Vanderbilt Law Review

Volume 27
Issue 3 *Issue 3 - April 1974*

Article 4

4-1974

Alternative Gains Tax Treatments of Decedents' Appreciated Capital Assets

D. Allen Grumbine

NOTES

Alternative Gains Tax Treatments of Decedents' Appreciated Capital Assets

I. Introduction

The present treatment of appreciated assets under section 1014[1] of the Code permits a great deal of accrued appreciation to escape the income tax. While decedents pay a greater estate tax because asset appreciation swells their estates, they pay no gains tax at death on this accrued appreciation. Moreover, the recipients of the decedent's property generally take a stepped-up basis for the property equal to its fair market value at the time of death. A great deal of criticism has been leveled at this system, and numerous proposals have been made for remedying the situation: imposition of a capital gains tax at death on accrued appreciation; implementation of a carryover-basis system similar to that accorded to gifts under section 1015;[2] imposition of an additional estate tax; conversion to a rollover system of treating capital gains; and conversion to an accrual system of taxing capital appreciation. This Note will not attempt to forecast what change, if any, ultimately will be made in the treatment of appreciated assets at death. It will attempt instead to explain the principal features of both the current system and the proposals and will set forth the criticisms and defenses of each.

II. Current Law—Internal Revenue Code Section 1014

A. Introduction

Section 1014 of the Internal Revenue Code[3] provides that a beneficiary of property transferred at death takes that property at a stepped-up basis equal to its fair market value at the time of death, or six months after death if election is made under section 2032(a).[4] The decedent pays no income tax on gains that accrued while he held the property, and the beneficiary pays a tax only when he sells the property and only on those gains that have accrued since

1. Int. Rev. Code of 1954, § 1014.
2. *Id.* § 1015.
3. Int. Rev. Code of 1954, § 1014(a).
4. *Id.* § 2032(a).

the death of the transferor. Thus neither the decedent nor the beneficiary is taxable on gains accruing prior to death, and similarly, neither receives the benefit of losses accruing prior to that time. For example, if the beneficiary sells property at a price lower than the decedent's cost basis but higher than the section 1014 stepped-up basis received through the transfer, he will recognize taxable gain even though the transferor's basis has not been recovered.

Accrued appreciation in a decedent's probate assets was excused from income taxation as early as 1918 under interpretations of the then current tax statute.[5] In 1921 the first explicit statutory provision for a stepped-up basis at death was enacted.[6] Today this step up in basis applies to most probate assets[7] and several classes of nonprobate assets, generally allowing a new basis only if the asset is included in decedent's gross estate for federal estate tax purposes.[8]

Attacks upon this system of gains-tax forgiveness began as early as the 1930's[9] and have continued to the present.[10] Criticism has fallen into three principal categories: the system "locks-in" assets so as to dissuade owners from selling them and reinvesting the proceeds; it deprives the federal government of a large amount of revenue; and it is inequitable both to holders of appreciated property who sell before death and to those whose investments derive their value primarily from the production of taxable ordinary income rather than capital appreciation.

---

5. The Revenue Act of 1918 did not make specific reference to property received by bequest, devise, or descent but was interpreted to provide a basis equal to fair market value on the date of death. *See* Revenue Act of 1918, ch. 18, § 202(a), 40 Stat. 1060.

6. Revenue Act of 1921, ch. 136, § 202(a)(3), 42 Stat. 229.

7. Many items of income in respect of a decedent are probate assets, however, but are expressly denied a new basis at death. INT. REV. CODE OF 1954, §§ 691, 1014(c). *See* 3 A.J. MERTENS, FEDERAL INCOME TAXATION § 21.83 (1968); Waterbury, *A Case for Realizing Gains at Death in Terms of Family Interests*, 52 MINN. L. REV. 1, 4 (1967).

8. *See* INT. REV. CODE OF 1954, § 1014; Treas. Reg. §§ 1.1014-1 to -8 (1957). Section 1014(b)(9), which was added in 1954, provides a new basis for

> property acquired from the decedent by reason of death, form of ownership, or other conditions . . . , if by reason thereof the *property is required to be included in determining the value of the decedent's gross estate* . . . . (emphasis added).

9. For a discussion of early attacks upon the stepped-up basis at death see *Hearings on the Subject of General Tax Reform Before the House Comm. on Ways and Means*, 93d Cong., 1st Sess., pt. 9, at 3987-90 (1973) (statement of William P. Sutter) [hereinafter cited as *1973 Public Hearings*].

10. *See, e.g.*, H. GROVES, POSTWAR TAXATION AND ECONOMIC PROGRESS 219 (1946); L. SELTZER, THE NATURE AND TREATMENT OF CAPITAL GAINS AND LOSSES 106, 299 (1951); Kurtz & Surrey, *Reform of Death and Gift Taxes: The 1969 Treasury Proposals, The Criticisms, and a Rebuttal*, 70 COLUM. L. REV. 1365, 1381-89 (1970); Comment, *Taxing Appreciated Property at Death: The Case for Reform*, 51 ORE. L. REV. 364 (1972).

B. *Criticism of 1014*

1. Lock-in.—It frequently has been argued that a stepped-up basis at death encourages the retention of appreciated assets in anticipation of completely avoiding capital gains tax. Critics claim that this effect, termed "lock-in," distorts resource allocation because it deters a more profitable reinvestment of the retained assets during the investor's lifetime.[11] As an example of the lock-in deterent, 1,000 dollars invested in assets appreciating at the rate of ten percent per annum would be worth only 47,000 dollars in fifty years if the investor sold the assets annually and reinvested the after-tax proceeds.[12] If the investor held the assets to avoid the gains tax on a sale and received a stepped-up basis at death, however, his beneficiaries would net 135,000 dollars—an increase of 88,000 dollars—before estate taxes.[13]

The economic effect of this asset retention is twofold. It adversely influences market stability and it impedes the fluidity of capital. The market instability theory postulates that lock-in of assets makes the market for them thinner and thus accentuates price fluctuations. In a period of rising prices investors tend to hold their investments to escape tax on their gains, thus causing a shortage of the asset that drives prices higher. Conversely when prices are falling, investors will sell their assets to take a deductible loss, available only prior to death, thus increasing the supply of the asset and driving the prices lower. Changes in market price are thereby accentuated, increasing cyclical instability.[14] Groves, however, disputes this theory,[15] postulating that an investor's refusal to sell one

---

11. *Hearings on the President's 1963 Tax Message Before the House Comm. on Ways and Means*, 88th Cong., 1st Sess., pt. 1, at 29, 54-60 [hereinafter cited as *1963 Hearings*].

In 1955 it was estimated that 1,000,000 investors age 65 and over, who owned over $50 billion in equity were in this "straight jacket." Brown, *The Locked-in Problem*, FEDERAL TAX POLICY FOR ECONOMIC GROWTH AND STABILITY, Joint Committee on the Economic Report, 84th Cong., 1st Sess., 370 (1955). In its study the Brookings Institute concluded that three-fourths of the gains on stocks are unrealized during the lifetime of the investor. *See* M. DAVID, ALTERNATIVE APPROACHES TO CAPITAL GAINS TAXATION 99 (1968).

12. Assuming a 25% capital gains rate, the proceeds of the sale would be diminished by one-fourth of each year's appreciation to pay the capital gains taxes.

13. Comment, *supra* note 10, at 365.

14. For a discussion of the theory that lock-in accentuates market fluctuations, see BUTTERS, THOMPSON & BOLLINGER, EFFECTS OF TAXATION, INVESTMENT BY INDIVIDUALS 45 (1953); SMITH, FEDERAL TAX REFORM 126, 146 (1961); Brown, *supra* note 11, at 369; Hanrahan, *A Proposal for Constructive Realization of Gains and Losses on Transfers of Property by Gift and at Death*, 15 KAN. L. REV. 133, 138 (1966); Somers, *An Economic Analysis of the Capital Gains Tax*, 1 NAT'L TAX J. 226, 232 (1948); Steger, *The Taxation of Unrealized Capital Gains and Losses: A Statistical Study*, 10 NAT'L TAX J. 266, 280 (1957).

15. Groves, *Taxation of Capital Gains*, 2 TAX REVISION COMPENDIUM, Compendium of Papers on Broadening the Tax Base Submitted to the House Committee on Ways and Means,

asset, while decreasing the market supply of that asset and increasing its price, simultaneously decreases the demand for another asset that the locked-in investor would have bought with his proceeds. The decreased demand for that second asset holds its price down, thus balancing the price increase of the unsold asset held by the investor.[16]

Fluidity of capital, on the other hand, is the market phenomenon by which investment capital seeks new and risky undertakings that promise a high rate of return. Although there is no empirical evidence of the extent of lock-in's effect on capital fluidity, it is safe to assume that tax forgiveness at death does hamper the movement of capital from one investment to another.[17] It may be argued that elderly investors, who allegedly are swayed by impending tax forgiveness, would not seek high risk investments with their capital even if there were no forgiveness. Nevertheless, these taxpayers would have more psychological freedom to move their capital to assets that offer the optimum mix of return and risk in light of business circumstances. Whether this freedom of movement uninfluenced by a stepped-up basis at death would have an appreciable effect on our economy, however, is a moot point.

Most authorities concede that some lock-in does exist. Some writers discount its importance,[18] pointing to the lack of evidence of any actual adverse effect upon the economy as a whole. Furthermore, some argue that few people base their investment decisions upon tax forgiveness at death until they reach an advanced age at which there are reasons in addition to tax forgiveness that cause their inattentiveness to alternative investments. Those authorities who attach greater significance to lock-in split over whether the capital gains tax or the stepped-up basis at death is the primary causative factor. One school of thought, represented by the New York Stock Exchange and similar financial interests, maintains that the present capital gains rates are too high and that they are the main deterrent to realization of appreciation.[19] The famous Harvard Business School Study of the early 1950's supports the thesis that the capital gains tax reduces the rate of realization,[20] and a more

86th Cong., 1st Sess., 1193, 1197 (1959); *see* Heller, *Investors' Decisions, Equity, and the Capital Gains Tax*, FEDERAL TAX POLICY FOR ECONOMIC GROWTH AND STABILITY, Joint Committee on the Economic Report, 84th Cong., 1st Sess., 387-88 (1955).

16. For further discussion of this theory see Hanrahan, *supra* note 14, at 138.
17. *Id.* at 139.
18. *See* M. DAVID, *supra* note 11, at 225-26; Waterbury, *supra* note 7, at 48-49.
19. Brown, *supra* note 11, at 307-09.
20. BUTTERS, THOMPSON & BOLLINGER, *supra* note 14, at 343.

recent survey by Louis Harris and Associates, Inc. made for the New York Stock Exchange[21] purports to correlate hypothetical capital-gains tax-rate reductions with resulting asset sales increases.[22] Other recent studies, however, have concluded that the opportunity to avoid capital gains tax by holding until death is a heavy factor in deciding whether to switch investments.[23] Both groups appear to have technically sound bases for their findings, and the reason for their different conclusions rests upon the fact that each is proceeding from a different premise. If one assumes that a stepped-up basis at death is desirable, he must conclude that high capital-gains tax rates are the cause of lock-in. If one opposes the stepped-up basis on equitable or other grounds, however, it is easy to assume that if an investor knew that he would incur a gains tax at death or, that there would be no stepped-up basis at death, the incentive to hold would be greatly reduced.[24] It appears that lock-in is a result of the combination of both of these factors and that a significant change in either one could have a marked effect on the situation. If one starts from the premise that lock-in is a sufficient problem to warrant elimination, the choice becomes one between significantly lower capital-gains tax rates or elimination of the stepped-up basis.[25]

2. *Loss of Revenue*.—A number of studies have examined the amount of unrealized appreciation passing at death and the consequent revenue loss.[26] Based upon 1966 estate tax returns, the Treasury has estimated that estates required to file returns pass seven billion dollars worth of unrealized appreciation each year. An estimated 4.5 billion dollars of capital appreciation is passed by nonfiling estates.[27] Taxing these gains at death would have produced a

---

21. New York Stock Exchange, A New Look at the Capital Gains Tax Rate, Summary of a New Survey of Investors by Louis Harris and Associates, Inc. (1965).

22. For a summary of these results see Hanrahan, *supra* note 14, at 136.

23. *See* Holt & Shelton, *The Lock-in Effect of the Capital Gains Tax*, 15 NAT'L TAX J. 337, 341-42 (1962).

24. *See* Hanrahan, *supra* note 14, at 137.

25. Some writers are doubtful that a change in § 1014 would help the lock-in problems much, however, because a person generally would rather that his estate pay the tax. *See Panel Discussions on the Subject of General Tax Reforms, Estate and Gift Tax Revisions Before the House Comm. on Ways and Means*, 93d Cong., 1st Sess., pt. 10, at 1504-22 (statement of Bart A. Brown, Jr.) [hereinafter cited as *1973 Panel Discussion*].

26. *See* Elibott, *The Revenue Gain from Taxation of Decedent's Unrealized Capital Gains*, 22 NAT'L TAX J. 506 (1969); Hanrahan, *supra* note 14, at 141-44; Kurtz & Surrey, *supra* note 10, at 1383; Okun, *The Taxation of Decedents' Unrealized Capital Gains*, 20 NAT'L TAX J. 368 (1967); Steger, *supra* note 14.

27. HOUSE COMM. ON WAYS AND MEANS AND SENATE COMM. ON FINANCE, 91ST CONG., 1ST SESS., TAX REFORM STUDIES AND PROPOSALS, U.S. TREASURY DEPARTMENT, pt. 3, at 333 (Comm.

federal revenue increase of between 2.5 and 3.1 billion dollars annually.[28] The higher capital-gains tax rate under the Tax Reform Act of 1969, coupled with an apparent upward trend in the amount of unrealized appreciation, would cause the additional revenues to be even greater today.[29] The net effect, however, cannot be calculated with certainty; if estate tax credit were to be given for the income tax paid by decreasing the taxable estate or by a direct credit against tax due, net revenues would be affected. Also, it is arguable that the hypothetical tax's chilling effect on investment would cause a decrease in revenues.[30]

While most would agree that federal revenues could be raised by eliminating the stepped-up basis at death, the desirability of raising revenues in this manner is debatable.[31] Many areas of economic activity could be taxed by the government but are not for any of a number of reasons. Accepting the premise that the federal government will raise roughly the amount of revenue necessary to finance its activities, the question becomes what portion, if any, of this need should be filled by taxing a given area of economic activity. The American Banker's Association, for example, proposes that the "cost of dying" should not be increased and that any tax at death on unrealized appreciation should be accompanied by a corresponding reduction in current estate tax rates.[32] For those subscribing to this view, the revenue loss resulting from a stepped-up basis at death is not a factor in analyzing section 1014.

3. *Equity*.—The principle of equity as applied to a tax system "maintains that those who are similarly situated should be similarly treated and those who are differently situated should be differently treated."[33] Tax relief through a stepped-up basis at death allegedly

---

Print 1969) [hereinafter cited as 1969 PROPOSALS]. This estimate is based on a finding that the total value of stock, real estate, trust interests, and noncorporate business assets reported on the 1966 returns equalled approximately $15 billion. The Treasury estimated that 40 to 50 % of this amount constituted appreciation.

28. 116 CONG. REC. 225 (daily ed. Jan. 19, 1970) (remarks of Representative Reuss).

29. Okun, *supra* note 26, at 384-85.

30. Hanrahan, *supra* note 14, at 143-44.

31. For a discussion of the view that unrealized appreciation should be taxed at death in order to help balance the national budget see *1973 Public Hearings, supra* note 9, pt. 10, at 4126-70 (statements of John Winthrop Wright).

32. *See* Covey, *Possible Changes in the Basis Rule for Property Transferred by Gift or at Death*, 50 TAXES 831, 832 (1972). One witness before the Ways and Means Committee has proposed that the government quit "harvesting dollars from the graves of the dead" altogether. *See 1973 Public Hearings, supra* note 9, pt. 10, at 4181-86 (statement of Phillip S. Fry).

33. Eisenstein, *Some Second Thoughts on Tax Ideologies*, N.Y.U. 23D INST. ON FED. TAX 1, 2 (1965).

violates this maxim on several grounds: it discriminates against a person who sells his appreciated assets immediately prior to death; it discriminates against one holding assets that primarily produce ordinary income rather than capital appreciation; and it destroys progressivity in the tax system.

Clearly the taxpayer who holds appreciated assets but sells them immediately before death receives different treatment from the one who holds similar assets until death and escapes gains tax. The latter taxpayer pays only an estate tax while the former pays a capital gains tax and an estate tax on the diminished estate—a violation of the horizontal equity requirement that similarly situated taxpayers be treated similarly.[34] It is arguable, however, that these are not similarly situated taxpayers. One who sells before death has free use of the liquid proceeds and may even consume them, thereby avoiding estate tax on them entirely. Furthermore, the selling taxpayer decreases his taxable estate by the amount of gains tax paid, thus lessening his estate tax bill. If both taxpayers' estates have a high marginal tax rate, a substantial portion—up to seventy-seven percent—of the amount paid as income tax would have been consumed by the estate tax anyway. The inequity is, therefore, not as large as it first seems.[35]

Income received during life is subjected to tax at rates between fourteen and seventy percent,[36] while capital gains, if not realized before death, escape gains tax completely. The taxpayer who deposits his money in a savings account has the return on his investment depleted by the annual amount of income tax, and yet his heirs receive no step-up in basis equal to the amount of the total income earned during life.[37] Taxpayers with earned income receive the same date-of-death fair-market-value basis as taxpayers with accrued gains. This violates vertical equity, which requires a "different tax treatment for taxpayers in different financial positions."[38]

As a final violation of tax equity, the stepped-up basis at death destroys tax progression. The effective tax rate on these accrued

---

34. Castruccio, *Becoming More Inevitable? Death and Taxes . . . and Taxes*, 17 U.C.L.A.L. REV. 459, 478 (1970). The person who sells before death and thus incurs the capital gains tax does pay a lesser estate tax because his gross estate has been diminished by the amount of gains tax paid. His total tax bill (lesser estate tax plus capital gains tax) is still higher, however, than that of the nonselling taxpayer.

35. Chaffin, *Restructing Federal Estate and Gift Taxes: Impact of Proposed Reforms on Estate Planning*, 69 MICH. L. REV. 211, 232 n.96 (1970).

36. *See* INT. REV. CODE OF 1954, §§ 1(a)-(d).

37. For an example of the loss to the wage earner see Kurtz & Surrey, *supra* note 10, at 1383-84.

38. Castruccio, *supra* note 34, at 481.

gains is zero, while assets sold during life are subjected to the effective tax rate on capital gains. "Assuming that the graduated rates reflect an established public policy that ability to pay increases faster than increases in income, this policy is completely thwarted at death. Taxing these gains at death at the capital gains rate would restore the progressivity, although to a limited extent."[39]

C. *Arguments in Favor of 1014*

Although critics of section 1014 may label it an unwarranted "loophole" on the tax law, there are several arguments that have been advanced in its favor. If one accepts the premise that some tax concession in the progressive rate structure should be made to "the family interest in inheritance," it is at least arguable that gains-tax forgiveness at death is an appropriate vehicle for this concession.[40] And even if the concession theory is rejected, it is possible that the existing estate tax is by itself a sufficient duty on property passing at death.[41] Furthermore, the taxpayer who holds no appreciated property at death may be said to receive equitable treatment because this method of tax avoidance was available on an equal basis to him. Also, any small inequities arising might be justified on the basis of administrative convenience and record keeping simplicity under the present law.[42] Finally, even if all criticisms are accepted as valid, their impact may be overridden by the fact that gains-tax forgiveness precludes a diminution of private investment capital by taxes and thus primes the economy.

Because there are a number of arguments concerning the wisdom of section 1014, no one by itself should be viewed as dictating its continued existence or abolition. Different persons attach varying weights to each of the arguments, and thus no unanimity will ever be reached. It is apparent that the fate of section 1014 will be determined by a balancing of all factors inherent in the various arguments, with the ultimate responsibility resting in the hands of Congress. The following sections of this Note will examine a number of proposals that have been advanced, each proposal reflecting a different attempt to balance the factors discussed above.

---

39. Hanrahan, *supra* note 14, at 146.

40. For a discussion of this thesis see Waterbury, *supra* note 7, at 18-47.

41. Mr. Covey, for example, maintains that any additional gains taxation at death should be accompanied by a corresponding estate tax reduction. *See Proposed Estate and Gift Tax Reforms*, 5 INSTITUTE ON ESTATE PLANNING ¶ 71.1003, at 10-25 (1971).

42. *See 1973 Public Hearings*, *supra* note 9, pt. 9, at 3971-81 (statement of Keith M. Barker).

III. Constructive Realization at Death

A. Proposals

1. 1963 Proposals.—In 1963 President Kennedy, as part of his plan to change the treatment of capital gains and losses, recommended an income tax on appreciation of capital assets at the time of death or of gratuitous transfer.[43] The accrued gains were to be included in a decedent's final income tax return[44] with assets valued at their fair market value at the date of death or alternative valuation date. The income tax was to be deductible from the gross estate for estate tax purposes since it was a debt of the estate. All gains from appreciated assets were to be considered long-term regardless of the holding period and were to be included to the extent of only thirty rather than fifty percent.[45]

Ordinary personal and household articles, except items of exceptional value, were to be permanently exempt from this gains tax, as were charitable gifts, bequests, or devises.[46] If one-half of decedent's property was passed to his spouse, no gain would be assessed on this property, but the spouse would take a carryover basis in order to preserve the gain for future tax. Transfer of a personal residence to the surviving spouse was also to be exempt from the tax, and in addition to the interspousal exclusions, the first 15,000 dollars of gain was to be permanently exempt. The tax on the gain was to be computed by adding the total amount of appreciation to the amount of income reported by decedent in his last full taxable year, and by taxing this gain at the marginal rate that would apply to the first one-fifth of such gain.[47]

When the decedent's basis exceeded the property's fair market value at the date of death, a loss would be treated as if sustained in a sale or exchange.[48] This loss would offset any capital gains and the first 1,000 dollars of ordinary income, with a three year carryback for any unused loss. Any additional loss would offset ordinary income in the last taxable year and three prior taxable years, but only to the extent of one hundred dollars of capital loss for each thirty dollars of ordinary income.

43. *1963 Hearings, supra* note 11, pt. 1, at 24 (statement of President Kennedy).

44. *Id.* at 128-29 (statement of Secretary Dillon).

45. *Id.* at 126.

46. *Id.* at 129-32.

47. *Id.* at 137. One-fifth of the total amount of appreciation was to be added to the amount of income reported by decedent in his last full taxable year. The marginal tax rate for this one-fiftb was to be ascertained and then applied to the total amount of appreciation. The product was to constitute tbe gains tax at death on the entire accrued appreciation.

48. *Id.* pt. 1, at 128-29 (statement of Secretary Dillon).

The proposal would have made applicable to the gains tax the existing provision that permits payment of the estate tax in ten-year installments where thirty-five percent of the estate consists of an interest in a closely held business[49] or where payment of the tax would create an undue hardship.[50] Also section 303, which grants sale or exchange treatment to stock redemptions used to pay estate tax, was to be expanded to cover the new gains tax.[51]

This proposal did not clear the House Ways and Means Committee.[52] The Committee, however, did tentatively approve a carryover provision, but this was deleted because of lack of time to work out the details of the statutory language.[53]

2. 1969 Proposal.—In 1969 the Treasury Department propounded a second proposal for taxing unrealized appreciation at death.[54] This proposal was quite similar to the Treasury's 1963 proposal except in four major areas: the marital exclusion, income averaging provisions, minimum basis provisions, and transitional periods.

The 1963 proposal provided for a maximum marital exclusion of one-half of the gain if the surviving spouse received property, other than cash, with a fair market value at least equal to the amount of the marital exclusion.[55] The surviving spouse would receive a carryover basis for the excluded property, and gain would be postponed. The 1969 proposal, however, provided for a one hundred percent marital deduction for all property passing to the surviving spouse.[56] All property going to the surviving spouse would be exempt from gains tax and would receive an allocated portion of decedent's total basis. If the spouse were to receive two-thirds of decedent's total estate, she would also be allocated two-thirds of decedent's total basis. Use of an allocated, rather than an actual, basis was intended to remove the incentive for decedent to leave low basis property to the spouse regardless of his true dispositive desires.[57] If the surviving spouse were in a higher tax bracket than the decedent, this allocation provision would work to her disadvantage.

49. INT. REV. CODE OF 1954, § 6166.

50. *Id.* § 6161.

51. *Id.* § 303. *See 1963 Hearings, supra* note 11, pt. 1, at 137 (statement of Secretary Dillon).

52. *Hearings on H.R. 8363 (Revenue Act of 1963) Before the Senate Comm. on Finance*, 88th Cong., 1st Sess., pt. 1, at 128, 251 (statement of Secretary Dillon).

53. *Id.* at 129.

54. 1969 PROPOSALS, *supra* note 27.

55. *1963 Hearings, supra* note 11, pt. 1, at 130-31.

56. 1969 PROPOSALS, *supra* note 27, at 343.

57. *Id.* at 337, 343.

The proposal, therefore, provided for optional realization at death upon the election of either decedent or the surviving spouse.

Although the 1963 proposal would have expanded the income averaging provisions—sections 1301-05 of the Code[58]—to include capital gains realized at death even if income in that year did not exceed that for previous years,[59] the 1969 version contained no such provision. The omission was apparently intentional.[60]

Under the 1963 proposal, 15,000 dollars of gain would have been exempted, regardless of the size of the estate.[61] The 1969 proposal, however, provided every taxpayer with a minimum basis of 60,000 dollars.[62] The impact of both proposals would be the same on an estate smaller than 15,000 dollars.[63] An estate between 15,000 dollars and 60,000 dollars, however, could fare better under the 1969 proposals;[64] whether an estate larger than 60,000 dollars would fare better under the 1963 or under the 1969 proposal would depend upon its actual basis and the amount of appreciation.[65]

The difference in the proposals with the potentially greatest impact on current taxpayers lay in their treatment of gains accrued prior to the enactment of any reform. Under the 1963 proposal all gains, whenever accrued, were to be taxable at decedent's death. Relief was to be given to those "caught off guard" only by the use of a three or five year transitional period during which only portions of gain would be taxed, and after which a tax would be paid on all

---

58. INT. REV. CODE OF 1954, §§ 1301-05.

59. *1963 Hearings, supra* note 11, at 55.

60. Income averaging was mentioned on page 29 of the 1969 Proposals, but was never expanded upon. According to the author of an Editorial Note in the *George Washington Law Review*, who spoke with a Treasury official, the omission of income averaging was intentional. *See* Editorial Note, *Taxation of Capital Gains at Death*, 38 GEO. WASH. L. REV. 138, 145 n.74 (1969).

61. *1963 Hearings, supra* note 11, at 129, 132.

62. 1969 PROPOSALS, *supra* note 27, at 335-37, 341-42.

63. An estate smaller than $15,000 would have an exclusion of up to $15,000 under the 1963 proposal or a deduction equal to its fair market value under the 1969 proposal and would, therefore, give rise to no taxes.

64. An estate between $15,000 and $60,000 would fare better under the 1969 proposal if its accrued appreciation were greater than $15,000—*e.g.*, an estate with fmv equal to $45,000 and an actual basis of $10,000. Under the 1963 proposal only $15,000 of this $35,000 gain would be excluded, leaving a taxable estate of $20,000. Under the 1969 proposal, however, a minimum basis of $45,000 would be attributed to the estate and no taxable gain would result.

65. An estate with a fmv of $70,000 and an actual basis of $20,000 would produce a taxable gain of only $10,000 ($70,000 - $60,000) under the 1969 proposal, while producing a taxable gain of $35,000 ($70,000 - $20,000 - $15,000) under the 1963 proposal. An estate with a fmv of $70,000 and an actual basis of $50,000 would produce a taxable gain of $10,000 ($70,000 - 60,000) under the 1969 proposal, however, while producing a taxable gain of only $5,000 ($70,000 - $50,000 - $15,000) under the 1963 proposal.

gains.[66] Under the 1969 proposal, however, all gains accrued prior to enactment of any reform were to be excused—only those gains arising afterwards were taxable.[67]

3. Subsequent Proposals.—In 1971 and 1972 two bills were introduced in Congress, which proposed a capital gains tax on accrued appreciation at death. H.R. 8757 (the Vanik Bill)[68] was introduced in the House of Representatives in 1971 by Representative Vanik, and section 113 of S. 3378 (the Nelson Bill)[69] was introduced in the Senate in 1972 by Senator Nelson. These two bills, while similar to the 1969 proposal, did contain certain differences. The 1969 proposal to accrue income in respect of a decedent was rejected in both of the 1971 bills.[70] Under the Vanik Bill there was to be a 2,000 dollar, rather than 1,000 dollar, personal and household effects exclusion, and under the Nelson Bill there was to be none. Each of these bills applied only to testamentary transfers and not to transfers subject to the gift tax. The Vanik Bill did not exempt property qualifying for the charitable deduction, while the Nelson Bill excluded neither property qualifying for the charitable deduction nor property qualifying for the marital deduction. The Nelson Bill excluded life insurance proceeds and the Vanik Bill did not, while the 1969 proposals were unclear as to their treatment. Although neither the 1969 proposal nor the Vanik Bill would have taxed appreciation accruing prior to their enactment, the Nelson Bill would have taxed this appreciation with a limited exemption for pre-1960 appreciation of assets acquired by decedent before that date. The 1969 proposal and the Vanik Bill would have permitted net loss to be applied against ordinary income for the year of death and decedent's three prior taxable years, whereas the Nelson Bill would not have permitted such a deduction.[71]

Although no affirmative action was taken by Congress on the

---

66. *1963 Hearings, supra* note 11, at 140. Assuming a 3-year transitional period, one-third of the appreciation would be taxed the first year, two-thirds the second year, and full taxation would occur the third year. *See* Hanrahan, *supra* note 14, at 153.

67. 1969 PROPOSALS, *supra* note 27, at 335, 340, 351. This would be accomplished by using a start-up basis. The asset would be given a basis equal to its fair market value on the date of enactment of the new tax unless the estate could prove a higher actual basis. Thus, all gains accrued prior to this start-up date would be excused.

68. H.R. 8757, 92d Cong., 1st Sess. (1971).

69. S. 3378, 92d Cong., 2d Sess. (1972).

70. Under the 1969 proposal items giving rise to ordinary income (income in respect of a decedent) were to be accrued and reported on decedent's final return. The 1971 bills rejected this return to pre-1942 tax law. *See* Covey, *supra* note 32, at 837; 4 J. RABKIN & M. JOHNSON, FEDERAL INCOME, GIFT AND ESTATE TAXATION § 54.12 (1974).

71. *See* Covey, *supra* note 32, at 837-38.

1963, 1969, or 1971 proposals, some positive legislation concerning section 1014 should occur in 1974. Under the Tax Policy Review Bill[72] the step up in basis of property acquired from a decedent is to expire on January 1, 1975.[73] Property acquired from a decedent dying on or after that date will take a carryover basis as provided in section 1015,[74] unless reform legislation is passed prior to that date.[75]

B. *Arguments Against Taxing Capital Gains at Death*

The proposed taxation of accrued capital gains at death has received at least as much criticism as has the current stepped-up basis system. The most common criticisms include the following: no constitutionally taxable realization event occurs at death; even if the event is constitutionally taxable, it does not comport with traditional tax concepts of a "realization event;" severe liquidity problems will arise for small family businesses and farms; wealth accumulation and investment will be deterred; the present tax on the inflationary element of capital appreciation will be compounded; the proposed tax will be regressive; and problems will arise in determining and proving basis.

1. Constitutionality.—The most important attack on a proposed gains tax at death is an allegation of unconstitutionality. While other problems may be mitigated by Congressional drafting, constitutionality is a threshold question that must be answered. Some academicians assert that the tax would be unconstitutional,[76] but a majority maintain that it would be upheld.[77]

72. H.R. 15230, 92d Cong., 2d Sess. (1972). A companion bill, S. 3657, was introduced in the Senate by Majority Leader Mike Mansfield.

73. H.R. 15230, 92d Cong., 2d Sess., tit. II, § 216 (1972).

74. INT. REV. CODE OF 1954, § 1015.

75. A panel discussion was held in February of 1973 before the House Ways and Means Committee in which possible alternatives to § 1014 were discussed by Marvin Collie, James B. Lewis, Bart A. Brown, Jr., David Westfall, Richard Covey, and Dr. Gerard M. Brannon. *See 1973 Panel Discussion, supra* note 25. In March, 1973, open public hearings before the Ways and Means Committee were held. *See 1973 Public Hearings, supra* note 9, pts. 9-10.

76. *See 1963 Hearings, supra* note 11, at 2808, 2839. The New York State Bar Association, Tax Section, Committee on Tax Policy, submitted a report to the Ways and Means Committee, expressing doubt as to the constitutionality of such a tax. The report was signed by professors of tax law, Roswell Magill, Robert J. McDonald, and Harry Rudick. *See also 1973 Public Hearings, supra* note 9, pt. 10, at 4247-61 (statement of Anthony John Perfilio, Jr.).

77. Louis Del Cotto maintains that Congress has the power to tax, without apportionment, the recipient of a gift or bequest for the full amount of the principal of the property transferred. *See* Del Cotto, *The Trust Annuity as Income: The Constitutional Problems of Taxing Gifts and Bequests as Income*, 23 TAX L. REV. 231 (1968). If Del Cotto's thesis is

(a) The sixteenth amendment and Eisner. The sixteenth amendment grants Congress the power to tax "incomes from whatever source derived, without apportionment."[78] The Supreme Court, however, in *Eisner v. Macomber*[79] held that a common-on-common stock dividend did not fit the definition of taxable income because sixteenth-amendment income must be "realized" to be taxable. The Court in discussing what was later denominated "realization" stated:

> Here we have the essential matter: *not* a gain *accruing to* capital, not a *growth* or *increment* of value *in* the investment; but a gain, a profit, something of exchangeable value *proceeding from* the property, *severed from* the capital however invested or employed, and *coming in*, being "derived," that is, *received* or *drawn by* the recipient (the taxpayer) for his *separate* use, benefit and disposal; *that* is income derived from property. Nothing else answers the description. (Court's emphasis).[80]

Although the Supreme Court's language in *Eisner* seemed to indicate that the definition of a realization event would be narrowly construed, subsequent cases have demonstrated a much broader view. In the years following *Eisner* the Court has held a variety of events to constitute a realization of income: the sale of a capital asset;[81] the taking of property by a taxpayer in satisfaction of a debt, which if paid would have constituted interest income to taxpayer;[82] and the acquisition of improvements by a lessor when his lessee forfeits the lease and is unable to remove the improvements because of a term in the contract.[83] Because none of these cases define the limits of realization, however, it is impossible to predict with accuracy what position the Supreme Court might take on the issue of constructive realization of gains at death.[84]

(b) As an article I excise tax. There are number of writers[85] who contend that the economic and distributional result sought by

---

correct it follows that Congress has the power to tax a single portion of the property transferred—the appreciation. For a discussion of the colloquy between Erwin Griswold, Stanley Surrey, Borris Bittker, Roswell Magill, and Robert N. Miller over the issue of constitutionality see Heckerling, *The Death of the "Stepped-up" Basis at Death*, 37 S. CAL. L. REV. 247, 265-72 (1964).

78. U.S. CONST. amend. XVI.

79. 252 U.S. 189 (1920).

80. *Id.* at 207.

81. Merchants Loan & Trust Co. v. Smietanka, 255 U.S. 509 (1921).

82. Helvering v. Midland Mut. Life Ins. Co., 300 U.S. 216 (1937).

83. Helvering v. Bruun, 309 U.S. 461 (1940).

84. For a more complete discussion of the constitutional questions see Waterbury, *supra* note 7 at 6-15.

85. *See* L. SELTZER, *supra* note 10, at 302-03 (1951); Waterbury, *supra* note 7, at 7 & n.35; Comment, *Transfer of Decedent's Basis at Death: The Allocated Carryover Approach*, 46 WASH. L. REV. 121, 123-24 (1970).

the gains tax could be reached under article I, section 8 of the Constitution by characterizing the measure as an excise tax, measured at capital gains rates, upon the gratuitous transfer of property to the extent of unrealized appreciation in value of the transferred property. This approach avoids the sixteenth amendment problems discussed above and is perhaps the better approach for advocates of a tax on gains at death. The constitutionality of the federal estate tax was upheld in *New York Trust Co. v. Eisner*,[86] and the federal gift tax was upheld in *Bromley v. McCaughn*[87]—both as exercises of article I, section 8 rather than as direct taxes that must be apportioned under article I, section 9. There is little reason to suspect that the proposed gains tax would fare any worse than the estate or gift taxes unless it runs afoul of fifth amendment due process.

It is doubtful, however, that this tax would be deemed to be so arbitrary and unfair as to violate due process. In *Watson v. Comptroller*[88] the Court upheld an additional inheritance tax upon certain assets, against a fourteenth amendment equal protection challenge. The Supreme Court is far more reluctant to strike down a congressional classification under the fifth amendment, which contains no equal protection clause, than to strike down a state classification under the equal protection clause of the fourteenth amendment.[89] Therefore, it is reasonable to believe that the Court, which allowed a state legislature in *Watson* to single out assets that had not been subject to a property tax for a compensatory inheritance tax, would allow an analogous congressional tax on appreciated assets.

2. *No Traditional Realization Event.*—Even if it is assumed that a gains tax upon accrued appreciation at death satisfies the constitutional criteria for realization, it is true that death does not fit the *traditional* tax concept of a realization event.[90] "Since the inception of the income tax law, a taxable gain has been considered to come into existence only when the owner of property voluntarily converts the property into another form—usually cash—so that, in layman's language, he has recognized a gain . . . The proposal for the taxation at death of unrealized capital appreciation violates all of these concepts. There is no voluntary act on the part of the

---

86. 256 U.S. 345 (1921).

87. 280 U.S. 124 (1929).

88. 254 U.S. 122 (1920).

89. *See* Detroit Bank v. United States, 317 U.S. 329, 337-38 (1943); H. ROTT-SCHAEFER, HANDBOOK OF AMERICAN CONSTITUTIONAL LAW 215 (1939).

90. *See Proposed Estate and Gift Tax Reforms, supra* note 41, at 10-29 (remarks of Barnett).

property owner. There is no sale or exchange of property. There is no conversion of property into cash or some other form of marketable assets but rather a gratuitous transfer from the decedent to his heirs or legatees."[91]

The argument that an accrued capital gain is not income for tax purposes assumes that for income to exist a realization event should occur whereby the taxpayer is put into a sufficiently liquid position so that he can pay an amount to the government. Although accrued capital gains do not differ greatly from other forms of income when viewed from a broader economic perspective, that is as accretions to wealth, they do differ in their effect on a person's immediate ability to pay taxes.[92] The fact that Americans are accustomed to viewing income from this liquid-ability-to-pay perspective is of some importance in a tax system dependent upon voluntary reporting. Although this attitude is not a determinative factor when considering a change in the tax system, it should be given some weight.

3. Liquidity.—Perhaps the greatest practical problem with imposing a capital gains tax at death is the liquidity problem that it would cause, or exacerbate, for small closely held businesses and farms. Generally, these are held with a small basis and consequently a substantial amount of appreciation. This problem should arise most frequently for small and medium-sized estates because the largest estates often contain easily tradeable securities in publicly held corporations.[93] All discussion of this problem will center on the problems of family businesses but will apply also to estates holding farmland.[94]

---

91. Dane, *Federal Estate and Gift Tax Reform: Some Arguments Against the Treasury Proposals*, 108 TRUSTS & ESTATES 782, 843 (1969). *See 1973 Panel Discussion, supra* note 25, pt. 10 at 1504-22 (statement of Bart A. Brown, Jr.). The Code provides that no taxable gain arises if the conversion is involuntary, as in the case of the receipt of proceeds of fire insurance, and if the money is reinvested in similar property. INT. REV. CODE OF 1954, § 1033.

92. *See generally* Seidman, *Status of Federal Estate and Gift Tax Legislative Proposals*, 51 TAXES 197, 201 (1973).

93. *See* Steger, *supra* note 14, at 268; Wormser, *The Case Against a Capital Gains Tax at Death*, 51 A.B.A.J. 851, 852 (1965).

94. For a discussion of the liquidity problem *see 1973 Public Hearings, supra* note 9, pt. 9 at 4008 (statement of Fred Wulff, Chairman of the National Livestock Tax Commission); *id.*, pt. 10, at 4079-126 (statement of John C. Davis, III, Past President of the National Association of Wholesaler-Distributors); *Hearings on Tax Reform Before the House Comm. on Ways and Means*, 91st Cong., 1st Sess., pt. 11, at 3970-75 (1969) (statement of Samuel J. Foosner) [hereinafter cited as *1969 Hearings*]; *id.*, at 4002-04 (statement of Mr. Robert J. Spindell); *id.*, at 4086-87 (statement of John C. Davis, III); *id.*, at 4096-97 (statement of Mr. Henry Bison, Jr.); *1963 Hearings, supra* note 11, pt. 3 at 1326 (statement of Henry Bison, Jr., for the National Association of Retail Grocers); *id.*, pt. 4, at 2395 (statement of Charles E. Walker for the American Bankers Association); *id.*, at 2323 (statement of Joel Barlow for

Several undesirable social consequences arise as a result of pressure to dispose of, or provide liquidity for, estates containing family businesses. Economic decisions are distorted for the owner as he tries to arrange the business during his life so that it will provide sufficient liquidity at his death. Upon the owner's death these businesses are hard to sell; there is often a limited market and value is conjectural. A sale, even if profitable, often involves loss of control of the business and perhaps its dissolution. The sale, however, will generally be at a loss because a part of the going concern's value is attributable to the decedent's peculiar exercise of control over the business. This value will be reflected in a sales price only in an intact sale to a buyer familiar with the particular business operation. A market of this type is generally thin and thus a sale usually produces a loss. The prudent owner, therefore, is encouraged to sell the business before his death and to make his expertise available to the buyer during a transition period. These sales, however, are generally to a larger corporation and accelerate the undesirable trend toward mergers and large business combinations.[95]

Several ostensible solutions to the liquidity problem are available to the owner: an entity buyout arrangement;[96] a shareholder (or partner) buy-sell agreement; personal life insurance; business keyman life insurance; a judicious sale of stock during the owner's life; or the use of a charitable foundation.[97] Insurance, however, is not available to the elderly owner, and any or all of these solutions may be infeasible for business reasons. A number of measures of legislative relief have been suggested to alleviate the post-death problems: averaging of the newly defined income; installment payment of the gains taxes; a start-up date for accrual of gains; an interspousal transfer exemption; extension of section 303[98] redemptions; accumulated earnings tax relief;[99] and other special provisions for small businesses with liquidity problems.

Income averaging and installment payments of taxes[100] would offer little relief to a business that produces revenue insufficient to pay the taxes. Mr. Kurtz and Professor Surrey suggest that a busi-

---

the United States Chamber of Commerce); *id.*, pt. 3, at 1412 (statement of G. Keith Funston for the New York Stock Exchange).

95. *See* Bosland, *Has Estate Taxation Induced Recent Mergers?*, 16 NAT'L TAX J. 159 (1963).

96. *See, e.g.*, 2 A. CASNER, ESTATE PLANNING, Ch. XV (3d ed. 1961).

97. *See* Waterbury, *supra* note 7, at 50-51.

98. INT. REV. CODE OF 1954, § 303.

99. *See id.* § 537.

100. *See id.* §§ 6161, 6166.

ness or farm in this position should be liquidated if it produces such a low rate of return because by definition it represents a poor allocation of economic resources.[101] Other writers, however, disagree with this conclusion.[102] The time after the death of a business's key man is a period of adjustment, with predictably lower profit margins until the new management gets experience. Because the heirs holding such a business would be hard pressed to pay the tax installments along with current business and personal income taxes[103] and because they probably would lack sufficient collateral to secure borrowed funds for payment of the tax, the government would be forced either to demand a sale of the business or to take a lien on the business in the hands of the heirs.[104] This lien would paralyze financial operations of the business by further destroying its borrowing capacity.[105] The 1969 proposal would have required the owners of a business subject to such a lien to give the District Director ninety-day notice before the sale of assets worth more than 1,000 dollars (other than sales in the ordinary course of business), the declaration of any dividend, any change in the salaries of officers or directors, and any other action with a substantial effect on the liquidation value of the business. Failure to furnish this information would constitute a default, which would authorize the District Director to enforce his lien.[106]

Because the liquidity problem would be greatest during the first few years after enactment of the tax, some have suggested a start-up date before which all accrued gains would be excused.[107] This plan would provide time for taxpayers to plan for the liquidity squeeze but would by no means guarantee success in actually attaining the necessary liquidity. A related proposal, that interspousal transfers be exempted from gain but entail a carryover basis, would also provide immediate relief but would merely postpone the necessity for a solution.

Extensions of section 303 and the accumulated earnings tax exemption, would provide some relief, but only if the corporation had sufficient liquid assets to buy out part of the estate's interest or were generating sufficient income to take advantage of the accu-

101. *See* Kurtz & Surrey, *supra* note 10, at 1398-99.

102. *See* Chaffin, *supra* note 35, at 236.

103. *See 1969 Hearings, supra* note 94, pt. 11, at 4087-89 (statement of John C. Davis, III).

104. 1969 PROPOSALS, *supra* note 27, pt. 3, at 405.

105. *See 1969 Hearings, supra* note 94, pt. 11, at 4090 (statement of John C. Davis, III).

106. 1969 PROPOSALS, *supra* note 27, pt. 3, at 405.

107. *See* note 67 *supra*.

mulation exemption. Under section 303[108] a corporation may redeem all or part of a decedent's interest with the decedent's estate receiving sale or exchange treatment, if the redemption is necessary to pay estate taxes and funeral and administration expenses. While this section could be expanded easily to include gains taxes at death, it would be of little avail to a corporation without sufficient liquid assets to make a redemption. Similarly, although section 537[109] might be extended to permit the tax-free accumulation of earnings in order to bring about this redemption or buy-out, it would be of little use to a corporation without sufficient earnings.

A number of special relief measures have been proposed that would assist only those estates with serious liquidity problems. Special valuation rules might be applied to closely held businesses and farms; their current value could be measured by capitalizing earnings at a low rate so that taxes would be geared to cash available to pay taxes.[110] Other lower values might be used for these assets, or interests in closely held businesses or farms could be exempt up to a value of 250,000 dollars, as proposed by Senator Mondale.[111] Relief of this character, however, would have to be carefully considered because it would violate strict principles of horizontal and vertical equity.[112]

Several writers do not view this liquidity squeeze as a real problem. Kurtz and Surrey maintain that most estates are liquid and that those that are not face a heavy death tax only because taxes were light during life.[113] Waterbury, while recognizing that liquidity may be a problem for a few illiquid estates, believes that it is not a national economic problem worthy of great concern.[114] While there may be dispute over the magnitude of the problem, it is apparent that some if not all estates consisting of small businesses or farms would be put in a squeeze by these taxes.[115] In the final analysis their treatment will turn on society's attitude toward the value of retain-

108. INT. REV. CODE OF 1954, § 303.

109. *Id.* § 537.

110. *See 1969 Hearings, supra* note 94, pt. 11 at 4024 (statement of O.C. Fisher); *id.* at 4033-34 (statement of Robert Price).

111. Senator Mondale proposed an amendment, No. 1441, to the Nelson Bill, S. 3378, 92d Cong., 2d Sess., § 113 (1972), in order to do this. *See* Covey, *supra* note 32, at 839.

112. *See* Kurtz & Surrey, *supra* note 10, at 1398. For a discussion of horizontal and vertical equity see notes 34-39 *supra* and accompanying text.

113. *Id.* at 1397 & n.88.

114. Waterbury, *supra* note 7, at 51-52.

115. It is true that these estates have been given a tax break during the owner's life in that they have been able to defer payment of taxes on accrued appreciation. *See* notes 12-13 *supra* and accompanying text.

ing and encouraging such entities. If their development and existence is not of overriding social value, they should be given no special treatment and should stand or fall on their economic merits. If these entities are beneficial to our social and economic structure, however, some protection and relief should be given. The question of how much, if any, protection will be a function of economic and tax policy analysis by the Congress.

4. *Deterrent to Wealth Accumulation and Investment.*—Opponents of a capital gains tax at death upon accrued appreciation maintain that this tax would discourage private capital formation. The logic runs that the estate must sell assets in order to raise money to pay the taxes, and those who purchase these assets must purchase them out of savings that otherwise would be available for investment in new productive assets.[116] This analysis is subject to the qualification, however, that economic incentives might be achieved through more desirable modifications of other income tax provisions. Opponents also charge that this tax would decrease equity investments.[117] Although a shift might occur from appreciation to income investments in order to provide a certain amount of liquidity, this dislocation would be small because capital gains rates are still lower than ordinary income rates. A final charge is that the tax would dampen the incentive to work, save, and invest. The tax, however, would not place a burden on the acquisition of gain for purely personal reasons during life and would not act as a deterrent to these incentives, qualitatively different from other transfer taxes.

5. *Compounding of Tax on Inflation.*—The progressive tax system when interacting with inflation produces a squeeze whereby assets, whose real purchasing power has remained constant, are thrust into a higher tax bracket. A capital gains tax on accrued appreciation at death would compound this situation. According to Mr. John Dane, Jr., "[A]t the time when the family breadwinner has been removed, his widow and children, in addition to paying an estate tax on the dollar value of his property, are forced to pay an additional tax on the decline in the purchasing power of the currency unit."[118] Professor Westfall maintains that the forgiveness of accrued gains at death represents a rough way for compensating for

116. *See* Waterbury, *supra* note 7, at 52-53.

117. *1963 Hearings, supra* note 11, pt. 4, at 2323 (statement of Joel Barlow for the United States Chamber of Commerce).

118. Dane, *supra* note 91, at 782.

this inflation.[119]

It may be argued, however, that inflation does represent some real gain to holders of appreciated assets as compared to those holding nonappreciating fixed-income assets—because the rate of appreciation might at least "keep up" with the rate of inflation.[120] In any event, Congress is aware of the problems injected into the tax system by inflation but has not yet seen fit to make amends in its tax policy.[121]

6. *Regressivity.*—In order to avoid double taxation of the same appreciation, the proposals have allowed a deduction from the taxable estate in the amount of gains tax to be paid on appreciation. This removes from the estate tax base a portion of the estate assets that would otherwise be taxed at the highest, or marginal, rate. The result is regressive: the larger the estate, and hence the higher the estate tax bracket, the lower the *actual* cost of the gains tax. If an estate were in the seventy percent estate tax bracket, the amount removed from it to pay the new gains tax would have been taxed at a seventy percent transfer tax rate in any event under the present system. The new tax, therefore, has cost the taxpayer only an additional thirty percent. An estate in the forty percent estate tax bracket, however, would lose a full sixty percent of the amount removed to pay the new gains tax. The actual cost to the taxpayer thus is the complement of the marginal rate at which the amount of the deducted capital gains tax would otherwise be taxed under the estate tax.[122] The net regressive effect from this correlation is shown in an example by Richard Covey.[123] Assume two estates, one having assets with a basis of 150,000 dollars and fair market value of 450,000 dollars and the other ten times larger, having assets with a basis of 1.5 million dollars and a fair market value of 4.5 million dollars. Applying the old twenty-five percent capital gains rate and the lower transfer tax rates suggested by Professor Surrey, the capital gains tax at death would produce a tax increase of only 7,700 dollars in the larger estate and an increase of 30,650 dollars in the smaller estate.

---

119. Covey, Surrey & Westfall, *Perspectives on Suggested Revisions in Federal Estate & Gift Taxation,* 112 TRUSTS & ESTATES 102, 107 (1973).

120. 1969 PROPOSALS, *supra* note 27, pt. 3, at 333. For a discussion of whether inflationary gains are true profit see Smith & Sullivan, *The Taxation of "Real Profit": Towards a Laissez-Faire Revenue Code,* 51 NEB. L. REV. 258 (1971).

121. *See* R. GOODE, THE INDIVIDUAL INCOME TAX 192 (1964); Kurtz & Surrey, *supra* note 10, at 1387-88.

122. Covey, *supra* note 32, at 838.

123. *Id.* at 838-39.

7. *Basis Problems.*—Great problems might arise for estates attempting to prove a decedent's basis when he is no longer around to answer questions. Presumably the burden of proving the decedent's basis, or perhaps the approximate value at the time of decedent's acquisition, would be on the estate. Failing to meet this burden, the estate could be relegated to a total basis not to exceed a statutory minimum basis, such as 60,000 dollars. Also a start-up basis might be used so that a basis would be assigned equal to the asset's fair market value on the date of the enactment of the tax. Gains and losses on assets acquired before the start-up date could be computed from this point unless the estate is able to prove a higher or lower actual basis. Assets acquired after the start-up date, however, would require proof of actual basis. Because exemptions for certain marital or charitable transfers would exist, an allocated, rather than actual, basis probably would be assigned to each asset in order to eliminate the incentive to transfer low basis property to one of these exempt beneficiaries.

IV. Carryover Basis at Death

A. *Background*

Assigning a carryover basis at death, as is done with gifts under section 1015,[124] has been proposed frequently as an alternative means of treating accrued gains at death. In 1942, Randolph Paul, then an adviser to the Treasury, proposed the adoption of a statutory carryover basis.[125] Little more was said about this idea until 1963 when the House Ways and Means Committee tenatively accepted a carryover-basis system as an alternative to the Kennedy Administration's proposed capital gains taxation of accrued gains at death.[126] Under the Committee's proposal an asset would have a basis to the heir equal to the decedent's basis plus estate tax attributable to that asset, but in no event greater than the date of death fair market value of the asset. The Committee finally rejected this alternative, however, and decided to retain the present stepped-up basis at death.[127]

---

124. INT. REV. CODE OF 1954, § 1015.

125. *See Hearings Before the House Comm. on Ways and Means on Revenue Revision of 1942*, 77th Cong., 2d Sess., vol. 1, at 89-90 (1942). That same year the carryover approach was endorsed by Dean Griswold in a law review article. See Griswold, *A Plan for the Coordination of the Income, Estate, and Gift Tax Provisions with Respect to Trusts and Other Transfers*, 56 HARV. L. REV. 337, 350 (1942).

126. *See* Revenue Release 63-9 (May 28, 1963).

127. *See* August 30, 1963 issue of U.S. TAX WEEK.

B. 1969 Proposals

In 1969 several bills were introduced in both the House and Senate to provide for a carryover basis.[128] The House Bills were identical except for their effective dates.[129] The only proposal on the carryover basis that was actively considered by the Senate was an amendment to the Tax Reform Act of 1969 proposed by Senator Tydings;[130] it was defeated by a vote of forty-seven to thirty-one with some Senators voting against it because they felt that the matter should be considered as a part of overall estate and gift tax revision.[131] Despite their nonenactment, the 1969 House and Senate Bills, which differ from each other in some respects, are good examples of what might be expected in a future carryover basis at death proposal. They therefore deserve discussion.

The House Bills left unchanged the treatment of gross estates with a value of less than 60,000 dollars. In estates exceeding this amount, however, a carryover basis would apply.[132] Each asset's basis would receive an apportioned share of all federal and state death taxes attributable to the appreciation element in the value of the carryover-basis property.[133] This method would not be used, however, when it produced an aggregate basis of less than the minimum of 60,000 dollars. In no event would the basis be allowed to exceed the fair market value of the property. Each asset's share of the basis increase would be computed by multiplying the percentage of aggregate appreciation attributable to that asset times the aggregate basis increase. The decedent would be permitted by will, however, to specify that all basis increase should be allocated first to stock redeemed under section 303[134] with any remaining increase to be allocated between other assets.

128. S. 2039, 91st Cong., 1st Sess. (1969); H.R. 5250, 91st Cong., 1st Sess. (1969); H.R. 10045, 91st Cong., 1st Sess. (1969); H.R. 10237, 91st Cong., 1st Sess. (1969); H.R. 10253, 91st Cong., 1st Sess. (1969) *as cited in* Young, *Proposed Revisions of the Federal Estate and Gift Tax Laws: The ALI Revisited*, 5 GA. L. REV. 75, 93 n.132 (1970).

129. *See* Young, *supra* note 128 at 93.

130. 115 CONG. REC. 37,305 (1969).

131. *Id.* at 37,310. In 1971 § 113 of H.R. 11058 again put forth a carryover proposal and was reintroduced in 1972 as H.R. 13857. *See* H.R. 11058, 92d Cong., 1st Sess., § 113 (1971); H.R. 13857, 92d Cong., 2d Sess. (1972). These House Bills were identical to the 1969 House Bills except for 2 minor respects; neither was enacted. *See* Covey, *supra* note 32, at 832.

132. The carryover basis would not be applied to certain types of property, however: (1) household or personal effects that are not of extraordinary value; (2) property acquired from a decedent prior to his death that was sold prior to death; (3) life insurance; and (4) property constituting income in respect of a decedent. *See* Covey, *supra* note 32, at 833.

133. For a discussion of basis allocation, see Comment, *supra* note 85, at 133-41.

134. INT. REV. CODE OF 1954, § 303.

The Senate Bill differed from the House Bill in several key respects. Under the Senate Bill the heir's basis for determining *loss* would be the lesser of decedent's basis or the estate tax value.[135] The House Bills used the decedent's basis in all events and rejected the approach currently used in the gift tax. The Senate Bill permitted a basis increase, up to the fair market value, for *all* federal and state death taxes paid while the House permitted an increase only for death taxes on the carryover-basis asset's *share* of net appreciation. The Senate Bill gave the Commissioner broad power to allocate increases among assets included in the taxable estate while the House Bills were very specific as to how allocation should be made. Finally, the Senate Bill contained no minimum-basis-increase provision and no continuation of the present basis rules for estates less than 60,000 dollars.[136]

C. *Problems Arising Under Carryover System*

Under a carryover basis system no constitutional problem should arise. In *Taft v. Bowers*,[137] which upheld this system for the gift tax, the Supreme Court indicated in dictum that a carryover basis at death was within Congress's power.[138] Nonetheless, many of the problems under the current section 1014 treatment would remain. According to some critics the lock-in problem would be aggravated.[139] The heir would know that upon sale he would be liable for tax not only upon appreciation accrued to him, but also upon appreciation that accrued during decedent's lifetime. The heir, if he contemplates a future sale, would know that in a sense he is retaining an interest-free loan of the amount of the taxes as long as he defers realization.[140] This pressure would increase from generation to generation if the property were passed down and could result in a time when it would be virtually economically infeasible to sell. There are a number of arguments, however, that support the thesis that the carryover basis might lessen the lock-in problem. Certainly, if the heirs were in a higher tax bracket than the holder, he would be encouraged to realize the gain during lifetime;[141] the decedent would know that if he realized the gain before death and reinvested the

135. *Cf. id.* § 1015(a).
136. For a discussion of these bills see Covey, *supra* note 32, at 833-34.
137. 278 U.S. 470 (1929); *see* Waterbury, *supra* note 7, at 6.
138. *See* M. DAVID, *supra* note 11, at 220; Comment, *supra* note 85, at 139.
139. *See* Editorial Comment, *supra* note 60, at 140.
140. *See* M. DAVID, *supra* note 11, at 158; Hanrahan, *supra* note 14, at 149.
141. M. DAVID, *supra* note 11, at 158.

proceeds he would give his heirs a higher basis for the new property while simultaneously removing the amount of taxes paid from his gross estate.[142]

Imposition of a carryover basis also would not satisfy completely the equity arguments against the present system. The taxpayer holding appreciating assets still would be allowed to defer tax indefinitely while the taxpayer holding income producing assets would pay annual tax.[143] The taxpayer holding the appreciated assets would ultimately be liable for taxes, however, under the carryover system; whereas, he would not be under the present system.

Certain practical problems also arise under the carryover system. While determining decedent's basis at his death would be extremely difficult, in many cases it would be even more difficult as time passes. Many taxpayers relying on the current system obviously have kept inadequate records. Several solutions, however, have been offered. One involves an audit by the IRS at the time of death for all but small estates in order to ascertain the basis to be carried over rather than waiting until future years when it would be even more difficult.[144] The estate would bear the expense of this service.[145] A more reasonable alternative would allow a start-up date,[146] upon which heirs could value property held by the decedent at its then fair market value. Property acquired by the decedent as a gift subsequent to that date might also be given a basis determined by its fair market value at that start-up date. Taxpayers would be put on notice to keep proper records for nongift property acquired after this date.

A mushrooming effect might occur in the situation in which an estate was forced to sell its "one asset" to meet its obligations. Because no estate tax deduction would be given for the capital gains tax attributable to gains realized from sales made to pay death taxes, the executor would have to make greater sales to pay the capital gains tax.[147] The extension of section 303[148] and possibly a system allowing primary allocation of basis to assets sold to pay death taxes, however, might help alleviate this problem.

142. Anthoine, *Tax Reduction and Reform: A Lawyer's View*, 63 COLUM. L. REV. 808, 816 (1963).

143. *See* Kurtz & Surrey, *supra* note 10, at 1388.

144. *See* Comment, *supra* note 85, at 138-39.

145. *Cf.* INT. REV. CODE OF 1954, § 4940.

146. *See* Covey, *supra* note 32, at 835.

147. *Id.*

148. INT. REV. CODE OF 1954, § 303.

V. Additional Estate Tax

A. *Background*

As an alternative to a capital gains tax on accrued appreciation at death, several people have urged that an additional estate tax (AET) be enacted. The American Bankers Association (ABA) favors taxing unrealized appreciation at death if the tax is in the form of an AET, but would favor a carryover basis if the choice were only between a capital gains tax and a carryover basis.[149] The ABA would apply the AET to transfers at death and to transfers within two years before death unless the donee has sold the assets, and thus paid a gains tax, prior to decedent's death. A carryover basis would be retained for inter vivos gifts not within two years of death. The ABA, however, would find this tax acceptable only if the estate tax rates were reduced, if the burden of proving basis were eased for taxpayers, and if a start-up date were instituted so that all appreciated property would receive a new basis. The burden of proof change would allow the estate to take a basis equal to proved fair market value as of the date decedent acquired the asset if actual basis is not known.[150] One of the primary proponents of the AET is Richard Covey[151] who has laid out at length a proposal and who has drafted a model statute.[152] The Tax Committee of the Trust Division of the American Bankers Association, while opposing any form of change, also has come out in favor of the AET if change must occur. Although in 1970 the Tax Committee favored a carryover basis as a palatable form of change, it altered its position in favor of the AET in the 1973 Public Hearings Before the House Ways and Means Committee.[153]

B. *Covey's Proposal*[154]

Richard Covey's version of an AET would apply a single rate (ten to fifteen percent) to all transfers of net appreciated property at death or in the two years immediately preceding, unless the donee sells the asset prior to decedent's death. The carryover basis

149. For a discussion of the ABA's position see Covey, *supra* note 32, at 832-33.

150. *See* Seidman, *supra* note 92, at 202.

151. *See* Covey, *supra* note 32, at 843-50; Covey, Surrey & Westfall, *supra* note 119, at 106; *Proposed Estate and Gift Tax Reforms, supra* note 41, at 10-24.

152. *See* Covey, *supra* note 32, at 846-50.

153. *1973 Public Hearings, supra* note 9, pt. 9, at 3742-43 (statement of Stetson B. Harman, President of Trust Division of the American Bankers Association).

154. For a discussion of this proposal see Covey, *supra* note 32, at 843-50.

of section 1015[155] would be retained for all other lifetime transfers. No credits or exclusions would be permitted under the AET—as for marital or charitable transfers. Thus, reallocation of basis problems would be avoided. Gifts to charity, however, would be deducted from the gross estate at their full value, without diminution for the amount of AET paid. In the interest of simplicity no special rule would be established for depreciation recapture, as under sections 1245 and 1250.[156] Only appreciation accruing after the start-up date would be taxable in order to avoid penalizing persons who did not keep an accurate record of basis because of the current law.

The AET would be accompanied by a gradual reduction in estate tax rates as revenues from appreciation accruing after the start-up date begin coming in. Although across-the-board rate reductions could be made immediately if a start-up basis were not used and actual bases were retained, the gradual reduction, start-up basis system should be used in the interest of fairness.

There are a number of advantages to the AET system. It is fair because the effect is progressive; the entire net appreciation is subject to both the state tax and the AET. The administration of the AET would be simple because there would be a single collection process and audit involving the same valuations by a single auditing agent. There would be no question of constitutionality because the AET is an excise, rather than an income, tax. Finally, the taxpayer's psychological distaste for a capital gains tax at death would be mollified.

The AET as proposed would not allow an increase in the estate tax basis for the amount of AET paid. Although this system is susceptible to a charge of double taxation, it eliminates the element of regressivity present in the 1969 proposals for a capital gains tax at death.[157] Any double taxation would be perhaps no more illogical than the overly large credit given under section 1015[158] to avoid double tax. Under section 1015(d) the donee's step-up in basis is not limited to the gift tax paid on accrued appreciation, but is rather given for the gift tax on the full value of the property. Because this gift tax system would act as an incentive for gifts immediately before death, Covey maintains that section 1015(d) should be revised, at least in its application to the two-year period before death.

The rate of the AET should reflect the complement of the

155. INT. REV. CODE OF 1954, § 1015.

156. *Id.* §§ 1245, 1250.

157. *See* notes 122-23 *supra* and accompanying text.

158. INT. REV. CODE OF 1954, § 1015.

highest estate tax rate and the highest capital gains tax rate. This should be done so that the taxpayer whose net appreciation is subjected to the highest estate tax rate would pay approximately the same total tax as he would pay if a capital gains tax at death were imposed on this appreciation and a deduction for this gains tax were given in computing the estate tax. All other decedents would pay a lesser AET than they would pay under the capital gains tax at death proposals. Covey postulates that a top estate tax rate of sixty percent is reasonable. Using this rate and the current capital gains tax rate of thirty-five percent, the AET would be 35% x (100-60)% = 14%.[159] On grounds of simplicity, Covey rejects a tax graduation based on the amount of net appreciation or on the percentage of net appreciation in the estate.

Covey proposes no exemption for marital or charitable transfers in the interest of simplicity—no basis allocation would be necessary. An AET exemption for marital transfers could be enacted so that it would resemble the manner in which the marital deduction currently provides a postponement of the estate tax in the estate of the first spouse to die. This system, while retaining more funds for the surviving spouse, would accentuate the lock-in effect and could work to the disadvantage of the spouse who is forced to sell the assets and realize gains at rates higher than those of the AET. Although the absence of a marital exemption would increase the tax liability upon the death of the first spouse to die, the impact might be mitigated by basic estate tax reduction and provision for a marital deduction of the greater of one-half of the adjusted transfer or 250,000 dollars. Also the AET might not be considered a debt of the estate for the purpose of computing the marital deduction, thus increasing the deduction's amount. Indirect relief for removing an AET charitable deduction would be provided by granting an estate tax charitable deduction in the amount of the fair market value of the asset transferred even though the actual amount received by the charity would be reduced for AET paid.

VI. Other Proposals

A. *Rollover*

Although not specifically aimed at changing tax treatment of appreciated assets at death, implementation of a "rollover" tax system would revamp the entire treatment of capital gains and

159. Covey, *supra* note 32, at 845.

would necessarily have an effect on tax treatment at death. Under a rollover system all income taxes would be deferred on realized capital gains to the extent that such gains are currently reinvested in other capital assets. Reinvested gain would be applied to decrease the cost basis of new assets purchased and would be prorated proportionately to the purchase price of each new asset in ratio to the total assets purchased.[160] All capital losses would be immediately recognized in full, while gain would be recognized in the year of withdrawal at ordinary income rates.[161] This approach is already used in the Code for exchanges in kind, the sale of personal residences, and involuntary conversions.[162] This rollover approach would necessitate a constructive realization at death to prevent indefinite tax avoidance. The problems of this taxation at death system have already been discussed.[163] The rollover system's chief virtue, however, would lie in the fact that it would tend to free investment capital from lock-in effects under the present system.[164]

B. Accrual

Implementation of an accrual method of taxing capital appreciation is another reform proposal that would force revision of the present death tax system although it is not solely aimed at tax treatment at death.[165] Under the accrual method all accrued and realized capital gains and losses would be recognized annually and subjected to tax.[166] This gain or loss would be treated as ordinary income.[167] The chief virtue of the accrual system is that it would eliminate the lock-in problem.[168] The accrual method, however, would be subject to the same constitutional attack as the proposed capital gains tax on accrued gains at death.[169] It would also produce such great administrative burdens that its implementation might be economically infeasible. Finally, the likelihood of such a system passing in Congress is quite remote.

160. *See* Heckerling, *supra* note 77, at 257-58; Marshall & Crumbley, *Reform Proposals for Taxation of Capital Gains*, 108 TRUSTS & ESTATES 871, 874-75 (1969).

161. *See* Clark, *An Alternative to Capital Gains Taxation: A "Rollover" Account for Investment Assets*, 4 How. L.J. 157, 161 (1958).

162. INT. REV. CODE OF 1954, §§ 1033, 1034.

163. *See* notes 43-123 *supra* and accompanying text.

164. *See* notes 11-25 *supra* and accompanying text.

165. *See 1969 Hearings, supra* note 94, pt. 12, at 4273-309 (statement of Professor Martin David).

166. *Id.* at 4281.

167. *Id.*

168. *See* notes 11-25 *supra* and accompanying text.

169. *See* notes 76-89 *supra* and accompanying text.

VII. Conclusion

The proposal that has arisen with the greatest persistency is the taxation of accrued gains at death. The resiliency of this system appears to be based primarily on its theoretical appeal to persons valuing a system that has no "loopholes" and that gives "equal" treatment to all. While these reasons may have appeal when voiced in the abstract, the practical results flowing from their application might be less than desirable. Incentives and "special" treatment exist in our tax structure for practical and political reasons. Perhaps the reason most basic to the American economic system is the idea that the pursuit of wealth and wealth accumulation are healthy. Some tax break for those investing in appreciating assets may be necessary to prime the pump. Furthermore, destruction of a financial empire built during life—especially when it is a family business or farm—may be bad for the economic system as a whole, both because of its disincentive to entrepreneurs and because of the corrosive effect it has on otherwise viable economic units.

The proposal that accommodates these economic realities and that also meets many of the critics' equitable challenges is a carryover system. While not a panacea, the carryover approach can be viewed as lessening lock-in, increasing equity, and bolstering federal revenue—all with reasonable administrative simplicity. Also, in the final analysis it is an approach that bears a good chance of passing Congress. While representing little more than half a loaf to any school of thought, it is at least reasonably platable to all.

D. Allen Grumbine