limited to capital assets (although it did not apply to IRD items).

294. The 1969 Treasury proposal, however, would have taxed inventory at death at its wholesale value. *Tax Reform Studies and Proposals* at 348 (cited in note 148).

295. Carryover basis, however, would require the complication of a deduction or basis increase on account of the estate tax attributable to the appreciation in the inventory, modeled after Section 691(c) (deduction for estate tax attributable to IRD item).

296. I.R.C. § 1211(b).

297. I.R.C. § 1212(b).

(and \$3000 of other income) are artificial—in the sense that they are offset by unrealized capital gains—and therefore should be nondeductible.²⁹⁸

If the law mandates the realization at death of *all* capital gains and losses, then obviously selective realization of losses is not an issue, and the ordinary limits on the deductibility of capital losses should not apply. Moreover, even if the law permits a marital exemption, there is no opportunity for selective realization of losses if the law requires reallocation of basis, rather than the use of the actual basis of each asset. Thus, in either a system without a marital exemption, or with a marital exemption and basis reallocation, the only limit on the deductibility of capital losses should be those indicated by statute of limitations concerns. A sensible ordering rule for the use of capital losses realized at death under such a system would be to deduct the losses against (a) capital gains of the taxpayer's final year, including capital gains at death, (b) \$3000 of ordinary income of the final year, (c) capital gains of the three preceding years, (d) remaining ordinary income of the final year, and (e) ordinary income of the three preceding years.²⁹⁹

There is, however, some opportunity for selective realization of losses at death under a system that allows a marital exemption and does not require basis reallocation. If a net capital loss realized at death is deductible against ordinary income without limitation, the executor might arrange to transfer the gain assets to the surviving spouse and the loss assets to other beneficiaries, thus generating an artificial loss to offset ordinary income. The opportunities to take advantage of this plan are limited by the inability to determine the time of one's death in order to maximize the opportunity to use capital losses.³⁰⁰ In addition, nontax considerations concerning how much value and which assets to pass to the surviving spouse and to other beneficiaries limit the advantages of this plan. Given these practical limitations on tax planning opportunities, the generous rules outlined above for the treatment of capital losses probably should apply even in a system with a marital

298. "Were capital losses deductible without limit, taxpayers would dispose of capital assets selectively to produce a net loss with which to shelter noninvestment income." *The President's Tax Proposals to Congress* at 172 (cited in note 15).

299. This is similar to the 1969 Treasury proposal, in the context of a system allowing a marital exemption and using basis reallocation. *Tax Reform Studies and Proposals* at 336 (cited in note 148). The proposed AET, which did not allow a marital exemption, nevertheless made no provision for the deductibility of a net loss. Graetz rightly criticizes this rule as "too inequitable." Graetz, 59 Va. L. Rev. at 851 (cited in note 84). To reflect the fact that capital gains are taxed at a lower maximum rate than ordinary income (28% versus 31%; I.R.C. § 1(a),(h)), the law could provide that capital losses offset ordinary income at a ratio lower than one to one—under current rates, that \$31 of capital losses would be required to offset \$28 of ordinary income.

300. Strictly speaking, one may be able to determine the time of one's own death, but only at the cost of incurring a significant non-tax disadvantage.

exemption and without basis reallocation. If Congress disagrees, however, a reasonable alternative would be: (a) to apply the generous deductibility rules in any case in which there is no marital bequest,³⁰¹ and (b) to apply the normal rules limiting the deductibility of capital losses by the decedent in other cases, but to permit the unused losses realized by the decedent at death to carryover to the surviving spouse. The justification for such carryover is simple: if the decedent is denied the losses on the presumption that they are offset by gains transferred to the surviving spouse, then appropriate matching of gains and losses requires carryover of the losses to the surviving spouse.³⁰²

Unlike transfers at death, when the opportunity for selective realization of losses is either limited or nonexistent (depending on the design of the statute), gifts during life offer ample opportunity for selective loss realization. It is clear that the normal capital loss limitations should apply to losses realized on lifetime gifts. In addition, it is arguable—as the Treasury proposed in 1969—that the Section 267 disallowance of losses on sales between related persons also should apply to gifts between related persons.³⁰³ An outright disallowance of such losses would have the considerable advantage of eliminating the possibility of manufacturing a loss by making a gift to a relative and claiming an unrealistically low value for the property.

G. Providing Liquidity Relief

An important argument against taxation of capital gains at death is that the imposition of the tax on illiquid estates consisting largely of farms or small businesses could lead to forced sales to raise cash to pay the tax, thereby hastening the demise of the family farm and the small business person. The political significance of this argument is considerable: many close observers of the demise of carryover basis attributed its repeal primarily to lobbying by farm and small business groups.³⁰⁴

301. Perhaps these deductibility rules also should apply to limited cases in which there is a marital bequest, but it is clear that unrealized gains have not been selectively transferred to the surviving spouse.

302. Canada, which has a marital exemption and no basis allocation, permits capital losses to be deducted against ordinary income without limit in the year of the taxpayer's death or the preceding year. Income Tax Act § 111(2) (1992). This two-year restriction on the deductibility of losses against ordinary income appears somewhat arbitrary.

303. *Tax Reform Studies and Proposals* at 339 (cited in note 148).

304. Hoffman, 37 Tax L. Rev. at 444 n.131 (cited in note 19). These groups argued against carryover basis on the grounds of both difficulty of proving basis and liquidity concerns. Although carryover basis did not result in a tax until an asset was sold, the argument was that it nevertheless would create liquidity problems because appreciated assets would have to be sold to pay the estate tax, and then the sale of those assets would generate an income tax, which would require the sale of more appreciated assets to pay the income tax, and so on indefinitely. This was referred to as the problem of "mushrooming" gains taxes. *Background and Issues* at 19 (cited in note 30).

The liquidity problem is real, but it is also quite limited. The Treasury Department estimated in 1979 that farms and closely-held businesses constituted only about seven percent of the value of all assets owned at death,³⁰⁵ and more recent information suggests that figure has not changed dramatically.³⁰⁶ Moreover, not every estate owning a farm or small business has a liquidity problem. A study of Iowa farmers, for example, found that liquid assets made up only 9.5% of the wealth of living farmers, but twenty-five percent of the gross estates of deceased farmers.³⁰⁷ The study speculated that this difference probably was attributable to elderly farmers adjusting their holdings in anticipation that liquidity would be needed to pay the estate tax.³⁰⁸ Elderly taxpayers could respond in the same way to the prospect of a capital gains tax at death. This is not to suggest that there never will be estates for which a capital gains tax at death will present a liquidity crisis. There will be such estates, but they will be the exception.

The problem of illiquid estates already exists, of course, under the estate tax; the addition of a capital gains death tax increases the problem in degree but does not change it in kind. Assuming a fifty percent top estate tax rate and a twenty-eight percent top capital gains tax rate, and assuming that the capital gains death tax is deductible in computing the estate tax, the highest combined tax rate on appreciation at death would be sixty-four percent. In terms of liquidity problems, such a combination of taxes could be no worse than a sixty-four percent top estate tax rate and no capital gains tax (and to the extent the estate's value was not appreciation, it would not be as bad). By the standards of recent history, sixty-four percent is not a particularly high death tax rate. Before 1976 the highest estate tax rate was seventy-seven percent,³⁰⁹ between 1976 and 1981 it was seventy percent,³¹⁰ in 1982 it was

305. *Carryover Basis* at 11 (cited in note 106) (statement of Donald C. Lubick).

306. The IRS has reported that 4.3% of the value of assets included in total gross estates on 1986 federal estate tax returns consisted of noncorporate business interests, and 27.6% consisted of stock. Johnson, 9 SOI Bull. at 29 (cited in note 181). Unfortunately, the report does not indicate what percentage of the stock was closely-held. A rather dated study (based on IRS data on 1965 estate tax returns) estimated that 15.9% of the value of all stock held by individuals was closely held. Blume, Crockett and Friend, *Stockownership in the United States: Characteristics and Trends*, 54 *Surv. of Current Bus.* 16 (1974), in Shakow, 134 U. Pa. L. Rev. at 1133 (cited in note 256). Applying that 15.9% figure to the 1986 data would result in closely-held stock constituting 4.4% of all assets held at death. Combined, closely-held stock and noncorporate business interests would constitute 8.7% of all assets. (Johnson does not indicate whether noncorporate farm real estate counted as real property or as noncorporate business interests. If it is counted as real property, the total asset percentage allocable to farms and small businesses would be somewhat higher.)

307. *Contemporary Studies Project: Large Farm Estate Planning and Probate in Iowa*, 59 *Iowa L. Rev.* 794, 929 (1974).

308. *Id.* at 930.

309. *Tax Reform Act of 1976* at 525 (cited in note 40).

310. *Tax Reform Act of 1976* § 2001, 90 Stat. 1846-47.

sixty-five percent, in 1983 it was sixty percent, from 1984 to 1992 it was fifty-five percent, and in 1993 it is scheduled to fall to fifty percent.³¹¹ Thus, even in degree the liquidity problems that would arise from the combined burden of the estate and gains taxes would not be a major change from the recent past.

This means that the obvious starting point in thinking about liquidity relief for the gains tax should be the existing rules providing liquidity relief for the estate tax. These are the deferral provisions of Sections 6166 and 6161, and the special use valuation rules of Section 2032A. The crucial question is to what extent these provisions should be expanded to deal with the additional liquidity burden that a death gains tax would impose.³¹²

Under Section 6166, an estate may qualify to defer payment of estate tax for five years, and then to pay the tax in as many as ten equal annual installments. For an estate to qualify, it must have an interest in a closely-held business that constitutes more than thirty-five percent of the value of the adjusted gross estate.³¹³ The amount of tax eligible for the five-year deferral and the ten-year installment payments is an amount bearing the same ratio to the total estate tax as the value of the closely-held business bears to the adjusted gross estate.³¹⁴ This provision could be amended easily to allow deferral and installment payment of death gains tax attributable to appreciation in a closely-held business.³¹⁵ This would require identifying the portion of the death gains tax attributable to the closely-held business interest. Several identification methods are possible, but the simplest (and most taxpayer-favorable) would be at the margin: that is, to allow deferral of the amount by which the death gains tax liability would have been decreased if the estate had not included the interest in the closely-held business. Assuming that the thirty-five percent test is appropriate to identify estates with liquidity problems in the estate tax context, the same test also should apply for purposes of qualifying for deferral of the death gains tax.³¹⁶

311. The rates for 1982 and later years are provided for by current Section 2001(c).

312. The current versions of all three liquidity relief provisions were in force in 1982, when the highest estate tax rate was 65%, *id.* § 2001(c)(2)(B)—slightly higher than the 64% combined burden of a 50% estate tax and a 28% gains tax. If Congress considered those provisions adequate liquidity relief against a 65% estate tax, it also might well consider them adequate relief against a 64% combined tax burden.

313. *Id.* § 6166(a)(1).

314. *Id.* § 6166(a)(2).

315. The definition of an interest in a closely-held business in I.R.C. Section 6166(b)(1) could apply for gains tax purposes as well as estate tax.

316. The death gains tax liability would reduce the adjusted gross estate (defined in I.R.C. § 6166(b)(6)), thus making it somewhat easier to satisfy the 35% test.

Interest is payable annually on the tax deferred by Section 6166.³¹⁷ The statute provides for a special four percent interest rate on the first \$345,800 of deferred estate tax liability.³¹⁸ Of course, Congress also could apply the special rate to some limited portion of the deferred gains tax liability.

Unlike the mechanical approach of Section 6166, Section 6161 gives the government the discretion to extend the time for payment of the estate tax. Upon a showing of reasonable cause, the extension may be for as long as ten years.³¹⁹ An example of reasonable cause would be having to sell property at a sacrifice in order to pay the tax.³²⁰ This provision also should apply to the death gains tax liability.

Section 2032A permits farmland (and real property used in a closely-held business) to be valued for estate tax purposes according to its value in its current use, rather than its "highest and best use" value, under certain circumstances. The aggregate reduction in value under this provision is limited to \$750,000.³²¹ In enacting this provision, Congress was concerned that including the full development value of farmland in an estate could force the heirs to sell the land for development in order to pay the tax, thereby threatening the future of family farms.³²² Although the congressional rationale certainly is subject to criticism—on the grounds that it subsidizes relatively nonproductive uses of land—whatever merit there is in special use valuation would apply just as much to gains tax valuation as to estate tax valuation. Thus, if Section 2032A continues to apply to the estate tax, it also should apply to the death gains tax. Alternatively, the law simply could provide for carryover basis rather than recognition at death, in cases in which Section 2032A property passes to qualified heirs.³²³ This goes beyond legitimate liquidity concerns, but it might be necessary to mollify the farm lobby.³²⁴

If the estate tax liquidity provisions of current law are adequate, then the minimal changes suggested above will be an adequate response to the liquidity problems created by a death gains tax. Any number of more radical changes are conceivable, of course, and Canada provides

317. Id. § 6166(f).

318. Id. § 6601(j).

319. Id. § 6161(a)(2).

320. Treas. Reg. § 20.6161-1(a)(2)(ii), Example (2) (interpreting stricter "undue hardship" test of prior law).

321. I.R.C. § 2032A(a)(2).

322. *Tax Reform Act of 1976* at 537 (cited in note 40).

323. Canada permits rollover of gain at death on the transfer of farm property to a child. Income Tax Act §§ 70(9), 70(9.1), 70(9.2), 70(9.3) (1992).

324. Of course, it might not be enough to mollify the farm lobby. Certainly the lobby was not satisfied with carryover basis in 1976.

two possibilities. First, Canada allows payment of death gains tax in as many as ten equal annual installments.³²⁵ Interest is charged and security must be furnished.³²⁶ The right to defer tax does not depend, however, on any showing of liquidity problems. This “no questions asked” deferral provision has the advantage of simplicity, and if the interest charged is appropriate and the security is adequate it does not lend itself to abuse. Nevertheless, Congress has indicated its belief—through Sections 6166 and 6161—that cases deserving liquidity relief can be identified, and if Congress is correct in that belief, there is no good reason to give such relief when it is not needed.

Canada also provides a special \$500,000 gain exemption (as contrasted with the standard \$100,000 gain exemption) for farms and closely-held businesses.³²⁷ Because this exemption is available regardless of the nature of the disposition—even a cash sale is eligible—it cannot be viewed plausibly as liquidity relief.³²⁸ But would a similar exemption, available only for a deemed disposition at death, be appropriate as liquidity relief? It certainly would not be carefully targeted relief. It would be overinclusive, in that a highly liquid estate could be eligible for the exemption,³²⁹ and it would be underinclusive, in that it would not solve the liquidity problems of estates with very valuable appreciated farms and few liquid assets.³³⁰ Better targeted liquidity relief can and should be used instead.

VI. CONCLUSION

Considering the amount of attention that has been given to base-broadening tax reform options since the mid-1980s, the virtual absence of consideration of reforming the treatment of gains at death has been appalling. The brief and unhappy life of carryover basis may explain the status of Section 1014 reform as the dog that did not bark.³³¹ But

325. Income Tax Act § 159(5) (1992).

326. *Id.* §§ 159(5), 159(7).

327. *Id.* §§ 110.6(2), 110.6(2.1).

328. Canadian practitioners, fearing the repeal of such a generous exemption, have developed “crystallization” techniques designed to trigger recognition of gain on farms and closely-held businesses without actually disposing of the properties, in order to ensure that their clients do not lose the exemption by repeal. (When exempt gain is recognized, basis is increased by the amount of the exempt gain.) For a discussion by Revenue Canada of some crystallization techniques, see ATR-42 (1991). This problem would not exist, of course, if the exemption were available only for deemed dispositions at death.

329. For example, an estate with a farm with a value of \$500,000 and a basis of zero, and \$2,000,000 of unappreciated liquid assets, would qualify.

330. Consider, for example, an estate whose only significant asset is a farm valued at \$2,000,000, with a basis of zero.

331. “Is there any point to which you would wish to draw my attention?”

“To the curious incident of the dog in the night-time.”

well over a decade has passed since the repeal of carryover basis, and it is time for Congress to revisit the area. When it does so, it will find that taxing gains at death is a more attractive option than carryover basis. It also will find that, although there are difficult choices to be made among simplicity, fairness, and revenue concerns, it is possible to design a death gains tax that is workable, fair, and raises substantial revenue. Consideration of such a tax should be high on Congress's tax agenda.

"The dog did nothing in the night-time."

"That was the curious incident," remarked Sherlock Holmes.

A. Conan Doyle, *Silver Blaze*, in William S. Baring-Gould, ed., *The Annotated Sherlock Holmes* 277 (C.N. Potter, 1967).

