[JOINT COMMITTEE PRINT]

BACKGROUND AND ISSUES

RELATING TO

CARRYOVER BASIS

SCHEDULED FOR A HEARING

BY THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

OF THE

COMMITTEE ON FINANCE

ON MARCH 12, 19, AND 20, 1979

PREPARED FOR THE USE OF THE

COMMITTEE ON FINANCE

BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

MARCH 9, 1979

U.S. GOVERNMENT PRINTING OFFICE

41-644 O WASHINGTON : 1979 JCS-6-79

CONTENTS

	Page
I. Introduction	1
II. Summary	3
III. Background—Income tax treatment of property acquired from a decedent	5
A. Prior to the Tax Reform Act of 1976	5
B. Carryover basis under the Tax Reform Act of 1976	7
C. Revenue Act of 1978	11
IV. Carryover basis issues	13
A. Tax equity issues	13
B. Liquidity issues	19
C. Lock-in issues	20
D. Administrative problems	21
V. Alternatives	29
A. Single Rate Additional Estate Tax (AET)	29
B. Graduated Appreciation Tax at Death	30
C. Taxing Gains at Death	31
VI. Transitional issue	32
VII. Revenue estimates	34

CONTENTS
2
3
4
5
6

I. INTRODUCTION

The carryover basis provision described in this pamphlet has been scheduled for hearings on March 12, 19, and 20, 1979, by the Subcommittee on Taxation and Debt Management Generally of the Senate Committee on Finance.

In connection with this hearing, the staff of the Joint Committee on Taxation has prepared a description of the prior and present income tax treatment of property acquired from a decedent, the principal issues raised by carryover basis, and possible alternatives to carryover basis. The estimated revenue effect from repeal or certain possible modifications of carryover basis also is presented.

II. SUMMARY

Under the law prior to the Tax Reform Act of 1976, the basis for determining gain or loss from sales of property acquired from a decedent generally was the value of the property at the date of the decedent's death. This was commonly referred to as a "step-up" in the basis of property at death. Thus, if property owned by a decedent had appreciated after it was acquired, that appreciation never was subject to the income tax. On the other hand, if nondepreciable property had declined in value after the decedent acquired it, the decline in value never could be deducted for income tax purposes.

Where property is transferred by gift, the basis in the hands of the donee is generally the same as the donor's basis. Also, where income had been earned by a decedent but was not properly includible in his last income tax return, the recipient is taxed in essentially the same manner as the decedent would have been if he had lived to receive it, i.e., the tax attributes are carried over to the beneficiary.

The Tax Reform Act of 1976 provided that the basis of most property acquired from a decedent after December 31, 1976, was no longer generally to be determined in reference to its fair market value on the date of the decedent's death.[1] In general, the basis of such property was to be the same as the decedent's basis immediately before death with certain adjustments (i.e., a "carryover basis").

The 1976 provision was added because Congress believed that prior law resulted in discrimination against those persons who sell their property prior to death as compared with those whose property was not sold until after death. Postponement of a sale until after the owner's death could result in all appreciation occurring before death not being subject to the income tax. In addition, Congress was concerned that prior law resulted in persons postponing sales to avoid tax on the appreciation and that this "lock-in" effect impaired the mobility of capital.

In order to prevent a portion of the appreciation from being taxed by both the estate and income tax, an adjustment was provided to increase the carryover basis by Federal and State death taxes attributable to the net appreciation of property subject to tax. In addition, in order to exempt smaller estates from administrative burdens arising from carryover basis, a $60,000 minimum basis adjustment was provided. Also, in order to prevent retroactive effect from the adoption of carryover basis, a 'fresh-start" adjustment was provided. Under that adjustment, the basis of an asset acquired from a decedent was to be stepped-up to its value on December 31, 1976, for purposes of determining gain if the asset had been held by the decedent on that date.

---

[1] The carryover basis provisions were added to the 1976 Act by the Conference Committee. These provisions had been included in a separate bill dealing with estate and gift taxes which had been reported by the Ways and Means Committee. The Senate Finance Committee has ot reported a carryover basis provision.

The carryover basis provisions have been criticized as being extremely complex and administratively unworkable. Administrators of estates testified that compliance with the provisions caused a tremendous increase in the time required to administer an estate and resulted in raising the cost of administration. In response to the problems raised, the Revenue Act of 1978 postponed for three years the carryover basis provisions, making the provisions applicable only to property of decedents dying after 1979.

The Administration strongly opposes further deferral or repeal of the carryover basis provisions. It argues that the appreciation on inherited assets passing annually is about $20 billion (at 1979 levels) and that, under prior law, this appreciation would not be subject to the income tax. During the 95th Congress, the Treasury Department endorsed a number of proposed amendments to simplify the application of carryover basis and to have it only apply to larger estates. One of these proposals would have increased the "minimum basis" adjustment amount from $60,000 to $175,000. It is estimated that, if carryover basis applied only to estates having carryover property with a value of more than $175,000, only about 2 to 3 percent of all estates would be subject to the carryover basis rules.

On the other hand, opponents of the carryover basis provisions state that no amount of "clean-up" can solve its major defects and make it work in a relatively simple manner. They point out that it is extremely difficult or impossible to prove the basis of certain property, and that this proof of basis problem cannot be satisfactorily solved. In addition, they argue that it would be unfair to apply these provisions to only a small number of estates. They also argue that coverage of only a small number of estates indicates that the provisions are too costly to administer in most cases.

III. BACKGROUND—INCOME TAX TREATMENT OF PROPERTY ACQUIRED FROM A DECEDENT

A. Prior to the Tax Reform Act of 1976

1. *Summary of provisions*

Under the law prior to the Tax Reform Act of 1976, the cost or basis of property acquired from or passing from a decedent was its fair market value at the date of the decedent's death (or at the alternate valuation date if that date was elected for estate tax purposes).[1] Thus, if the fair market value of the property had appreciated after the decedent acquired it, that appreciation never would be subject to income tax. On the other hand, if nondepreciable property declined in value after the decedent acquired it, the decline in value never could be deducted for income tax purposes. The basis of property acquired from or passing from the decedent under prior law was often referred to as a "stepped-up basis." (Although basis may have been adjusted upward or downward at death, upward adjustments were more common, partly because many types of property tend to appreciate over time, and partly because individuals may have disposed of their loss property prior to death, but tended to hold property which had appreciated.)

For the purpose of determining what property was given a stepped-up basis, the test was generally whether the property was included in the gross estate of the decedent. In addition, the surviving spouse's share of community property was treated as if it were acquired from the decedent (and received a stepped-up basis) even though that portion of the community property was not includible in the gross estate of the decedent. The purpose of this rule was to equalize the basis treatment of a surviving spouse's share of community property with property passing to a surviving spouse in a common law State.

Where property is transferred by gift, the basis of the property in the hands of the donee is generally the same as the donor's basis. However, this "carryover basis" was increased by the amount of any gift taxes paid on the transfer by gift, but not in excess of the property's fair market value as of the date of the gift. An exception to the carryover basis rule is provided in computing any loss resulting from the sale or other disposition of property acquired by gift. Under that exception, the basis of the asset for purposes of computing loss is the lesser of the fair market value of the property on the date of gift or the basis of the property in the hands of the donor. Where the asset is sold at a price greater than the fair market value at the date of gift, but less than the basis of the donor, then neither gain nor loss is recognized on the transaction.

---

[1] For purposes of this discussion, a reference to the fair market value at the date of the decedent's death will include reference to the value of the property on the alternate valuation date.

In addition, where income had been earned by a decedent but was not properly includible in his income tax return, the person receiving the income must treat the income essentially in the same manner as the decedent would have if he had lived to receive it. Thus, the tax treatment of this income, called income in respect of a decedent, carries over to the recipient of the income. However, a separate income tax deduction for the Federal estate tax attributable to an item of income in respect of a decedent is allowed to avoid double taxation.[2]

2. *Previous proposals for change*

Prior to the 1976 Act, the law relating to the income tax treatment of property acquired from a decedent had remained generally unchanged since the enactment of the income tax laws in 1913. However, in 1963, the Kennedy Administration proposed imposing a capital gain tax on unrealized appreciation on property held at death. Generally, gain would have been recognized in a decedent's final income tax return as if the property had been sold immediately prior to death. In response to that proposal, the Committee on Ways and Means, during the markup of the bill which became the Revenue Act of 1964, tentatively agreed to adopt a "carryover basis" provision. The tentative decision was subsequently reversed, and the reported bill did not contain any changes to the treatment of property held by or acquired from a decedent.

In its tax reform studies published in 1969, the Treasury Department recommended taxation under the income tax, in a manner similar to that of capital gains, of the appreciation in the value of assets transferred at death or by gift.

Finally, in 1972, the American Bankers Association recommended, as an alternative to either capital gains at death treatment or carryover basis, the imposition of an additional estate tax on appreciation. This recommendation was developed in connection with a proposal for comprehensive revision of the estate and gift tax laws.

---

[2] In the typical case where income is realized before death, an income tax is imposed on the realized gain. In addition, an estate tax is imposed on income retained after payment of the income tax. Thus, there is normally both an income tax and an estate tax imposed on income. However, any income tax paid on income realized before death reduces the amount of the gross estate subject to the estate tax. As a result, there is no estate tax imposed on the portion of the income used to pay the income tax. However, where the income is realized after death, the value includible in the gross estate is not discounted for any potential income tax liability. Consequently, in those cases where income is recognized after death, the carryover basis rules and other rules where income is taxed to the decedent's beneficiary (income in respect of a decedent, joint and survivor annuities, etc.) provide that the amount of income subject to the income tax is reduced by the amount of estate taxes imposed on the income item. In the case of income in respect of a decedent, a deduction for estate taxes attributable to the income item is allowed. In the case of carryover basis, an adjustment to the basis of the property is allowed.

All of these types of adjustments are designed to achieve a result similar to the result reached when income is recognized before death. In the interest of brevity and simplicity, that purpose is often referred to as "avoiding double taxation."

B. Carryover Basis Under the Tax Reform Act of 1976

1. *In general*

Under the 1976 Act, the Congress adopted a carryover basis provision for property acquired from a decedent. The provision was to apply with respect to property acquired from a decedent dying after December 31, 1976.

The Congress believed that prior law resulted in discrimination against those people who sell their property before death as compared with those whose property was not sold until after death. Also, the Congress believed that repeal of the stepped-up basis rules would reduce the lock-in effect upon investments which resulted when older persons refrained from selling property because they realized that the appreciation would be subject to income tax if the sale were made then, but would not be if the property was held until death and later sold by the estate or heirs. In addition, the Congress believed that a carryover basis rule for property acquired from a decedent eliminated an unwarranted difference in treatment between lifetime gift transfers, which were subject to a carryover basis rule, and deathtime transfers.

2. *Description of provisions*

General

Under the Tax Reform Act of 1976, the basis of most property acquired from or passing from a decedent dying after December 31, 1976, was not to be stepped up (or stepped down) to reflect the fair market value of the property on the date of death. Property which was no longer entitled to this adjustment based on fair market value was referred to, under the Act, as "carryover basis property." Property which was not carryover basis property continued to be governed by the basis rules of prior law.

The Act added a new provision (sec. 1023) to provide rules for determining the basis of "carryover basis property." In general, the basis of carryover basis property acquired from or passing from a decedent dying after December 31, 1976, was to be the decedent's basis immediately before his death with certain adjustments discussed below.

Where the carryover basis rules apply, the gain on the sale or other disposition of property received from a decedent was to be taxed to the recipient who sold, or otherwise disposed of, the property. This gain reflects any decrease in basis of the property in the hands of the decedent from depreciation, depletion, or amortization deductions taken by him. Therefore, the gain on the sale of such property was characterized as ordinary income to the extent provided by the recapture provisions (secs. 1245, etc.) of the Code. In addition, cost depletion, depreciation, and amortization was to be computed in reference to the carryover basis.

The Act generally did not limit the adjusted carryover basis to the fair market value of property acquired from or passing from a decedent. Thus, in the case of investment assets held by the decedent, losses as well as gains were measured by reference to the basis of the property in the hands of the decedent.

However, losses that typically occur in connection with personal and household assets were not allowed to offset gains attributable to the investment assets of the decedent, since these losses would have been treated as nondeductible personal losses if they had been realized by the decedent during his life.

Definition of carryover basis property

Generally, the term "carryover basis property" includes all property acquired from or passing from the decedent (within the meaning of section 1014(b)). Thus, the term generally covers all property which received a stepped-up basis under prior law. However, there are a number of exceptions to the general rule.

First, the Act excepted life insurance on the decedent's life from the definition of carryover basis property. Second, the Act made a number of other exceptions for property where the income attributable to it is already taxed to the recipient under present law.[2]

Third, the executor of the estate may elect to exempt up to $10,000 worth of household and personal effects of the decedent from the carryover basis rules by making an election designating which items are not to receive carryover basis treatment. If the executor makes such an election, the personal and household effects to which the election applies would receive a stepped-up basis, as under prior law.

Adjustments to carryover basis

In addition to a transitional "fresh start" adjustment described below, the Act provided three adjustments that are made to the adjusted basis which is carried over from the decedent. Under the first adjustment, the basis is increased by Federal and State estate taxes paid by the estate attributable to the appreciation in the carryover basis property. Second, after the adjustment for Federal and State estate taxes, if $60,000 exceeds the adjusted bases of all carryover assets, the bases of appreciated carryover basis property is increased by the excess. Finally, the basis of carryover basis property is increased by any State death taxes which are paid by the distributee of carryover basis property and which are attributable to any remaining appreciation in carryover basis property received by that distributee. However, in no event may the basis of any asset be increased by the three adjustments in excess of its fair market value on the date of the decedent's death.

Adjustment for "fresh start"

Under the Act, the adjusted basis of property which the decedent was treated as holding on December 31, 1976, was increased, for purposes of determining gain (but not loss), by the amount by which the

[2] Sections 72, 402, 403, 423(c), 424(c)(1), 691, and 1014(b)(5) (and sec. 1014(b)(9) with respect to property included in the gross estate where the donee has sold it before the decedent's death). For purposes of the exception with respect to payments and distributions under a deferred compensation plan, life insurance proceeds payable under the plan and excludible under section 72(m)(3) are treated as taxable to the beneficiary and thus excluded from the term "carryover basis property."

fair market value of property on December 31, 1976, exceeded its adjusted basis on that date. In essence, this modification continued prior law with respect to appreciation in property accruing before January 1, 1977, and provides everyone with a "fresh start."

In order to avoid the necessity of obtaining an appraisal on all property held on December 31, 1976, the Act contained a provision which required that all property, other than securities for which market quotations are readily available, be valued under a special valuation method. The special rule was to be used where the carryover basis property does not reflect the basis of property which, on December 31, 1976, was a marketable bond or security. In general, the special rule determined the adjustment by assuming that any appreciation occurring between the acquisition of the property and the date of the decedent's death occurred at the same rate over the entire time that the decedent was treated as holding the property.

Under the Act, the December 31, 1976, value of marketable bonds or regional exchange; securities regularly traded in the national or 1976. Marketable bonds or securities are securities which are listed on the New York Stock Exchange, the American Stock Exchange, or any city or regional exchange in which quotations appear on a daily basis, including foreign securities listed on a recognized foreign national or regional exchange; securities regularly traded in the national or regional over-the-counter market, for which published quotations are available; securities locally traded for which quotations can readily be obtained from established brokerage firms; and units in a common trust fund.

Adjustment for Federal and State estate taxes

The Act increased the basis of carryover basis property by a portion of the Federal and State estate taxes attritbutable to the net appreciation in value of carryover basis property. The purpose of the adjustment for Federal and State estate taxes was to prevent a portion of the appreciation from being subject to both the estate tax and the income tax. For this reason, the adjustment was limited to the portion of the Federal and State estate taxes that is attributable to the appreciation in the carryover basis assets. That portion for each individual carryover basis asset was to be determined by multiplying the net Federal and State estate tax after all credits by a fraction. The numerator of the fraction is the amount of appreciation in the individual carryover basis asset and the denominator is the total value of all property of the decedent subject to the estate tax.

The adjustment to carryover basis provided under the Act was made only with respect to property which is "subject to tax" for Federal estate tax purposes. For this purpose, the Act provided that property for which a charitable or marital deduction is allowed (secs. 2055, 2106 or 2056) is not considered to be "subject to tax."

Income in respect of a decedent

The Act made two amendments to section 691 (relating to income in respect of a decedent) in order to more nearly equate the treatment of items of income in respect of a decedent with the treatment given to carryover basis property. First, under prior law, the recipient of income in respect of a decedent was permitted a deduction only with respect to Federal estate taxes which were attributable to the income

in respect of a decedent. The Act broadened the types of taxes for which a deduction was allowed to all Federal and State estate taxes (as defined in section 1023(a) (3)) attributable to that income.

Second, under the Act, the deduction for Federal and State estate taxes attributable to income in respect of a decedent was computed on the basis of the average estate tax rate on the decedent's estate rather than the highest marginal rates.

Basis of property acquired by gift

The Act provided that the increase in basis of property acquired by gift is limited to the gift tax attributable to the net appreciation on the gift.

Procedural aspects of carryover basis

(1) *Decedent's basis unknown.*—In some cases, it will be extremely difficult, if not impossible, for the executor to determine the basis of some of the property owned by the decedent. Consequently, the Act contained a provision which permits the executor and the Internal Revenue Service to assume that the purchase cost of the property to the decedent (or last purchaser, where relevant) is the fair market value of the property on the date that it was purchased. In essence, this provision permits the executor and the Service to assume that the decedent (or other relevant person who last purchased the property) paid fair market value for the property at the time of purchase.

(2) *Information required to be furnished by executor.*—In order for the Service and the recipients of property from a decedent to know the carryover basis of that property, the Act added a provision which required the executor to provide such information concerning carryover basis property to the Service as may be required by regulations. Failure of the executor to provide this information was to result in the imposition of a penalty on the executor equal to $100 for each failure with a maximum amount for all such failures equal to $5,000. It was expected that the Service would establish a procedure under which the executor was deemed to have met this reporting requirement if the executor had done everything reasonable to obtain the information, but was unable to do so.

In addition, the provision required the executor to provide to each recipient of property from a decedent the adjusted basis of that property with the adjustments provided for Federal and State estate taxes and minimum basis, but before adjustment for State succession taxes. Failure to provide this information would have resulted in the imposition of a penalty on the executor of $50 for each such failure (unless such failure is due to reasonable cause) with a maximum amount for all such failures of $2,500.

C. Revenue Act of 1978

1. *Postponement of the carryover basis provisions*

The Revenue Act of 1978 postponed the effective date of the carryover basis provisions so that they only will apply to property acquired from decedents dying after December 31, 1979. For property passing or acquired from a decedent dying before January 1, 1980, the basis of property will be its fair market value at the date of the decedent's death or at the applicable valuation date if the alternate valuation provision is elected for estate tax purposes. The Act provided that the basis of that farm or closely held business real property will be the amount determined under the special valuation provision if elected for estate tax purposes rather than fair market value based on its highest and best use.

The Act also postponed the effective date of the changes made by the 1976 Act relating to the deduction for estate taxes attributable to income in respect of a decedent. For the postponement period, the deduction will be based on the highest marginal rates rather than the average rate and will be determined only for Federal estate taxes rather than for both Federal and State death taxes. As a conforming change, the basis of property included in a generation-skipping transfer which occurs during the postponement period, as a termination by reason of the death of the deemed transferor, will be determined in the same manner as for property acquired from or passing from a decedent during the postponement period (i.e., a stepped-up basis).

2. *Technical corrections*

The Revenue Act of 1978 also contained several technical corrections to the carryover basis provisions. The following provisions were included in the technical corrections.

An alternative method was provided to ascertain the fresh-start basis of tangible personal property. This elective method was provided because Congress believed that it would be difficult for an executor to determine the basis or acquisition date of some items of tangible personal property. Under this rule, the fresh start value would be determined by discounting back the date of death value under a formula using an 8 percent annual rate, compounded for the period from 1976 until the date of death.

Another change provided that debt (including non-recourse debt) is to be ignored in determining the amount of appreciation for purposes of making the various adjustments. This change was designed to eliminate possible distortions in allocating the various adjustments among assets on the basis of appreciation when an asset was subject to a nonrecourse debt. Without the change, appreciation would be measured without regard to debt in some cases but would be reduced by nonrecourse debt in other cases.

Another amendment clarified that a fresh-start adjustment may be made only once for any item of property.

Another amendment provided that carryover basis property automatically satisfied the holding period for long-term capital gains. Therefore, all capital assets sold by the executor or heirs will qualify for long-term capital gains treatment.

Another amendment clarified that the adjustment for State death taxes would be made on the basis of State death tax rules determining which property is subject to tax rather than the Federal estate tax rules.

Another amendment clarified that all stock redeemed under Code section 303 (relating to treatment of redemptions of closely-held stock to pay death, etc. taxes) would qualify for capital gains treatment.

IV. CARRYOVER BASIS ISSUES

A. Tax Equity Issues

There are two principal arguments made in favor of carryover basis which are based on tax equity considerations. First, it is argued that it is inequitable to impose a greater combined income and estate tax burden with respect to property sold during a person's life than is imposed with respect to property held at death. Second, it is argued that it is inequitable to discriminate in favor of deathtime transfers and against lifetime gift transfers by allowing a step-up in basis for appreciation which has not been subject to income tax for deathtime transfers but providing a carryover basis for gift transfers.

The argument relating to unequal tax burdens may be illustrated by comparing the net after-tax proceeds retained by a decedent's beneficiary in the case of a sale before death for a $100 gain with the case where property with $100 appreciation is retained until death, subsequently sold by the decedent's estate and then distributed to the beneficiary. Assuming application of a capital gains tax rate of 28 percent and a marginal estate tax rate of 50 percent actually, a 49 percent rate applies to the portion of a taxable estate from $2 million to $2.5 million), the net amount retained by the decedent's beneficiary would be as follows:

	Sale before death	Asset retained until death
Amount of gain or appreciation	$100	$100
Capital gains tax	28	0
Amount included in gross estate	72	100
Estate tax	36	50
Net amount to beneficiary	$36	$50

Under these tax rates, the effective tax rate for the combined income and estate taxes is 14 percentage points higher in the case of the sale before death.[1] Using the highest estate tax marginal rate of 70 percent, the effective tax rate for the combined income and estate taxes is 8.4 percentage points higher in the case of the sale before death. The proponents of carryover basis (or an alternative tax at death) argue that this represents a significant difference in the respective effective rates. In addition, the proponents emphasize the significance in the difference in treatment by stressing the dollar amount of appreciation which is estimated to pass annually from decedent's estates and which would never be subject to income tax under the stepped-up basis rules.[2] It has been estimated that approximately $20 billion in untaxed appreciation passes from decedents annually.

Many proponents of carryover basis believe that this equality of treatment argument makes a stronger theoretical case for taxation of appreciation at death than it does for carryover basis. However, because of other considerations, such as additional stress on liquidity needs if tax is imposed at death, there is a preference for carry-

---

[1] Under carryover basis, the combined estate and income tax burden generally is the same as in the case of pre-death sale after taking the income tax from a post-death sale into account. This may be illustrated as follows:

Amount included in the gross estate	$100.0
Estate tax at 50% marginal rate	50.0
Amount of gain subject to income tax (after basis adjustment of $50)	50.0
Capital gain tax (28% of $50)	14.0
Net amount to beneficiary	36.0

In this illustration, the net amount to the beneficiary in the case of the sale before death and the sale after death under carryover basis is the same. In actual practice, the net amount to the beneficiary may not be identical in both cases because the marginal income tax rate of the decedent and the beneficiary may not be the same.

[2] Since a tax shelter investment is usually highly leveraged and usually results in deductions in early years which exceed the amount of a taxpayer's cash (and property) investment in the tax shelter, the tax basis of a tax shelter immediately prior to the taxpayer's death often may be less than the amount of the liability owed with respect to such a shelter. In such a situation, the taxpayer cannot dispose of the shelter without recognition of gain. Also, if carryover basis applies, the income recapture potential inherent in the shelter property cannot be eliminated by retaining the property until death (or rolling over the property into another tax shelter) because the liability in excess of basis problem will remain for the taxpayer's executor or heirs. Conversely, under a stepped-up basis approach, it appears that a substantial part of the income recognition inherent in tax shelter property is usually eliminated (because the basis after the step-up to fair market value will usually exceed the amount of liabilities to which the property is subject). Proponents of carryover basis point out that carryover basis tends to discourage, to some degree, investments in tax shelters and that stepped-up basis tends to encourage tax shelter investments (and, in particular, to encourage taxpayers who have invested in tax shelters to continue to invest in additional shelters relying on the stepped-up basis as a bailout).

Opponents of carryover basis argue that, to some extent, tax shelter investments have been curtailed by provisions in the 1976 and 1978 Acts (other than the carryover basis provisions) and that, if further limitations are desired, they should be made directly, not through the carryover basis provisions. Some opponents of carryover basis also argue that even if there are some inequities in the tax shelter area under a stepped-up basis approach, these tax shelter problems are relatively insignificant when compared with the problems in a carryover basis approach.

over basis, or an acceptance of carryover as the next best approach, by these proponents. Since the unrealized appreciation ultimately will be taxed if there is an actual disposition, the carryover basis approach is considered generally consistent with the equality of treatment argument by these proponents although there may be considerable deferral of the income tax compared with taxation of gains at death.

On the other hand, a number of persons acknowledge the theoretical correctness of the equality of treatment argument for carryover basis but favor its repeal for practical, administrative reasons. They are convinced that the complexity, administrative burdens, and financial costs incurred to comply with the provisions outweigh the need to have complete equality for all similar situations. They argue that the problems under carryover basis are so great that its continuance in the tax law will have a serious adverse impact on our self-assessment system of taxation.

Others reject the correctness of the theoretical justification for carryover basis or believe there are basic differences involved in selling or retaining assets which justify different tax consequences. It has been argued that a person who has accumulated wealth through taxable transactions usually has had an economic benefit of diversification of investments whereas the person who has accumulated wealth by holding assets for appreciation has had less diversification in investments and possibly greater risk in holding assets over a longer period. In this light, it is argued that the differences in tax burdens in these cases are justified.

Another distinguishing aspect urged by some opponents of carryover basis relates to the fact that most pre-death sales are made voluntarily and with assumed knowledge of the consequences upon the amount of property which eventually will be passed on to the taxpayer's heirs and beneficiaries. Although carryover basis does not directly trigger recognition of unrealized appreciation, it is argued that the involuntary act of dying will have the practical effect of causing some income tax consequences under carryover basis since some portion of the appreciated assets may have to be sold to liquidate debts or pay administrative and funeral expenses.

Others argue that it is undesirable to impose an income tax on pre-death from the sale of inherited property because it has already been subject to the estate tax. It is argued that the progressive estate tax rate schedule does a fair job of taxing appreciation at little administrative cost.

Carryover basis rules also have been criticized because they may increase the financial burden placed on some estates due to the income tax attributable to sales of appreciated property to liquidate debts and pay expenses. It is said that the tax impact "mushrooms" because it then is necessary to sell additional property to pay the income tax on the other sales made to pay debts. Also, it is argued that inequities arise because many of these sales may occur under forced and disadvantageous conditions, quite unlike those which probably would have been selected by the decedent for a lifetime sale. Further, it is argued that the potential income tax burden resulting from such a sale may be a particularly acute problem in the case of illiquid estates consisting primarily of closely held business interests.

On the other hand, some proponents of carryover basis have suggested several ways to provide some relief for the liquidity problem. It has been suggested that the special extended payment rules provided for the payment of certain state taxes (e.g., secs. 6161(a)(2), 6166, 6166A) and the special rule for capital gains treatment of closely held business stock redemptions to pay death taxes (sec. 303) could be expanded to cover the income taxes incurred by an estate on the sale of carryover basis property.

Proponents of allowing a step-up in basis for property passing on death also have criticized the carryover basis rules on the ground that recent proposals to modify those rules would eliminate 98 percent of all decedents' estates from the operation of carryover basis. For purposes of coverage under carryover basis, it is argued that is unfair to single out a small fraction of the estates whose executors must contend with a complex provision. In this instance, it is argued that reasonable classifications of covered and exempt estates should not be based solely on the size of the estate.

In addition, these proposals also have been criticized on the ground that a "notch" problem would be created if an exclusion is provided for estates having carryover basis assets with a value equal to or less than the minimum basis. That is, those estates valued at less than the carryover basis threshold would receive a basis equal to their estate tax values, and assets of estates which are equal to or exceed that threshold would receive a carryover basis. Thus, the income tax consequences to the recipients of property would depend substantially on whether the value of the gross estate was under or over the carryover basis threshold. It is argued that inequities might arise with respect to the treatment of assets in estates of relatively comparable value for estate tax purposes. For example, assuming that a $175,000 carryover basis exclusion was provided, as has been suggested by some proponents of carryover basis, if two decendents had made an identical lifetime investment at a cost of $200,000 and the value had declined so that one decedent's gross estate with one other asset was $175,000 but the other decedent's gross estate was $1 less, then the built-in loss of $25,000 ($200,000 cost less $175,000 value) would be allowable for a sale of the investment by the estate or beneficiaries of the first decedent, but no amount of loss would be allowable upon the sale of the investment by the estate or beneficiaries of the second decedent. It is further argued that undue stress might be placed on planning possibilities in anticipation of death with respect to estates within a reasonable range of the exclusion amount. Thus, for example, debt payments might be deferred or accelerated, or new loans arranged, to manipulate the size of the gross estate in order to come under the carryover rules if it is advantageous to do so, or to avoid them if that is advantageous. Accordingly, it is argued that routine transactions might have far greater significance with new planning techniques for those who have access to sophisticated counsel and that these rules would be a trap for the unwary for those who do not.

Conversely, it can be argued that Congress continuously has found it appropriate to differentiate between small and larger estates. Prior to 1977, this line was set at $60,000 under the estate tax specific exemption, and subsequently set at $175,000 to conform to the unified estate and gift tax credit. The proponents of carryover basis argue that a

dollar amount exclusion for smaller estates is appropriate for several reasons. First, a major portion of appreciation passing from decedents annually will be attributable to estates of wealthier decedents. Thus, it is argued that the significant portion of appreciation which is not being taxed for income tax purposes will be covered even if a dollar exclusion is provided. Second, it is argued that in the case of larger estates, adequate cost records are more likely to be maintained for investments in stocks, bonds, and real estate.

Opponents of carryover basis also have argued that it may result in inequities to beneficiaries depending upon choices made by the executor. For example, a residuary legatee may be adversely affected if an executor sells property to fund a bequest, and apportions taxes to the residue, rather than transferring property directly. Similarly, an executor's choice of assets for the personal and household effects exemption, or in funding a bequest with high or low basis property, may affect the income tax consequences ultimately experienced by the beneficiary or heir, and this is viewed as creating new tax disparities. Proponents of carryover basis argue, conversely, that any executor discretion may result in some differences in the taxes finally borne by heirs, and that this problem is not peculiar to carryover basis.

Another equity-related issue concerns the question of whether carryover basis results in regressive taxation. Under the carryover basis provisions, an adjustment to basis is permitted for the estate and death taxes attributable to appreciation. Because of the progressive nature of the estate tax rates, a greater basis adjustment is permitted in the case of larger estates where the marginal estate tax rate is higher. This, in turn, may result in a proportionately greater reduction of income taxes to larger estates upon an ultimate sale of the property. Using a capital gains rate of 28 percent and the top estate tax rate of 70 percent, the effective income tax rate for pre-estate tax appreciation is 8.4 percent (28%×30%) after reflecting the death tax adjustment. With a capital gains rate of 28 percent and a marginal estate tax rate of 40 percent, the effective income tax rate is 16.8 percent (28%×60%). It has been contended that this result is unsound and amounts to regressive or "upside down" taxation.

On the other hand, proponents of carryover basis argue that the adjustment is greater in larger estates because they pay proportionately more in estate taxes. They contend that this does not mean that the income tax is regressive or that the adjustment should be denied. The funds to pay an income tax on the entire appreciation are not available due to the estate tax imposed on the appreciation and, therefore, should not be subject to income tax. It is argued that, although the effective rate of tax may be higher in smaller estates, this comparison, by itself, generally is inappropriate. They point out that the proper comparison is the comparison of the total of the estate and income taxes to the value of the estate and that this is consistent with the progressive rate structure, as it should be. Thus, using the preceding illustrations, the combined estate and income tax rate for appreciation in the 70 percent estate tax bracket is 78.4 percent (70%+8.4%) for the largest estate and the combined rate for appreciation in a 40 percent estate tax bracket is 56.8 percent (40%+16.8%).

The proponents argue that the purpose of carryover basis and the estate tax adjustment to basis is to treat a taxpayer selling property before death and one selling property immediately after the decedent's death in substantially the same manner. If a taxpayer sells appreciated property prior to death, no estate tax is imposed on the income tax attributable to appreciation. The estate tax adjustment is designed to achieve a similar result and prevent a portion of the appreciation from being subject to both estate taxes and income taxes. Also, the carryover basis adjustment for death taxes provides the same kind of relief from double taxation as is provided by allowing an income tax deduction for the Federal estate tax attributable to an item of income in respect of a decedent where the peson actually receiving the item must treat it as taxable income.

B. Liquidity Issues

Those supporting a stepped-up basis for property acquired from a decedent frequently argue that any other tax rule is likely to generate significantly adverse financial problems for illiquid estates. This could result, under carryover basis, from a "mushrooming" of income taxes due on the sale of appreciated assets which were being disposed of to raise the funds to pay debts, expenses, and death taxes. Such income taxes, in turn, could necessitate other sales of appreciated property, which then would generate additional income taxes. This problem, it is argued, may be especially acute where an estate is comprised largely of a closely held business. It is said that liquidity needs and the carryover basis rules aggravate the difficulty faced by an executor in reaching sales and funding decisions.

To the extent that illiquidity problems might be accentuated by income taxes due on the sale of appreciated carryover basis assets, it can be argued that these concerns actually relate to the time when taxes are payable, not the amount of the tax. To deal with these problems, and thereby to accommodate illiquid estates, some would suggest that the various special estate tax rules presently in the Code could be modified or extended to the income tax. These provisions relate to special extensions for the payment of the estate tax (secs. 6161(a)(2), 6166, 6166A) and capital gains treatment for redemptions of stock in a closely held corporation to pay death taxes and funeral and administrative expenses (sec. 303).

Any, or all, of these special payment rules could be extended to include income taxes due on the sale of appreciated carryover basis property where an estate meets certain requirements related to illiquidity.

C. Lock-In Issues

"Lock-in" may be described generally as the reluctance of individuals to incur taxes upon the realization of accrued appreciation in assets they hold. Assuming an asset continues to represent a reasonably good investment, lock-in effects generally would increase if the accrued appreciation will not be subject to income taxation if the asset is held until some specified future event. Since parties who become "locked-in" to their investments are reluctant to sell them, lock-in may adversely affect the mobility of capital.

Proponents of carryover basis have contended that allowing property which passes at death to attain a basis equal to its fair market value at the time of the decedent's death accentuates lock-in and generates a significant immobility of capital. Since income taxes on accrued appreciation can be avoided entirely if the basis of property that passes at death is stepped up to its fair market value at that time, many individuals may be reluctant to sell appreciated property prior to death.

Since carryover basis would result in the imposition of income tax upon the ultimate sale of appreciated assets, proponents argue that it would de-emphasize the lock-in effect. In addition, they contend that it would aid capital formulation.

Conversely, opponents of carryover basis argue that it does not eliminate, but rather perpetuates, lock-in since the potential income tax liability also carries over to the beneficiary. Thus, under carryover basis, the decedent's beneficiary may also refrain from selling an asset because of the income tax consequences although the amount of unrealized appreciation may not be as much as it was in the hands of the decedent because of the increase in basis for death taxes. Opponents of carryover argue that the stepped up basis rule removed the lock-in effect once each generation. They also argue that the lock-in effect under carryover basis increases for a beneficiary as additional appreciation in value accrues after the decedent's death.

D. Administrative Problems

1. *Proof of basis problems*

Opponents of carryover basis argue that proof of basis problems are so significant that carryover basis is unworkable. They argue that adequate records for ascertaining cost basis simply do not exist. Moreover, they argue that records also do not exist for the purpose of determining when a decedent had acquired property by purchase (rather than by gift or inheritance) so that the rule permitting use of acquisition date fair market value as the basis will provide no relief for inadequate cost records. Although the problem may be more acute with certain types of property, it is argued that proof of basis problems can arise with respect to any kind of property, including marketable securities. Unlike the situations where basis must be determined for lifetime sales or gifts, the inadequate records problem is said to be impossible for executors for deathtime transfers because the person who was in the best position to supply information concerning cost, and when and how an asset was acquired, is deceased.

Opponents also point to specific types of property which typically may involve inadequate or incomplete records. The assests most often mentioned include personal and household effects, personal residences (and particularly numerous improvements to a residence made over a relatively long period of time), stamp and coin collections, and investments in mutual fund shares where dividends have been reinvested. It is argued that most people simply do not keep sufficient records concerning these assets. Nevertheless, under carryover basis, an executor would have an obligation to use his best efforts to ascertain the decedent's basis. It is argued that unreasonable costs are incurred in attempting to ascertain basis and eventually these additional costs will have to be passed on to beneficiaries.

Another point raised is that, even if diligent efforts have been made to ascertain basis, there is nothing to prevent an Internal Revenue agent from challenging the basis, long after an estate has been closed, when a beneficiary sells the assets and reports a gain or loss on his income tax return. This is referred to as being part of a "suspended basis" problem. This aspect of the suspended basis problem arises because the mere furnishing of basis information to the IRS or beneficiaries will not create any tax deficiency or overpayment so that the issue could be litigated. (Another aspect of the "suspended basis" problem relates to estate tax audit adjustments which increase the basis adjustment for death taxes.)

Many proponents of carryover basis believe that the proof of basis problems are overstated and that most of the troublesome areas relate to "esoteric" assets and can be resolved in a variety of ways. Proponents argue that most of the proof problems are handled in practice under present law for sales and exchanges, gifts, and items of income in respect of a decedent, and that carryover basis for inherited property does not involve any significantly different problems. Pro-

ponents argue that when cost records are unavailable, secondary sources are available in many instances to ascertain cost basis or the time of acquisition. For residential property, proponents argue that secondary basis sources would include the permanent records maintained by a local recorder of deeds, property tax assessment records, building permit records, and property schedules and binders prepared in connection with casualty insurance policies. Some proponents of carryover basis also would respond to the problems for a personal residence by providing a special exclusion and by permitting an adjustment to basis for each year a decedent had owned the residence (such as $250 to $500 annually) to cover small improvements for which no records were kept.

With respect to other types of property, proponents argue that secondary sources include third party records, the permanent books of account of a closely held business, commercial publications showing the capital adjustments for publicly owned corporations, insurance schedules for specially covered items (such as jewelry, antiques, and works of art), and income tax returns (e.g., depreciation schedules and dividend income schedules which could be used to ascertain the number of shares owned during a taxable year by reference to commercial dividend publications).

A number of changes have been suggested by some proponents to deal with proof of basis problems. One suggested change is to increase the $10,000 personal and household effects exemption so that fewer items for which basis records may not be normally kept would be treated as carryover basis property. Another suggestion is to change the exemption to cover nonbusiness or noninvestment tangible personal property so that definitional complexities concerning personal and household effects would be eliminated. Another suggestion is to permit averaging of basis for similar items of property which have been acquired at various times. This change would apply where aggregate cost is known but unit cost records are not kept (e.g., mutual fund shares acquired through dividend reinvestments, and stamp and coin collections). Also, as noted above, a number of suggestions are made by proponents to deal with proof of basis problems for a personal residence.

Proponents also argue that increasing the minimum basis will indirectly deal with proof of basis problems because smaller estates, where it is less likely that adequate records have been maintained, would not be under the carryover system. As a transitional matter, proponents also argue that the discount formula (included in the 1978 Act) for ascertaining the frest start basis of tangible personal property will alleviate to some extent the proof of basis problems for this type of property. Proponents have also suggested further changes to the discount back approach that would make it more beneficial in addressing proof of basis problems. Among these changes, some proponents have suggested broadening the category of assets eligible for discounting, reducing the discount rate from 8 percent to 6 percent, and providing a floor percentage of date of death value below which fresh-start basis will not fall (e.g., 25 to 50 percent of date of death value). Proponents argue that there will generally be no need to extend a discount back approach to assets acquired here after December 31, 1976, because taxpayers were on notice after that date that basis records would be essential.

Opponents of carryover basis argue that these changes will not solve the proof of basis problems because basis and acquisition date records are nonexistent.

2. *Fiduciary responsibilities*

Opponents of carryover basis argue that it may create severe problems of fiduciaries. If assets must be sold to liquidate debts or pay administrative or funeral expenses, the executor must evaluate the consequences of selling specific high or low basis assets or distributing them to beneficiaries. Also, in the case of any distribution to a beneficiary, an executor may have to consider the future income tax consequences to the beneficiaries from a sale by them of high or low basis assets. Generally, an executor is under a fiduciary duty in funding pecuniary bequests to treat beneficiaries fairly. Normally, an executor would take a number of factors, such as yield and growth potential, into account in distributing property in a fair and equitable manner. Arguably, under carryover basis, an executor must also take an asset's basis into account in evaluating the fairness of a possible distribution because of the potential income tax consequences of a sale of appreciated or depreciated assets by the distributee. It is argued that this consideration makes an executor's job extremely difficult. Moreover, it is argued that State law generally is unclear as to whether an executor would breach his fiduciary duties, and therefore be subject to surcharge, if proper recognition is not made for basis in making distributions.

In addition, it is argued that, under the subject to tax requirement property deductible under the estate tax law as a charitable or marital bequest will not be eligible for a death tax adjustment for Federal estate taxes attributable to appreciation, the amount of this adjustment for high or low basis assets must be taken into account in deciding which property should fund charitable, marital, or other bequests. Opponents argue that this creates uncertainty of tax consequences during a significant portion of the period of estate administration because many facts about basis have not been established when funding and sales decisions must be made. Opponents also argue that choosing property for the personal and household effects exemption creates the same kind of problem.

Opponents argue that these problems do not arise solely in the context of estate administration but also arise in connection with estate planning. Thus, these basis considerations would be relevant to investment and will drafting decisions (including the advisability of making specific bequests or devises of particular items of property although this kind of bequest or devise would not create these fiduciary problems in the administration of estates.)

Proponents of carryover basis argue that most reasonably sophisticated executors can cope with these decisions. They argue that decisions of this nature must be made even without regard to carryover. basis. In particular, they contend that a similar situation arises when a funding decision must be made with respect to the distribution of an item of income in respect of a decedent. Proponents also contend that in those situations where there are extremely difficult funding decisions, the executor could put the matter before the probate court to review distributions.

3. *Complexity of computations, exemptions and adjustments*

Cost basis

Opponents of carryover basis argue that the mere mathematical computations required to comply with the provisions are extremely burdensome and result in unreasonable costs being incurred. They argue that the task of ascertaining a decedent's cost basis may involve numerous computations. For example, even where an aggregate cost is known, the determination of basis for stock may involve computations to allocate cost to additional shares received as stock dividends while the stock had been owned by the decedent. In addition, similar problems are said to arise with respect to mutual fund shares acquired through dividend reinvestments. The proponents of carryover basis argue that the provision of a basis averaging rule for similar items of property would reduce the number of computations which might otherwise be required.

Personal and household effects exemption

Opponents of carryover basis also argue that selection of property eligible for the personal and household effects exemption will entail some computational complexity. These problems may rise in cases where it might be necessary to ascertain cost or assign an allocable portion of the exemption to particular items included in a set or collection, e.g., allocation of original cost or a remaining exemption amount to a set of silverware purchased and valued for estate tax purposes as a collection where the individual units making the set might have varying costs and values. Proponents of carryover basis contend that this is not a significant problem and that any potential problems would be eliminated through an increased exemption for any nonbusiness tangible personal property. Further, they argue that this also would address the definitional complexity relating to personal and household effects. They also argue that any difficult choice faced by an executor in applying the exemption could be resolved by making it mandatory that the exemption must be applied to eligible property on the basis of ascending estate tax values. Opponents respond that, while that approach might resolve an executor's discretionary problems in selecting property for the exemption, it would create a new type of suspended basis problem because audit adjustments of estate tax values may change the items eligible for exemption under the dollar limitations.

Fresh-start adjustment

Opponents of carryover basis argue that the fresh-start adjustment to basis is complicated for several reasons. First, with respect to marketable securities, the fact that the fresh start adjustment is made only for purposes of gain may make it necessary to maintain two bases for each security, i.e., a "split-basis" problem. Second, with respect to nonmarketable securities, it is necessary to make calculations under the holding period formula for allocating appreciation to pre-1977 periods. It also is argued that it is not always clear as to whether a security should be treated as marketable or nonmarketable. If certain securities having a relatively fixed value, such as preferred stock, are treated as nonmarketable, it is argued that the time apportionment formula is inequitable because it treats appreciation as having accrued

after 1976 when in fact the value has changed very little since accquisition.

Another problem raised by opponents concerns the treatment of appreciation when there have been substantial improvements after 1976 to property which is eligible for the fresh-start adjustment because it originally was acquired before 1977. It is argued that the concept of substantial improvements creates definitional problems. Also, it is argued that in these cases it is difficult to allocate the aggregate value of an improved property to portions representing its condition on December 31, 1976, and the improvements which were made after that date. In other words, an improved property is traditionally valued in its present state, and the sum of the values for separate acquisitions and improvements may not equal the whole value of the improved property.

The proponents of carryover basis argue that many of these problems could be resolved or alleviated by several changes in the law. The split-basis problem for marketable securities could be eliminated by permitting the fresh-start adjustment to be made for loss purposes as well as gain. The marketable security rule could be extended to cover property, such as preferred stock, with a relatively fixed value to eliminate potential inequities and the definitional complexities involved in categorizing property as a marketable or nonmarketable security. Some proponents also argue that making a discount-back formula for determining fresh-start basis available for more types of property would reduce the complexities of applying the time apportionment formula to nonmarketable property. Under this approach, it only would be necessary to know the value of the property for estate tax purposes and that it was owned by the decedent on the fresh-start date. Then, fresh-start basis could be determined by applying a percentage taken from a table (based on the time elapsing from the fresh-start date to the date of the decedent's death) to its value for estate tax purposes.

Carryover basis proponents argue that the problems relating to substantial improvements are not insurmountable. Thus, apportionment of value to improvements might be considered analogous to other situations where an aggregate value must be apportioned to component parts. A common example of where this type of apportionment is done involves the allocation of an aggregate purchase price between land and building for depreciation purposes. In this case, the apportionment is made on the basis of the relative values of the components. Another common case involves the so-called component method of depreciation where an aggregate amount is allocated to the various components of a building for depreciation purposes.

Death tax adjustments

Opponents of carryover basis argue that the adjustments to basis for death taxes are perhaps the most complicating aspect of carryover basis. As indicated above, the opponents argue that there is a basic question of which property will qualify for an adjustment because only property subject to tax is eligible for the adjustment. 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. Moreover, for sales by an executor, the amount of gain for the fiduciary's income tax return may not be readily determinable until after the estate tax has been calculated finally for purposes of making the adjustment to basis. It is argued that this problem will arise frequently because the administration of many estates can span several taxable years.

Another problem raised by opponents relates to the "suspended basis" of assets until an audit has been completed. Thus, it is argued that a great deal of complexity may arise because the death tax adjustment may have to be recalculated for every carryover basis item if a single change results in a higher or lower estate tax than was reported on the return as filed. In this case, opponents say that the problem is not just that numerous recalculations must be made but that the fiduciary's and beneficiaries' income tax returns also may have to be amended to adjust the amount of gain reported for sales of assets or the amount of depreciation claimed for depreciable assets acquired from the decedent.

Opponents argue that the computational complexities of the death tax adjustment are too difficult even in those cases where the assets eligible for the adjustment are identified and the information necessary to make the adjustment is known (net appreciation and the amount of death taxes to be allocated). They argue that the number of calculations required are onerous. For each carryover basis item, there might be three separate calculations, i.e., an adjustment for Federal estate taxes, another for State estate or inheritance taxes paid by the executor, and still another for State inheritance taxes paid by the beneficiary. Opponents argue that these calculations are extremely burdensome.

On the other hand, proponents of carryover basis argue that changes could be adopted to eliminate or substantially minimize these problems. Some have suggested that the identification of property eligible for the adjustment is not as great as portrayed by others but, assuming that it is a significant problem, they would permit an adjustment for any carryover property sold by the executor even though the proceeds may be used to fund a marital or charitable bequest.

Other proponents argue that a simplified "rough justice" death tax adjustment could alleviate suspended basis problems and reduce the number of calculations required. Under the simplified adjustment procedure advocated by some proponents, a single death tax adjustment would be made in reference to the highest Federal estate tax rate to which the estate was subject. Since the rate would be taken from the estate tax rate schedule before any credit for State death taxes is determined, no separate adjustment would be made for State death taxes. Also, in order to mitigate suspended basis problems, the taxable estate would have at least $50,000 in the highest rate bracket or the next preceding rate would be used to make the adjustment. proponents argue that audit adjustments in most cases normally will not push the amount of the taxable estate into the next bracket by as much as $50,000, and, therefore, recalculation of the death tax adjustment would be required infrequently.

Opponents generally agree that the "simplified rough justice" approach has the virtue of simplicity. However, they contend that it does not satisfy any reasonable fairness test. For smaller estates, the ad-

justment would be permitted for amounts which are not actually paid because of the unified estate and gift tax credit. In addition, it would discriminate against beneficiaries who acquire property from a decedent who resided in a State which imposed a death tax exceeding the credit allowable against the Federal estate tax. In this case, the adjustment would be too little. However, in other cases where the State imposed no death tax or one that was less than the credit allowable, the adjustment would be too great. Opponents argue that the simplified adjustment would permit adjustments for "phantom" taxes and have "upsidedown" results in other cases. Also, opponents argue that basing the adjustment on Federal inclusion rules results in distortions as between the property being adjusted and the property which actually was subject to tax. This results from the fact that States may provide different kinds of exemptions and limitations.

Opponents also argue that the simplified adjustment does not solve the suspended basis problem but merely changes the point at which recalculations must be made.

Minimum basis adjustment

Opponents of carryover basis argue that the $60,000 minimum basis adjustment also is very complicated. Since the amount is apportioned on the basis of relative net apprepriation, a great number of calculations may be required and, where numerous assets are involved, the adjustment for each asset may be quite small. Opponents also argue that if the basis of one asset is unknown, so that its net appreciation cannot be determined, then a suspended basis problem is created for all carryover items because the amount allocated for any asset depends upon the relationship of its net appreciation to net appreciation in value for all property.

Proponents of carryover basis argue that these problems are not overly significant because most moderate and large sized estates already have assets with an aggregate basis exceeding $60,000 or even higher amounts and are unaffected by the adjustment. Proponents have suggested increasing the minimum base limit and reordering the adjustments so that the minimum basis adjustment would be made first and thus become a floor for other adjustments. Also, some have suggested that a threshold exclusion from carryover be provided so that, if the value of carryover property in the gross estate was equal to or less than the minimum basis amount, the property in the estate would not be subject to carryover.

Others have suggested that executors be permitted to select assets eligible for the minimum basis adjustment so that the number of calculations would be reduced, suspended basis problems arising because the basis of an asset is unknown, would be eliminated and the current income tax burden would be minimized by permitting maximum adjustments to assets sold by an executor. Opponents argue that discretionary allocation of the minimum basis adjustment would often place the executor in an untenable position of benefiting one beneficiary to the detriment of others.

4. *Finality of basis determinations*

In addition to the suspended basis problems arising from the various basis adjustments, opponents of carryover basis express great concern about the lack of any procedure to finally determine cost basis during examination of the estate tax return. Thus, it may be several years before basis is challenged by the Internal Revenue Service upon examination of a beneficiary's income tax return which reflects gain or loss from the sale of carryover property.

Some proponents of carryover basis have suggested that a procedure similar to a declaratory judgment procedure could be provided to litigate basis questions during the period of administration of an estate. Other have suggested an administrative type procedure similar to binding arbitration which would deal with basis issues without the formality and cost of a judicial proceeding.

5. *Reporting requirements*

Many opponents of carryover basis complain about reporting burdens. As indicated earlier, the 1976 Act required reporting of carryover basis information to the Internal Revenue Service and to the beneficiaries. Failure to supply information was subject to penalty.

Proponents of carryover basis argue that the reporting and supplying of information is necessary under a carryover system and the provisions are quite like information reporting requirements in other areas of the tax law.

Some have argued that it will be necessary for the Internal Revenue Service to maintain basis information to make a carryover system workable. It is argued that beneficiaries simply will fail to keep, or will lose, basis information submitted to them by an executor. These people were highly critical of Treasury regulations issued under the 1976 Act because no detailed information was required, and, therefore, no permanent basis records could be maintained to supply missing or lost information to beneficiaries in the future.

V. ALTERNATIVES

Except for repeal of carryover basis, most of the alternatives to carryover basis involve some type of tax on appreciation at death. The three most frequently discussed are a single rate additional estate tax (AET), a graduated appreciation tax, and a capital gains tax.

A. Single Rate Additional Estate Tax (AET)

Under the AET proposal, a single flat rate of tax would be imposed on the net appreciation included in the decedent's gross estate. No AET would be imposed below a minimum basis. The basis of property subject to the AET then would be increased or "stepped-up" to its fair market value at the date of death. However, unlike the other two proposals for an appreciation tax at death, the AET would not be deductible in computing the regular estate tax. In order to avoid complexity, there would be few, if any, exemptions from the tax.

Proponents of the AET point out that its biggest advantage is one of simplicity, especially if there were no exemptions (such as an exemption for property passing to charity). They state that the computation is straight forward and the complexity involved in making various basis adjustments required under the carryover basis provisions is eliminated. In addition, the AET would eliminate the "suspended basis" problems since the basis of assets would be determined with finality upon audit of the return.[1] Further, some argue that the lock-in problem would not be as great under AET as under carryover basis for property owners since holding until death will not completely avoid an appreciation tax and for beneficiaries since the basis of property subject to the tax would be stepped-up to its fair market value at death.

Opponents of the AET argue that it is unfair to impose a tax on appreciation because of an involuntary occurrence such as death since income has not been realized and funds may not be available to pay the tax. Also, they argue that, compared to carryover basis, AET increases the liquidity problems that are already severe due to the high rates of Federal and State death taxes. In addition, it is argued that AET, as compared to carryover, would provide a worse lock-in effect for some taxpayers (i.e., where the AET would be lower than the capital gains tax) and would create for others an artificial incentive for lifetime sales (i.e., where capital gains tax would be lower than the AET). Since measurement of the appreciation tax base requires a determination of basis, proof of basis problems would also arise under an AET. Further, to the extent that exemptions are provided, most of the complexity of proof of basis and the basis adjustments under carryover would be retained. Other opponents of the AET proposal argue that a single rate AET is inequitable since it would impose a single rate of tax without regard to the size of, or the amount of appreciation in, the estate.

[1] A problem would remain to the extent that special exemptions from AET were provided.

7

B. Graduated Appreciation Tax at Death

Another alternative that has been discussed is to tax appreciation at death under a graduated, rather than a single, rate schedule. In addition, the tax would be deductible in computing the estate tax, and the executor could elect to apply the carryover basis provisions.

Proponents of an appreciation tax at death contend that this proposal achieves a greater degree of equity between taxpayers than the AET. They point out that taxpayers who sell property before death and those who hold their property until death are treated in substantially the same manner. This proposal, as compared to AET, takes into account the size of the estate and the amount of appreciation under a progressive rate schedule. In addition, to the extent that the amount of tax imposed on appreciation at death more closely approximates the amount of tax that would have been imposed on a lifetime sales, the lock-in problem is substantially lessened.

Opponents of a tax on appreciation at death with graduated rates argue that it is unfair to impose a tax upon an involuntary occurrence such as death. There has been no realization of income, and the imposition of a tax on unrealized income is contrary to the principle of taxing according to the ability to pay. Proof of basis problems would also arise under a graduated appreciation tax at death. In addition, election to apply carryover basis retains the complexity of proof of basis and the basis adjustments while at the same time forcing the executor to make additional computations and evaluations in determining whether or not to make an election. Further, it is pointed out that, in many estates, an appreciation tax at death would substantially aggravate an already serious liquidity problem.

C. Taxing Gains at Death

A third alternative, an example of which was proposed by the Treasury in 1969, is to tax appreciation at death in a manner similar to that in which capital gains are taxed. Under this alternative, no tax would be imposed on gains equal to or less than a minimum basis. The proposal would allow an unlimited exemption for transfers between spouses or to charity, and a limited exemption for transfers to orphan children and of personal and household effects. Under the proposal, the appreciation tax would be an estate tax deduction, and the gain taxed would be eligible for special averaging treatment. The basis of property which is subject to the tax would be stepped-up to its date of death value.

Proponents of this recommendation argue that it coincides with principles of vertical equity, i.e., comparably situated parties are accorded similar tax treatment regardless of whether the appreciation in any particular asset is realized before or after death. Moreover, no duplicative taxation would result, they argue, because the estate tax base would be reduced by the applicable appreciation tax. Since this is the same result as that which is obtained where estates have been accumulated from ordinary income and capital gains realized prior to death, proponents contend that this method of taxing gains at death would eliminate lock-in because it substantially would equalize pre- and post-death tax consequences.

Conversely, it has been argued that it is inappropriate to tax unrealized gains at death, and that any such proposal would create unnecessary problems of liquidity and raise tax complexity. For example, elections related to the unlimited interspousal and charitable transfer exemptions could force individuals to make unnecessary and speculative evaluations of the advantages of any particular transfer. In addition. Proof of basis and fresh start adjustment problems would be similar to those under carryover basis.

VI. TRANSITIONAL ISSUE

Apart from any decision Congress may make concerning the treatment of basis of property acquired from a decedent dying after 1979, there are additional issues relating to the retroactive postponement of the carryover basis rules by the Revenue Act of 1978. Some have argued that a carryover basis election should be provided with respect to property acquired from decedents dying after 1976 and before the day after the date of enactment of the postponement (November 9, 1978). The argument for a transitional carryover election is based on equity considerations, i.e., it is argued that it is unfair to retroactively change the ground rules after sales and distributions have been made in reliance upon the law in effect when the sales and distribution decisions were made. A typical example often used in arguing for a transitional election involve the case where an asset acquired from a decedent, with a cost basis in excess of its date of death value, is sold by an executor or beneficiary to offset gains from sales of other property or income from items of income in respect of a decedent received by the executor or beneficiary. Thus, after postponement of carryover basis, there will be no offsetting loss and possibly an additional gain from postdeath appreciation of the item of property having the excess cost basis. It is argued that, but for reliance upon the carryover basis provision, property acquired from a decedent and other appreciated property held by a beneficiary might not have been sold.

As passed by the Senate, the Revenue Act of 1978 would have permitted an executor to elect the carryover basis rules with respect to estates of decedents dying after 1976 and before the date of enactment of the act. If elected, the basis of all property passing from a decedent would have been determined under the carryover rules (including property that was not sold or distributed before the date of enactment). The election was to be irrevocably made within 120 days after the date of enactment. The election provision was deleted by the committee of conference on the Revenue Act of 1978.

If a transitional election should be provided, some may argue that carryover treatment should apply only to assets sold during the transitional period and that the stepped-up basis rule should apply to all other assets. It is argued that this approach would minimize the complexities of carryover basis and, since regulations have not been promulgated for carryover basis, minimize the uncertainty of applying the provisions to a wide range of assets. On the other hand, some argue that this approach would provide relief which is more generous than warranted. It is argued that this approach in effect would permit executors and beneficiaries to have relief two ways, a stepped-up basis for appreciated assets and a carryover basis for loss assets.

It has also been argued that, if an election is provided, the carryover basis rules applicable during the transitional period should be streamlined to deal with the complexities of carryover and uncertainties because of the absence of Treasury regulations. Some have suggested that the carryover rules should be revised so that no adjustments would be permitted and carryover basis would be determined solely in reference to the decedent's cost basis. On the other hand, others argue that if the rationale for relief is reliance upon the law existing at the time sales and distributions were undertaken, then the provisions should be closely identical to those upon which reliance was based.

VII. REVENUE EFFECTS

The revenue effect of carryover basis depends upon the amount of appreciation passing at death. This is estimated to be $20 billion in 1979 as shown in Table 1. This was derived from 1972 estate tax returns which were extrapolated to 1979 wealth levels based upon historical estate tax *Statistics of Income* data for 1960, 1962, 1965 and 1969. The 1973 IRS capital gains study provides length of holding period data [1] which, in conjunction with an estimate of the growth in market value of appreciating assets, yields a long-run estimate of the portion of market value which is appreciation. These calculations produced appreciation ratios of 49 percent for corporate stock and 30 percent for real estate. A 1965 Treasury Department study found comparable ratios of 36 and 26 percent respectively.[2] Multiplying the appreciation ratios for particular wealth classes by the amount of wealth on the 1979 estate tax file yields an estimate of $16.5 billion of appreciation passing at death on returns which would have filed under a $60,000 filing requirement. The estate tax file offers data on wealth holdings of corporate stock and real estate which yields the appreciation estimates of $8.3 billion and $7.2 billion, leaving $1.0 billion of other appreciation.

Once these amounts of appreciation have been imputed to the estate tax file, computer runs of alternative minimum bases and basis adjustments yield the estimates of how much appreciation would still pass at death. These amounts are then adjusted for an average five-year deferral period between the time the appreciation passes and the heir realizes it. Finally, a capital gains tax rate appropriate to the heir is applied, yielding the revenue estimates.

Table 2 shows the effect of increasing the present law $60,000 minimum basis. A $175,000 minimum basis would leave 53,000 estates (2.7 percent of all decedents) with appreciation which, when taxed upon realization by heirs, would yield long-run annual revenue of $560 million. This is a reduction of $273 million from the present law $833 million annual revenue effect.

Table 3 shows comparable estimates for allowing a marginal estate tax basis adjustment, a $25,000 minimum basis for household effects, and a $100,000 minimum basis for personal residences. The estimates for these three proposals assume the overall minimum bases shown in the first column.

---

[1] There is reason to believe that assets held until death are more highly appreciated than assets sold lifetime. Thus, these estimates may be less than they would be if the holding period at death were known.

[2] Working paper by Gerald Brannon, Henry Copeland, and Nelson McClung, Office of Tax Analysis.

TABLE 1.—ESTIMATED APPRECIATION PASSING AT DEATH IN 1979

[Billions of dollars]

Total Appreciation		20.0
Total Appreciation on Estate Tax Returns:[1]		16.5
Corporate stock		8.3
Real estate		7.2
Business, farm, other	4.1	
Residences	3.1	
Other		1.0

[1] Assuming a $60,000 filing requirement.

TABLE 2.—LONG RUN[1] ANNUAL REVENUE EFFECT OF PRESENT LAW CARRYOVER BASIS[2] WITH INCREASED MINIMUM BASIS, AT 1979 LEVEL OF WEALTH

	Estates passing appreciation			Revenue loss versus present law (millions)
Minimum basis	*Returns*[3] *(thousand)*	*Percentage of decedents*	*Revenue effect (millions)*	
$60,000 (present law)	187	9.4	$833[4]	
$100,000	106	5.3	702	$131
$150,000	64	3.2	598	235
$175,000	53	2.7	560	273
$200,000	44	2.2	528	305
$225,000	38	1.9	501	332
$250,000	33	1.7	476	357
$300,000	26	1.3	433	400
$400,000	18	.9	369	464
$500,000	13	.7	324	509

[1] 20 years, when there is no effect from "fresh start."
[2] Without postponement.
[3] Under a $60,000 filing requirement.
[4] This estimate would have been $1,229 million with capital gains taxation as it was prior to the Revenue Act of 1978.

TABLE 3.—LONG RUN [1] ANNUAL REVENUE EFFECT VERSUS PRESENT LAW OF [2] CARRYOVER BASIS WITH INCREASED MINIMUM BASIS, MARGINAL ESTATE TAX BASIS ADJUSTMENT, $25,000 HOUSEHOLD EFFECTS MINIMUM BASIS, AND $100,000 RESIDENCE MINIMUM BASIS, AT 1979 LEVEL OF WEALTH

[Millions of dollars]

Basis	*Increased minimum basis*	*Marginal estate tax basis adjustment* [3]	*$25,000 minimum basis for household effects* [3]	*$100,000 minimum basis for personal residence*
$60,000		$121	$5	$123
$100,000	$131	119	4	93
$150,000	235	117	3	69
$175,000	273	115	3	62
$200,000	305	113	3	57
$225,000	332	112	2	54
$250,000	357	111	2	52
$300,000	400	107	2	46
$400,000	404	99	1	39
$500,000	509	92	1	33

[1] 20 years, when there is no effect from "fresh start."
[2] Without Postponement.
[3] Assuming the minimum basis change in the first column.