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TRANSFER OF DECEDENT'S BASIS AT DEATH: THE ALLOCATED CARRYOVER APPROACH

A complete about-face in the tax treatment of appreciated property owned by a decedent at his death is looming in the congressional hopper.¹ Currently, under section 1014(a) of the Internal Revenue Code,² property passing from the decedent at death has as its basis the fair market value at the date of the decedent's death or the alternative valuation date.³ Since death is not treated as a taxable event for purposes of recognizing capital gain, the gains which have accrued on property held by the decedent at death are completely foregone as a source of income tax revenue.⁴ Critics of this gains tax forgiveness have the support of the United States Treasury Department.⁵ This has resulted in the House Committee on Ways and Means and the Senate Committee on Finance jointly proposing the taxing of gains at death.⁶ Because of the current congressional attention being given this aspect of our tax law, it is vital that estate planners recognize the vulnerability of gains tax forgiveness at death.

How should accrued gains be treated for tax purposes at death? Three basic alternatives will be considered: (1) gains tax forgiveness as it now exists; (2) taxation of gains at death; and (3) carryover

1. HOUSE COMMITTEE ON WAYS AND MEANS AND SENATE COMMITTEE ON FINANCE, 91ST CONG., 1ST SESS., TAX REFORM STUDIES AND PROPOSALS, U.S. TREASURY DEPARTMENT 331 (Comm. Print 1969) [hereinafter cited as 1969 PROPOSALS].

2. INT. REV. CODE of 1954, § 1014(a). [Hereinafter all Internal Revenue Code sections are cited both in the text and notes as IRC §. They include December 30, 1969 amendments only where specifically so stated.]

3. The executor may elect to value all the property included in the gross estate as of one year after the date of decedent's death, except that if such election is made, property disposed of within such year shall be valued as of the date of disposition. IRC § 2032(a).

4. Note, however, that IRC § 691 generally provides that all items of income which were earned or realized by the decedent but which were not reportable in the decedent's final return must be reported as income by the successor in interest of the decedent at the time of receipt.

5. Editorial Notes, *Taxation of Capital Gains at Death*, 38 GEO. WASH. L. REV. 138 (1969) [hereinafter cited as 1969 Notes]; SENATE FINANCE COMMITTEE, 91ST CONG., 1ST SESS., SUMMARY OF TREASURY DEPARTMENT TAX REFORM STUDIES AND PROPOSALS 23-24 (Comm. Print 1969).

6. 1969 PROPOSALS, *supra* note 1, at 331-51. Property other than capital assets, as defined in IRC § 1221, may appreciate in value. The language in the 1969 proposals is inconsistent as to whether only "capital" gains would be taxed at death, but it appears that all gains would be taxed. *Compare id.* 347-48 *with id.* at 334.

of basis at death. This paper will show that a workable combination of gains tax forgiveness and carryover of basis represents the fairest and most practical revenue producer.

I. CONSTITUTIONALITY

Congress has plenary power to lay taxes by virtue of article I of the Constitution, provided that all duties, imposts, and excise taxes are uniform and direct taxes are apportioned.⁷ The sixteenth amendment allows Congress to tax incomes directly regardless of source and without the necessity of apportionment; it does not dilute Congress' power under article I.⁸ Opponents of taxation of unrealized gain contend that it is of doubtful constitutional validity under the sixteenth amendment.⁹ They argue that IRC section 61(a) requires that "gain derived from capital" be realized before it is considered income.¹⁰ Section 61(a) provides that gross income includes "all income from whatever source derived." The contention is that this definition is based upon the sixteenth amendment and the word "income" is used in its constitutional sense.¹¹ The following often quoted portion of *Eisner v. Macomber*,¹² holding a common on common stock dividend not taxable as a distribution of gains accruing to capital, is the foundation of the above realization argument:¹³

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,

7. Every bill passed by the House of Representatives and the Senate must either be approved by the President or be repassed by two-thirds of the House of Representatives before it becomes law. U.S. CONST. art. I, § 7.

8. Mullock, *The Constitutional Problem of Taxing Gifts as Income*, 53 MINN. L. REV. 247, 249 (1968).

9. See *Hearings on the President's 1963 Tax Message Before the House Comm. on Ways and Means*, 88th Cong., 1st Sess., at 2808 (American Apparel Manufacturers Association, Inc.), 2397-403 (Opinion of the Special Tax Counsel for the American Bankers Association), 2839 (Committee of the Tax Section of the New York State Bar Association) (1963) [hereinafter cited as *1963 Hearings*]; Roehner & Roehner, *Realization: Administrative Convenience or Constitutional Requirement?* 8 TAX L. REV. 173, 174-75 (1953).

10. *1963 Hearings*, *supra* note 9, at 2397.

11. S. REP. NO. 1622, 83d Cong., 2d Sess., at 168 (1965); see also Mullock, *supra* note 8.

12. 252 U.S. 189 (1920).

13. *Id.* at 207.

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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).

Proponents of taxing unrealized appreciation contend that post-*Eisner v. Macomber* Supreme Court decisions have so eroded this concept of income that the Supreme Court would not declare unconstitutional a congressional decision to tax unrealized appreciation at death.¹⁴ Yet, it remains unclear which of the post-*Eisner v. Macomber* decisions held unrealized appreciation constitutionally taxable.¹⁵

Even if it were found that there is a constitutional limit on the power of Congress to determine what shall constitute an appropriate taxable event under the sixteenth amendment, it appears that the distributional and economic effects of gains taxation at death could be achieved under article I, section 8 of the Constitution by an excise tax upon the gratuitous transfer of property to the extent of the unrealized appreciation in value of the transferred property levied at capital gains tax rates.¹⁶ The constitutionality of this excise tax ap-

14. Hanrahan, *A Proposal for Constructive Realization of Gains and Losses on Transfers of Property by Gift and at Death*, 15 KAN. L. REV. 133, 155 (1966); Waterbury, *A Case for Realizing Gains at Death in Terms of Family Interests*, 52 MINN. L. REV. 1, 8-18 (1967); 1963 *Hearings*, *supra* note 9, at 592-98. Among the proponents are Solicitor General Erwin N. Griswold, formerly Dean of Harvard Law School; Professor Stanley S. Surrey of Harvard Law School, and formerly Under Secretary of the Treasury; Professor Boris I. Bittker of Yale Law School; and apparently Dean William C. Warren of Columbia Law School. Roehner & Roehner, *supra* note 9, at 173 n.3.

15. The cases generally relied upon are *United States v. Davis*, 370 U.S. 65 (1962) (transfer of appreciated assets pursuant to divorce settlement held taxable event); *Helvering v. Bruun*, 309 U.S. 461 (1940) (on cancellation of lease, lessor regained property plus newly constructed building. Fair market value of building on date of cancellation held realized by lessor); *Helvering v. Eubank*, 311 U.S. 122 (1940) (assignment of insurance commissions held taxable event); *Helvering v. Horst*, 311 U.S. 112 (1940) (gift of negotiable interest coupons held taxable event to donor); *Helvering v. Midland Mutual Life Ins. Co.*, 300 U.S. 216 (1937) (interest taxable where insurance company took over property at foreclosure sale for principal plus accrued interest); *Campbell v. Prothro*, 209 F.2d 331, 336 (5th Cir. 1954) (dicta that a taxable gain is not recognized from a gift of appreciated property only because Congress has not adopted such a view).

Roswell Magill, formerly Professor of Law, Columbia Law School, and earlier Under Secretary of the Treasury, relies upon *Helvering v. Bruun* and *Helvering v. Midland Mutual Life Insurance Co.* Roehner & Roehner, *supra* note 9, at 173 n.4. Professor Bittker finds support in *Helvering v. Eubank* which, along with *Horst*, was principally relied upon by the Treasury to support the 1963 proposals to tax unrealized appreciation. Heckerling, *Death of the "Stepped Up" Basis at Death*, 37 S. CAL. L. REV. 247, 269 (1964); 1963 *Hearings*, *supra* note 9, at 597.

16. Waterbury, *supra* note 14, at 7; L. SELTZER, *THE NATURE AND TAX TREATMENT OF CAPITAL GAINS AND LOSSES* 302-03 (1951).

proach appears as nearly certain as any prediction of court behavior can be. The federal estate tax and the federal gift tax were held constitutional in *New York Trust Co. v. Eisner*,¹⁷ and *Bromley v. McCaughn*,¹⁸ respectively. Both excise taxes were sustained as excise taxes authorized by article I, section 8 of the Constitution, rather than direct taxes which, under article I, section 9, must be apportioned. The requirement of article I, section 8, that excise taxes be uniform is only one of geographic uniformity.¹⁹ An excise tax limited to unrealized appreciation might be attacked as being so unreasonable and arbitrary in classification as to violate fifth amendment due process, but it is unlikely that the Supreme Court would so hold. In *Watson v. Comptroller*,²⁰ the Court held that an additional state inheritance tax on certain assets, upon which the decedent had not paid property taxes during a fixed period prior to death, did not violate the equal protection clause of the fourteenth amendment, and the Supreme Court seems even more reluctant to strike down a congressional determination under the fifth amendment, which contains no equal protection clause.²¹ As Professor Waterbury of the University of Minnesota Law School points out, since the Supreme Court in *Watson* found it reasonable for a state legislature to single out assets which had not been subjected to a property tax for a compensatory additional inheritance tax, it is hard to believe that the Court would deny an analogous privilege to Congress.²² It is even debatable whether additional legislation is necessary to impose a gains tax upon unrealized appreciation at death.²³

17. 256 U.S. 345 (1921).

18. 280 U.S. 124 (1929).

19. *Flint v. Stone Tracy Co.*, 220 U.S. 107, 158 (1911); *Knowlton v. Moore*, 178 U.S. 41, 85-87 (1900).

20. 254 U.S. 122 (1920).

21. *Detroit Bank v. United States*, 317 U.S. 329, 337-38 (1943); Waterbury, *supra* note 14, at 7 n.35.

22. Waterbury, *supra* note 14, at 7 n.35. This is probably based upon the belief that the Court would recognize that the federal government's need for revenue is as great as that of the states, rather than as a matter of constitutional interpretation.

23. E.g., Roswell Magill and Professor Bittker believe that congressional action is necessary, whereas, Solicitor General Griswold and Professor Surrey believe no such congressional action is necessary. R. MAGILL, *TAXABLE INCOME* (1945); Bittker, *Charitable Gifts of Income and the Internal Revenue Code: Another View*, 65 HARV. L. REV. 1375 (1952); Griswold, *Charitable Gifts of Income and the Internal Revenue Code*, 65 HARV. L. REV. 84 (1951); and Surrey, *The Supreme Court and the Federal Income Tax: Some Implications of the Recent Decisions*, 35 ILL. L. REV. 779 (1941).

See Hanrahan, *supra* note 14, at 155-56; Heckerling, *supra* note 15, at 263-65; 1963

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If Congress wishes to adopt a carryover of basis approach, rather than immediate taxation of unrealized gains, *Taft v. Bowers*,²⁴ upholding the carryover basis rule which was made applicable to *inter vivos* gifts in the 1921 Act, indicates in dictum that a carryover basis rule at death is within Congress' power to tax income under the sixteenth amendment.²⁵

Therefore, it seems that the search for the "best" treatment of accrued gains at death may proceed without undue concern over the treatment's constitutional validity.

II. REASONS FOR CHANGE

A. Equity

Inequities in a tax structure should be tolerated only when supported by an overriding public policy.²⁶ Capital gains are given preferential treatment over ordinary income as an incentive to encourage investments.²⁷ However, there is no overriding public policy justifying the current procedure of completely forgiving capital gains which have accrued at a decedent's death. No public policy is served by requiring a man who liquidates his holdings just before death to pay a capital gains tax and then subjecting his remaining liquidation proceeds to estate tax, while requiring those who hold their appreciated property at death to pay only an estate tax.²⁸ Why should there be a reward for retaining appreciated assets until death?

To be sure, since death is not a voluntary event, there are arguments against treating death the same as if it were a taxable sale for capital gains tax purposes. For example, a transfer at death results in neither proceeds with which to pay the gains tax, nor tangible benefits to the

Hearings, supra note 9, at 592-98. See generally Del Cotto, *The Trust Annuity as Income: The Constitutional Problems of Taxing Gifts and Bequests as Income*, 23 TAX. L. REV. 231 (1968); Mullock, *supra* note 8; Del Cotto, *The Constitutional Problem of Taxing Gifts as Income: A Reply to Professor Mullock*, 53 MINN. L. REV. 259 (1968).

24. 278 U.S. 470 (1929).

25. *Id.* at 482-84. Waterbury, *supra* note 14, at 6 n.33 states:

Mr. Justice McReynold's opinion broadly affirms the power of the Congress to prevent avoidance of the tax on realized gain by requiring a donee to accept the basis of his donor.

26. Hanrahan, *supra* note 14, at 144.

27. *Id.* at 144-45.

28. Such difference in treatment violates the "horizontal equity" principle that similarly situated taxpayers should pay similar taxes. Hanrahan, *supra* note 14, at 145.

decedent. If the *inter vivos* seller consumes the proceeds, he gets the enjoyment therefrom and reduces the amount of his estate tax.²⁹ Although the size of the *inter vivos* seller's estate is reduced, he is paying less net tax than the seller who holds his assets until death.³⁰

Phillip J. Hanrahan, a member of the Wisconsin Bar, argues that the retaining investor's lack of cash to pay the gains tax is the result of his voluntary decision to defer realization of his gains, instead of selling the assets before death or requiring them to be sold by will.³¹ At least in the area of closely-held businesses, to encourage such sales seems inconsistent with the general public policy of discouraging mergers and concentration of economic power.³² Nevertheless, Mr. Hanrahan argues that the decedent's decision to defer realization should not result in the permanent escape from exposure and income tax rates on his gains; to do so is inconsistent with the public policy underlying the progressivity of the individual income tax structure.³³ While an immediate gains tax at death has disadvantages, some change is necessary in order to correct the inequities of gains tax forgiveness at death.

B. Revenue Loss

Right or wrong, the present system of complete gains tax forgiveness at death results in a loss of potential tax revenues. Studies indicate that the proportion of capital gains forgiven at death is as large as that taxed as a result of sales or exchanges.³⁴ Based upon estate tax returns filed in 1966, it is estimated that about \$7 billion of appreciation passed through the estates of those filing returns in that year.³⁵ Additional appreciation of about \$4.5 billion passed from decedents for whom an estate tax return was not required.³⁶ Thus, through either immediate gains taxation at death or tax deferral via a basis carryover

29. *Id.*

30. *Id.* This argument is valid only where an estate tax is payable by the decedent's estate. See note 87, *infra*.

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

32. See note 72 and accompanying text, *infra*.

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

34. 1963 Hearings, *supra* note 9, at 369; Waterbury, *supra* note 14, at 48; M. DAVID, ALTERNATIVE APPROACHES TO CAPITAL GAINS TAXATION 227 (1968).

35. 1969 PROPOSALS, *supra* note 1, at 333-34. This was based upon a finding that the total value of stock, real estate, trust interests, and noncorporate business assets reported on those returns was about \$15 billion. Of this amount, forty to fifty percent was considered to represent appreciation. *Id.* at 333 and 333 n.1.

36. *Id.* at 334.

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approach, a departure from the present practice of forgiveness at death could produce substantial tax revenues.

C. *The Lock-in Effect*

One of the most frequent criticisms of gains tax forgiveness at death is that the retention of appreciated assets until death in anticipation of completely avoiding gains tax creates what is often called a "lock-in" problem.³⁷ It is felt that this lock-in effect distorts the allocation of resources because the retained assets would otherwise be reinvested more profitably during the investor's lifetime.³⁸

Professor Martin David reports that although the force of this lock-in effect is disputed, the consensus at a 1966 Brookings Institution conference on capital gains taxation was that gains tax forgiveness at death is a major cause of whatever lock-in occurs and that the effect increases with the age of the investor.³⁹ Investment counselors felt, however, that professional investment counseling substantially reduces this lock-in effect.⁴⁰ Professor David notes that because the corporate executor or trust officer has (1) a "professional bias" in favor of diversifying and avoiding large, closely-held business interests, and (2) he knows that it may be better to avoid progressive rates on gains accrued over long periods of time by realizing gains annually, the professional fiduciary is less likely to respond to lock-in incentives.⁴¹ Al-

37. The lock-in problem, as discussed in the text, is part of a larger lock-in problem attributed to the entire capital gains tax structure, *i.e.*, taxpayers avoid selling their capital assets and reinvesting in other capital assets because they do not feel the opportunity for excess profit from the second investment offsets the certainty of a presently payable capital gains tax. To avoid the economic effects of this lock-in problem, it has been suggested that if the net gains realized in any year are reinvested, then to that extent the tax on the gains would be deferred. All net capital losses would be recognized in full. This is the so-called "rollover approach." Commentators say that this rollover approach is dependent upon constructive realization at death. In theory, this does not necessarily follow. The rollover approach and carryover of basis at death are not inconsistent; they would merely result in continued tax deferral until there was a sale without reinvestment. This rollover principle is already reflected in IRC §§ 1031, 1033, and 1034, relating to exchanges in kind, involuntary conversions, and the sale of personal residences, respectively. See Heckerling, *supra* note 15, at 257-58; Marshall & Crumbley, *Reform Proposals for Taxation of Capital Gains*, 108 TRUSTS & ESTATES, 871, 874-75 (1969).

38. 1963 Hearings, *supra* note 9, at 29, 54; Waterbury, *supra* note 14, at 48.

39. M. DAVID, *supra* note 34; see also, Holt & Shelton, *The Lock-In Effect of the Capital Gains Tax*, 15 NAT'L TAX J. 337, 349, 352 (1962). The investor's life expectancy in his own mind would seem to have a more direct bearing on the "lock-in" than age itself.

40. M. DAVID, *supra* note 34, at 225-26.

41. *Id.* at 226.

though the second point, regarding the effect of progressive tax rates, is not applicable to taxpayers in the highest tax brackets,⁴² these findings, if valid, are significant in view of the rapidly increasing role that professional fiduciaries have come to play in the management of wealthy taxpayers' finances in the last two decades.⁴³

Furthermore, the lock-in due to gains is offset to the extent of any inverse lock-in resulting from capital losses.⁴⁴ Realized capital losses may be used to offset realized capital gains and 50 percent of net long-term losses and 100 percent of net short-term losses are deductible for federal income tax purposes to the extent of \$1,000 plus an unlimited carryover.⁴⁵ If tax advantage is to be taken from capital losses, then they must be realized during the investor's lifetime; otherwise the assets will get a stepped-down basis at death, that is, to fair market value at death.⁴⁶

There seems to be little empirical evidence on the magnitude of the "lock-in" problem or the effect of lock-in incentives on the total gains tax forgiveness at death.⁴⁷ As Professor Henry C. Wallich put it: "The lock-in effect of the capital gains tax has been enveloped in a great deal of controversy, but of evidence there is not much."⁴⁸ Without such empirical evidence, one should be careful not to place undue weight upon the economic importance of eliminating the lock-in effect.

42. Under our progressive federal income tax structure, the greater one's recognized income in a given year the higher the tax bracket. One-half of the excess net long-term capital gain over net short-term capital loss realized in a given year is recognized income (see IRC § 1202) and consequently it increases the taxpayer's marginal tax bracket. However, for taxable years beginning before 1970, IRC §§ 1201(b) and 1202 prevented net long-term capital gains from increasing the tax bracket of a taxpayer beyond 50% (excluding any surtax). The Tax Reform Act of 1969 amended IRC § 1201 and added IRC § 1222(11). Tax Reform Act of 1969, Pub. L. No. 91-172, § 511(a)-(b), 83 Stat. 635. As a result, the above statement regarding the inability of net long-term capital gains to increase one's tax bracket over 50% is applicable for taxable years starting after 1969 only if such gains do not exceed \$50,000. The excess of such gain over \$50,000 may, for taxable years beginning in 1970, increase the marginal tax rate up to 59%, and, for taxable years beginning in 1971, up to 65%. For taxable years beginning in 1972 and thereafter, net long-term capital gains could result in a taxpayer reaching the top marginal tax rate of 70%. *Id.*

43. M. DAVID, *supra* note 34, at 225-26.

44. Wallich, *Taxation of Capital Gains in the Light of Recent Economic Developments*, 18 NAT'L TAX J. 133, 146-47 (1965).

45. INT. REV. CODE of 1954, as amended on Dec. 30, 1969, §§ 1211(b) and 1212(b).

46. IRC § 1014.

47. Waterbury, *supra* note 14, at 48-49; Wallich, *supra* note 44, at 145.

48. Wallich, *supra* note 44, at 145. Professor Wallich is Professor of Economics at Yale University and was Assistant to the Secretary of the Treasury 1958-59. *Id.* at 133 n.*.

III. THE CURRENT PROPOSAL

The first official step toward changing the present exclusion of appreciation on property held at death from capital gains taxation was a 1963 proposal by President Kennedy.⁴⁹ Although that proposal was defeated in the House Ways and Means Committee,⁵⁰ a similar proposal has again been submitted by the Treasury.⁵¹ As in the Kennedy proposals, the 1969 scheme would tax accrued appreciation at death.⁵² The basis of the property would then become equal to its fair market value at the date of death or at the alternate valuation date as is the current practice under IRC section 1014(a). Where the property's fair market value is less than its tax basis in the decedent's hands at the date of his death, the loss would be deductible,⁵³ as under the regular rules applicable to capital losses.⁵⁴ In order to relieve the hardship of the bunching effect of what may be considered involuntary realization of capital gains, IRC sections 6161 and 6166, allowing the estate tax to be paid in up to ten annual installments either where payment of the tax would create undue hardship, or where 35 percent of the gross estate or 50 percent of the taxable estate consists of interest in a closely-held company, would be expanded to cover the capital gains tax at death.⁵⁵ IRC section 303 would be available to allow stock redemption without payment of ordinary income tax on the redemption.⁵⁶ Regardless of the holding period, all capital gains taxed under this proposal would be treated as long term.⁵⁷ The income tax attributable to the gains taxed at death would be a deduction for

49. 1963 Hearings, *supra* note 9, at 24, 128-37; 1969 Notes, *supra* note 5, at 141.

50. See Heckerling, *supra* note 15, at 247, author's note; U.S. TAX WEEK, Aug. 30, 1963, at 1337; Waterbury, *supra* note 14, at 3.

51. See generally 1969 PROPOSALS, *supra* note 1. See 1969 Notes, *supra* note 5, at 141-44 for a summary and comparison of the 1963 and 1969 proposals.

52. 1969 PROPOSALS, *supra* note 1, at 334, 340; 1963 Hearings, *supra* note 9, at 128. See note 6, *supra*.

53. 1969 PROPOSALS, *supra* note 1, at 336, 341.

54. The 1969 Tax Reform Act amended IRC §§ 1211(b) and 1212(b) so that only 50% of net long-term capital losses may be deducted from ordinary income. Tax Reform Act of 1969, Pub. L. No. 91-172, § 513(b), 83 Stat. 642.

55. 1969 PROPOSALS, *supra* note 1, at 347, 404, 406-07. Under both IRC §§ 6161 and 6166 a 4-percent rate of interest is imposed. *Id.* at 347. It is proposed that the 50 percent of the taxable estate requirement of IRC § 6166(c) be amended to 25 percent of the taxable estate. *Id.* at 404.

56. *Id.* at 347, 406-07. See discussion in part V A, *infra*.

57. 1969 PROPOSALS, *supra* note 1, at 335-36, 340. Presumably this will have little effect on the lock-in problem; see notes 37-48 and accompanying text, *supra*.

the estate in computing the estate tax.⁵⁸ Both appreciation on property bequeathed to a qualified charity and gains on ordinary personal and household effects of the decedent of a value of less than \$1,000 per item would be excluded.⁵⁹

The 1969 proposal contains significant changes from the 1963 proposal. For example, the current proposal would provide that every taxpayer be deemed to have a minimum basis in property owned at death equal to the lesser of \$60,000 or the fair value of such property,⁶⁰ while the 1963 proposal would have permanently exempted gain up to \$15,000 without regard to the size of the estate.⁶¹ Thus, the minimum basis in the current proposal would not benefit the beneficiaries of any decedent whose basis in property owned at death would be equal to, or greater than, \$60,000 at his date of death. For the beneficiaries of a decedent whose tax basis was less than \$60,000 at death, but who had over \$15,000 worth of accrued capital gains, this aspect of the 1969 proposals would be more beneficial than the 1963 proposals.

The 1969 proposal would allow a one hundred percent marital deduction.⁶² This would exclude all property passing to the surviving spouse from the gains tax at death, including property in which the surviving spouse receives a limited but definite interest.⁶³ The property so transferred would not receive the stepped-up basis which now exists under IRC section 1014; rather, it would receive an allocated share of the total basis of all the decedent's property proportionate to the

58. 1969 PROPOSALS, *supra* note 1, at 340.

59. *Id.* at 335, 337, 342-44. Assets which constitute a set or collection, such as stamps, guns, coins, or works of art, would be treated as a single asset for purposes of this rule. *Id.* at 342. Dispositions of IRC § 306 stock at death would receive capital gains treatment. *Id.* at 348. Whether the charitable exemption would apply to testamentary gifts of IRC § 306 stock is unclear, since such exemptions would not apply where an asset giving rise to ordinary income is transferred to a charity at death. *Id.* at 344.

60. *Id.* at 29, 335-37, 341-42.

61. 1963 Hearings, *supra* note 9, at 129, 132.

62. Unlike this proposal, the Kennedy proposal would have allowed a marital exclusion of one-half the gain, provided that the surviving spouse received property, other than cash, with a fair market value at least equal to the amount of the marital exclusion. 1963 Hearings, *supra* note 9, at 130-31. This latter proposal was largely based upon the present estate tax marital deduction; IRC, § 2056.

63. 1969 PROPOSALS, *supra* note 1, at 343. The current proposal provides a similar gains tax exclusion for property passing to an orphan beneficiary, but only to the extent of \$3,000 times the number of years he is under 21 years old at the time of the decedent's death. *Id.* at 337, 343-44, 366.

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total property passing to the surviving spouse.⁶⁴ Therefore, if the surviving spouse receives three-fourths of an estate which had a fair market value of \$200,000 and a basis of \$100,000, then under the current proposals he would receive \$150,000 worth of property which would have an allocated basis of \$75,000 (three-fourths of the total basis of the decedent's property). Either the transferor or the surviving spouse could elect, however, to have any portion of the property passing under the marital deduction at the decedent's death subjected to the gains tax.⁶⁵ This election may be beneficial where the surviving spouse is in a higher tax bracket than the transferor.⁶⁶

The strongest argument raised against President Kennedy's 1963 proposal to tax unrealized appreciation at death was that it would create severe liquidity problems for non-liquid estates.⁶⁷ The proposals would not eliminate these problems which would be particularly acute for estates consisting primarily of a closely held business, since such a business is frequently characterized by relatively little initial investment capital and great appreciation.⁶⁸ In cases where such a business constitutes most of the decedent's wealth, the tax burden of a capital gains tax at death, in addition to the estate tax, could force an involuntary liquidation, or sale of a controlling interest, or complete sale of the business.⁶⁹ Often such sale or liquidation would be at far below the actual value of such interest or business because an immediate buyer could not otherwise be found.⁷⁰ To avoid this result, owners

64. *Id.* at 338, 343-45. The concept of allocated basis, as distinguished from actual basis, will be discussed in greater detail in the text accompanying notes 77-100, *infra*. Under the 1963 proposal, the decedent's basis would be carried over to the surviving spouse. 1963 *Hearings*, *supra* note 9, at 131.

65. 1969 PROPOSALS, *supra* note 1, at 343.

66. Note that the benefit of deferring both recognition of the gains and payment of the tax may more than offset differences in tax rates.

67. 1963 *Hearings*, *supra* note 9, at 1326 (statement of Henry Bison, Jr., for the National Association of Retail Grocers), 1412 (statement of G. Keith Funston for the New York Stock Exchange), 2323 (statement of Joel Barlow for the United States Chamber of Commerce), 2395 (statement of Charles E. Walker for the American Bankers Association).

68. Hanrahan, *supra* note 14, at 154; Wormser, *The Case Against a Capital Gains Tax at Death*, 54 A.B.A.J. 851, 852 (1965); 1969 Notes, *supra* note 5, at 144.

69. Under the current proposal the income tax attributable to the gains taxed at death would be deductible from the estate before computation of the estate tax. This estate tax deduction should be distinguished from an estate tax credit. Such a credit would result in a smaller liquidity problem than a deduction, but the federal tax revenues would also be smaller. See text accompanying note 58, *supra*.

70. 1969 Notes, *supra* note 5, at 144.

might either sell their interest while they are still living, or execute a buy-sell agreement or a business purchase agreement, but these alternatives would also be dependent upon finding a willing and able purchaser.⁷¹ Often this would mean a sale to another concern, hence increasing concentration of economic power. Such concentration seems to be socially undesirable and inconsistent with a governmental policy of minimizing mergers and consolidations.⁷²

While the use of personal life insurance or business life insurance could supply the cash necessary to pay taxes at death, and thereby alleviate the liquidity problem, many taxpayers, particularly the elderly, would find life insurance difficult or impossible to obtain except at prohibitive premium rates.

In qualifying cases, of course, the tax may be paid in installments and the benefits of IRC section 303 redemptions may be available.⁷³ In order to further reduce the liquidity problem and allow time for adequate estate planning, the current proposal would only tax gains which accrue after the date of enactment,⁷⁴ whereas the Kennedy proposal provided for a transitional period (three or five years was suggested) after which all gains would be taxed.⁷⁵ The valuation of all closely held corporations, land, portfolios, and small business interests on a given effective date, which would be necessary under the 1969 proposals, appears to be a difficult and unnecessary problem.⁷⁶ Omitting pre-enactment gains would limit the scope of the tax, but would not eliminate the liquidity problem. For those whose business or other non-liquid property greatly appreciates in post-enactment value, liquidity problems would still exist. The exclusion of pre-enactment gains from capital gains at death would mean only that some taxpayers would have time to prepare estate plans and that taxpayers (and voters) whose current holdings have appreciated in value would

71. See Bosland, *Has Estate Taxation Induced Recent Mergers?* 16 NAT'L TAX J. 159 (1963). Based on a survey of businesses that sold out in 1955-59, Professor Bosland concludes that the "estate tax and valuation problems have continued to be a leading, if not the leading consideration in decisions of the owners to sell out or merge." *Id.* at 167.

72. See Hanrahan, *supra* note 14, at 154; see 1969 Notes, *supra* note 5, at 144.

73. See text accompanying notes 55-56, *supra*.

74. 1969 PROPOSALS, *supra* note 1, at 335, 340, 351. This is similar to British tax treatment of transfers of property at death. Finance Act of 1965, c. 25 § 22(10). For a brief summary of the British treatment, see Hanrahan, *supra* note 14, at 157-58.

75. 1963 Hearings, *supra* note 9, at 140.

76. See M. DAVID, *supra* note 34, at 149-50.

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not suffer the same tax burden as those whose wealth appreciates in the future.

The current proposal would solve the problems existing under the present practice of gains forgiveness at death, but would replace them with an even more complex Internal Revenue Code (including special treatment both for property passing to a surviving spouse, an orphan beneficiary, or qualified charities, and for gains on personal and household effects), valuation problems, and liquidity problems. The individual hardship and economic concentration which these new problems could create if capital gains taxation at death were adopted provide strong arguments against adopting such an approach.

IV. ALLOCATION OF BASIS AT DEATH

From the foregoing, it appears clear that both capital gains tax forgiveness at death and immediate taxation of unrealized appreciation at death have grave disadvantages. The alternative of carrying over the decedent's tax basis at death so that the property retains the decedent's basis, first advanced by Randolph Paul and Solicitor General Griswold,⁷⁷ was almost adopted by Congress in 1963 as a compromise substitute for the then proposed taxation of capital gains at death.⁷⁸ IRC section 1015(a) already requires that the transferor's basis be carried over when there is an *inter vivos* gift; extending this carryover approach to testamentary gifts would be a less drastic change than imposition of an at-death gains tax.

Despite this coordination with the income tax treatment of gifts, if one attempts to carry over the decedent's actual tax basis in each asset passing at death, virtual administrative impossibilities are encountered whenever the decedent fails to specify exactly which items are to be given to whom.⁷⁹ For example, if one dies intestate and ac-

77. *Hearings Before Comm. on Ways and Means of the House of Representatives on Revenue Revision of 1942*, 77th Cong., 2d Sess., pt. 1, at 89 (unrev. ser. 1942). 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). Heckerling, *supra* note 15, at 261; Waterbury, *supra* note 14, at 3.

78. See Press Release RR 63-25 issued by Comm. on Ways and Means of the House of Representatives on August 7, 1963, in *1963 Hearings*, *supra* note 9, at 383-84; Heckerling, *supra* note 15 at 247, author's note; U.S. TAX WEEK, Aug. 30, 1963, at 1337; Waterbury, *supra* note 14, at 3.

79. See M. DAVID, *supra* note 34, at 155-59, 221.

ording to the intestate succession laws of his domicile his property is to be divided equally among his three surviving children, how should his administrator divide the decedent's estate? If the administrator divides the estate into thirds only on the basis of the fair market value of the assets, then each beneficiary's basis in the property may vary considerably and the distribution would not be truly "equal" as required by state law. Similarly, if nine shares of stock were purchased in one lot of one and two lots of four, they could be divided into three shares each, if the basis of the shares could be ignored. If the basis is not ignored, how could the stock be divided equally among the heirs?

The solution to this administrative impasse appears to be to allocate the decedent's tax basis at death.⁸⁰ This approach has been suggested in the 1969 proposals, but only for property not subject to capital gains tax at death under those proposals.⁸¹ Such an approach would function as follows: The executor or administrator would distribute the estate by the decedent's will or by the laws of intestate succession, whichever is applicable. The administrator or executor would have to total the decedent's tax basis for all the assets held at death, but in making the actual distribution he need only concern himself with the fair market value at the date of death. When the decedent's estate is distributed, that portion which the fair market value of each asset bears to the total fair market value of the entire estate would be multiplied by the decedent's total tax basis to arrive at the allocated basis of each asset. For example, if the decedent leaves an estate with a fair market value of \$100,000 and a total tax basis of \$50,000, then nine shares of stock with a fair market value of \$1,000 per share would have a carryover basis of \$500 per share, no matter what the actual basis of the specific shares had been in the hands of the decedent. The computation in arriving at this allocated basis is:

$$\frac{\$1,000 \text{ (fair market value of the asset in question)}}{\$100,000 \text{ (fair market value of the entire estate)}} \times \$50,000$$

(total tax basis) = \$500 (allocated basis of the asset in question).

If this allocation formula were strictly applied a basis would be

80. See proposed statute in APPENDIX, *infra*.

81. 1969 PROPOSALS, *supra* note 1, at 338, 343-46.

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assigned to cash. Cash should be excluded from this formula, however, for it seems illogical to allocate a tax basis to cash; it is certainly inconsistent with current income tax treatment. Furthermore, it is unlikely that people would accept the task of keeping records every time they spent any cash. This task would be necessary if a beneficiary's inherited cash were assigned an allocated basis of less than face value, for then each expenditure would become a taxable event.⁸² Assuming the fair market value of the estate in the above example included \$20,000 of cash, by excluding this cash from the formula each share of stock would have an allocated basis of \$625, computed as follows, rather than \$500 as before:

$$\frac{\$1,000 \text{ (FMV of the asset in question)}}{\$80,000 \text{ (FMV of the entire estate, excluding cash)}} \times \$50,000$$

(total tax basis) = \$625 (allocated basis of the asset in question).

To avoid inequities some type of exemption is necessary. Both the Kennedy proposal and the 1969 proposal recognized this need. Under the Kennedy proposal this was to be achieved by exempting gains up to \$15,000.⁸³ Under the 1969 proposal every decedent's estate would be deemed to have a tax basis of the lesser of \$60,000 or its fair market value at the date of the decedent's death or the alternate valuation date.⁸⁴ This minimum basis would assure that no capital gains would result unless the decedent's estate had a fair market value in excess of \$60,000. Thus, this exemption method, unlike the one contained in the Kennedy proposal, would have the advantage of being correlated with the federal estate tax. This same minimum basis approach could be utilized with either at-death gains taxation or the basis carryover method, but in either case such treatment would benefit only those whose estates have a basis of less than \$60,000. For example, if decedent X leaves an estate with a fair market value of \$60,000 and a tax basis of \$10,000, no gain would be taxed under the 1969 proposals, and since the \$60,000 fair market value would be carried over under the carryover of basis approach, decedent X's \$50,000 unreal-

82. Such taxation could be eliminated by amending IRC § 1002 to exclude cash from the term "property" as used in that section.

83. See note 61 and accompanying text, *supra*.

84. See note 60 and accompanying text; *supra*.

ized gain would never be taxed. However, if decedent *Y* leaves a \$120,000 estate, with a tax basis of \$70,000, the full \$50,000 unrealized gain would be taxed under the 1969 proposals. Under a carry-over method, decedent *Y*'s \$70,000 tax basis would be carried over and the recognition of the \$50,000 gain would be deferred, rather than forgiven. This difference in treatment seems unnecessarily arbitrary and inequitable. The minimum basis method used under the 1969 proposal would, in effect, allow capital gains forgiveness of up to \$60,000 where the decedent had a zero tax basis (*e.g.*, where the property had been completely depreciated), while automatically disallowing forgiveness where the decedent had a tax basis of \$60,000 or more. When dealing with a capital gains tax, either at death or at the time the beneficiary disposes of the inherited assets, any such gains tax forgiveness should be dependent upon the size of the gain, rather than the amount of the decedent's basis.

Equitable forgiveness would be achieved by carrying over as basis the *lesser of* (1) the decedent's tax basis plus \$60,000, or (2) the fair market value at date of death (or the alternate valuation date if election is made under IRC section 2032).⁸⁵ If a taxation-at-death, rather than carryover, approach were adopted, this recommended exemption method could still be used instead of the minimum basis scheme contained in the 1969 proposals. Under either approach this recommended exemption method would, in effect, forgive up to \$60,000 of capital gains at death for all decedents without regard to their tax basis. Using the above example, the result would be the same for decedent *X* since the \$60,000 fair market value of *X*'s estate would either result in no gain under a taxation-at-death approach, or be carried over at death if that approach were adopted. The result, however, would be quite different in the case of decedent *Y*; the carry-over basis would be \$120,000 (the lower of *Y*'s \$70,000 tax basis plus \$60,000, or the \$120,000 fair market value), rather than \$70,000 as before, or if there were taxation at death there would be no gain, instead of the \$50,000 gain.

85. This same formula for determining basis should also be applied by the beneficiary for the purpose of determining loss. This treatment would be the most consistent with IRC § 1015(a), which provides that the basis for determining loss on the disposition of property acquired by *inter vivos* gift is the lesser of the transferor's basis or the fair market value at the time of the gift. Thus, recognition of the accrued losses would be forgone by transfers both at death and by gift.

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Even under a carryover of basis approach coupled with the above-recommended exemption method, there would still be administrative difficulties. The decedent's basis plus \$60,000 could not be used as the carryover basis without allocating the \$60,000 to the specific assets. However, as has already been shown, an allocation of basis carried over at death is much more desirable than attempting to carry over the actual basis of each asset. A far more difficult problem when dealing with either a carryover of basis approach or a capital gains at death approach is to determine what the decedent's basis was at the time of his death. This problem already arises under IRC section 1015(a) and in determining capital gains. At death, however, the problem is further complicated because the decedent would often be the only one who could establish the basis of a particular asset. Under any of these methods it would be necessary to keep accurate records. Arguably this problem would be reduced under the 1969 proposal since only that appreciation in value occurring after the date of enactment would be taxed, but it is unrealistic to assume that taxpayers would leave accurate valuations of their estates as of the date of enactment. In practice this emphasis on record-keeping would tend to penalize those with small and moderate estates who have not had professional advice.

Under the recommended exemption method, whether implemented as part of an allocated carryover or taxation-at-death approach, there would be no reason to establish the decedent's actual tax basis unless the fair market value of the estate exceeded \$60,000. Thus, only those estates required to file a federal estate tax return would have to determine the decedent's tax basis.⁸⁶ Since only about three percent of all adult decedents in the United States each year leave an estate of over \$60,000, this problem of basis determination would be eliminated for most estates.⁸⁷

While the establishment of the decedent's basis would be a severe

86. A federal estate tax return must be filed for the estate of every citizen or resident of the United States whose gross estate as defined by IRC § 2031 exceeded \$60,000 in value at the date of death. Treas. Reg. § 20.6018-1(a) (1954).

87. Hanrahan, *supra* note 14, at 146. Mr. Hanrahan's estimate is based on 1961, during which time 45,439 estate tax returns were filed from an estimated 1.5 million adult deaths. *Id.* at 146 n.74. In 1966, the latest year for which figures are available, there were 97,339 federal estate tax returns filed for United States citizens and resident aliens. Of these, 67,404 were taxable. STATISTICS OF INCOME—1965, FIDUCIARY, GIFT, AND ESTATE TAX RETURNS (Internal Revenue Service Pub. No. 406, Nov. 1967).

problem under the taxation-at-death approach, proof of this basis when beneficiaries of large estates sell their inherited assets years after the decedent's death might be even more difficult if the carry-over approach is adopted. They would need some way of establishing the decedent's tax basis at death. To overcome this difficulty, if a carryover approach is adopted, the Internal Revenue Service should establish a department to audit all estates of \$60,000 or more. This audit should be of sufficient scope to allow the Internal Revenue Service and the decedent's administrator or executor to come to a binding determination of the decedent's tax basis and the proposed allocation thereof. If the decedent's administrator or executor does not wish to accept the Internal Revenue Service's determination, he should be allowed to seek judicial redetermination.

Since the purpose of this audit would be to ease the decedent's beneficiaries' burden of proof in future years, Congress may believe the cost of imposing this added audit task upon the Internal Revenue Service should be borne by those estates utilizing this service. There is some precedent for this type of user charge. IRC section 4940, as recently enacted by the Tax Reform Act of 1969, providing for an excise tax on the investment income of private foundations, reflects a congressional decision that the costs of the substantial supervision to which private foundations should be subject "should not be borne by the general taxpayer, but rather should be imposed upon those exempt organizations whose exempt activities have given rise to much of the need for supervision."⁸⁸ If Congress were to extend this type of reasoning to the audit of estates, consideration should be given to whether the excise tax imposed should be added to the decedent's tax basis or whether it should merely be deductible as an administrative expense for estate tax purposes. If the administrator or executor feels that the decedent's tax basis is so nominal as not to justify incurring such an excise tax and additional legal expenses, then he should not be required to submit to an audit to determine the decedent's basis. Nevertheless, total administrative

88. U.S. CODE CONG. & AD. NEWS 2053 (1969). See also *id.* at 1663-64, 2053-54, 2392. Under § 101(b) of H.R. 13270 as reported to the Senate on Nov. 21, 1969, the then proposed IRC § 4940 was titled "Audit-Fee Tax."

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costs could presumably be reduced by having the Internal Revenue Service conduct both this audit to determine the basis and the federal estate tax return audit at the same time, rather than separately.

The allocated carryover approach, coupled with the recommended exemption method discussed above, should be adopted. At least with respect to large estates, such an approach would eliminate the inequities of the current procedure of rewarding one for retaining appreciated assets until death. Admittedly, taxation of capital gains at death would also solve this forgiveness problem, and provide a more immediate increase in tax revenues. By omitting pre-enactment capital gains, however, the 1969 proposals would forgive gains which would only be deferred under a carryover approach.

While taxing unrealized appreciation at death would eliminate whatever lock-in effect results from current gains tax forgiveness at death,⁸⁹ the impact of basis carryover at death upon the lock-in problem is not as clear. Professor David reports that the majority at the Brookings Institution conference felt that "carryover of basis would not solve, and might aggravate, lock-in problems."⁹⁰ The economic pressures would be different. The knowledge that after their death their heirs would be left with a low basis and that any income tax paid would be removed from the estate tax base would often move holders to trade their assets.⁹¹ Even if they have short life expectancies, taxpayers who anticipate that their heirs would be in as high a tax bracket as they are would be more likely to engage in taxable transactions that they would otherwise forego.⁹² However, this reduction of the lock-in problem may be offset by the "aggravated 'lock-in' feeling"⁹³ that a carryover of basis at death may leave with the heir. This feeling would result from the heir's knowledge that upon disposing of the inherited property he would be taxed, not only upon the gain accruing to him, but also upon the gain which accrued during the decedent's lifetime.⁹⁴ This disincentive to the prompt sale of

89. Waterbury, *supra* note 14, at 49.

90. M. DAVID, *supra* note 34, at 220.

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

92. M. DAVID, *supra* note 34, at 158.

93. Anthoine, *supra* note 91, at 816.

94. See 1969 Notes, *supra* note 5, at 148.

a bequest would not arise where there is a stepped-up basis at death.⁹⁵ By deferring sales of inherited property, under carryover of basis, the heirs would maintain, in effect, an interest-free loan to the extent of the postponed tax.⁹⁶ Nevertheless, to the extent that bequests pass to heirs with lower marginal tax brackets, the heirs could realize gain at a lower tax cost than the decedent could have and some moderation of lock-in would occur.⁹⁷

Thus, taxing gains at death would probably counteract the lock-in problem more effectively than a carryover of basis at death. In view of the absence of empirical evidence as to the impact of the lock-in problem,⁹⁸ however, the importance of this single factor in comparing the alternatives to gains tax forgiveness at death is highly questionable.

Unlike the lock-in problem, the liquidity problem which would result from taxing capital gains at death is a certainty, not conjecture; it justifies the rejection of such an approach.⁹⁹ There would be no liquidity problem at death, other than that created by the estate tax, under a carryover of basis approach, since at death there would be no income taxation for which cash would be needed.

As previously discussed, the carryover of the decedent's actual basis would create such administrative difficulties that the more workable allocated carryover approach should be employed. Using allocated, rather than actual, basis also would eliminate any tax incentive for the decedent, or his administrator or executor, to make otherwise undesirable transfers of particular property to a specific person or entity.¹⁰⁰

If either the taxation of gains at death or the allocated carryover basis approach is adopted by Congress, the recommended exemption method, as discussed above, should be incorporated with it. This exemption method clearly offers greater gains tax forgiveness than the method incorporated in the 1969 proposals, but the inequities of this

95. See M. DAVID, *supra* note 34, at 158.

96. *Id.*; Hanrahan, *supra* note 14, at 149; 1969 Comment, *supra* note 5, at 148.

97. M. DAVID, *supra* note 34, at 158. For taxable years beginning before 1970, this is only true if the heirs are in less than a 50% tax bracket. See note 42, *supra*.

98. See notes 47-48 and accompanying text, *supra*.

99. See notes 67-72 and accompanying text, *supra*.

100. 1969 PROPOSALS, *supra* note 1, at 338, 343-46.

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latter method are clear, and it is poor tax policy to create injustices without cause.

V. THE EFFECT OF AN ALLOCATED CARRYOVER OF DECEDENT'S BASIS ON RELATED INTERNAL REVENUE CODE SECTIONS

Would an allocated carryover of the decedent's tax basis at death have undesirable effects upon related Internal Revenue Code sections? While a section by section analysis of the Internal Revenue Code is beyond the scope of this paper, the basic answer is "No." The direct effect of adopting a carryover of basis approach coupled with the recommended exemption method, discussed above, would be that the beneficiary's basis would no longer automatically be the fair market value at death, unless the fair market value of the decedent's estate is \$60,000 or less. Except possibly in community property states, as noted below, the adoption of this carryover approach and exemption system would have no effect upon estates of \$60,000 or less since the beneficiaries' basis would be the fair market value at death just as is the practice under IRC section 1014(a). If the basis carried over is \$60,000 plus decedent's tax basis at death, rather than the fair market value as is the practice under section 1014(a), then the beneficiary would acquire a basis in the property which is less than the fair market value of the property inherited.¹⁰¹

A. *Depreciation*

If the inherited property is depreciable property in the beneficiary's hands, as provided for in IRC section 167, then this carryover of basis would result in the beneficiary's future depreciation being reduced. Such reduction would violate no major public policy, however, since the allowance for the depreciation would be on property for which the beneficiary had no out-of-pocket cost. If any approach violates public policy, it is one which would step up basis beyond cost, rather than the allocated carryover approach which would limit depreciation to

101. This will be the case whenever the fair market value of the estate is greater than the total of \$60,000 plus decedent's tax basis at death.

original cost, deviating only to the extent that the policy decision to provide an exemption necessitates.

B. Section 303 Redemptions

If the beneficiary takes a basis in inherited property which is less than the fair market value, then the immediate sale of this property would result in taxable gain to the beneficiary. This realization of gain would offset some of the potential benefits of IRC section 303, which, as previously mentioned, provides that a redemption of stock to pay death taxes and funeral and administration expenses in certain cases will be treated as a sale, rather than as a dividend under IRC section 301.¹⁰² Section 303 has become a popular estate planning tool for providing liquidity because with the beneficiary taking the fair market value at decedent's death as his basis, there is virtually no gain realized on an immediate redemption. To the extent that the allocated basis of the property redeemed under IRC section 303 is less than its fair market value at the date of redemption, capital gains would be immediately realized, thereby reducing the amount of liquid funds available for death taxes and funeral and administration expenses. Still, this liquidity problem would not be nearly as severe as taxing capital gains at death. Furthermore, IRC section 303 could be amended by adding IRC section 303(a)(3) to provide that the amount of distribution allowed under section 303 be increased by the amount of capital gains imposed because of such section 303 redemption other than that authorized by section 303(a)(3).¹⁰³ Such an amendment to section 303 would preserve its effectiveness as a means of providing liquidity.

C. Community Property Problems

A question arises in community property states regarding the surviving spouse's one-half share of community property.¹⁰⁴ Currently,

102. B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 304-06 (2d ed. 1966).

103. See proposed statute in APPENDIX, *infra*. Note that the limitation contained in the proposed statute is necessary to prevent circularity.

104. This question seems to have been completely ignored by the advocates of taxing unrealized appreciation at death. Presumably they would not tax the appreciation on the surviving spouse's share of community property. However, the 1969 proposal provides that property passing to the surviving spouse receive an allocated portion of decedent's

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under IRC section 1014(b)(6), this share is treated as if acquired from the decedent. Thus, the entire community property takes a basis equal to the fair market value at decedent's death.

Under the allocated carryover approach, as developed in this paper, the lesser of (1) the decedent's tax basis plus \$60,000, or (2) the fair market value of the estate would be allocated to the property passing to the decedent's beneficiaries. If Congress continues to treat the surviving spouse's one-half share of community property as if it were acquired from the decedent, how would this affect the carryover formula proposed here? The fair market value of the surviving spouse's share neither should be treated as part of the decedent's estate nor, correspondingly, should the tax basis of the surviving spouse's share be added to the decedent's basis. Otherwise, the complete coordination of federal estate tax audits and the proposed audits to determine decedent's basis would be lost. Adding the surviving spouse's community interest to the decedent's estate would mean that determination of decedent's basis would be necessary for many estates which would not have to file a federal estate tax return because the gross estate, as defined in IRC section 2031 (which excludes the surviving spouse's community interest) would be less than \$60,000. This would increase the administrative difficulties faced by these estates and place an additional audit burden on the Internal Revenue Service. The loss of coordination with the federal estate tax does not seem justified. If Congress wishes to continue equalizing the bases of the surviving spouse's share of community property and the decedent's share of such property it can do so without affecting the carryover formula. For example, if the decedent's estate consists of separate property worth \$30,000, with a basis of \$10,000, and community property of which decedent's one-half interest is worth \$30,000, with a basis of \$30,000, then decedent's share of community property has an allocated basis of \$20,000.¹⁰⁵ This same \$20,000 basis could be assigned to the surviving spouse's one-half of community property. In this example, this

basis, rather than a stepped-up basis as now exists under IRC § 1014. From this one can only assume that the surviving spouse's one-half share of community property would no longer receive a stepped-up basis at the decedent's death. See note 64 and accompanying text, *supra*.

105.
$$\frac{\$30,000 \text{ (FMV of decedent's share of community property)}}{\$60,000 \text{ (FMV of decedent's estate)}} \times \$40,000$$
$$\text{(total tax basis)} = \$20,000 \text{ (allocated basis).}$$

would result in a reduction in the basis of the surviving spouse's share from \$30,000 to \$20,000.¹⁰⁶ Alternatively, Congress may wish to protect the surviving spouse by according the greater basis of (1) the decedent's allocated community property basis, or (2) the surviving spouse's actual basis in the community property; or it may repeal IRC section 1014(b)(6) and simply have the surviving spouse's basis in community property continue notwithstanding the decedent's death.

CONCLUSION

A carryover of decedent's allocated tax basis at death, coupled with the recommended exemption method, offers a practical compromise between complete gains tax forgiveness at death and immediate at-death taxation of appreciated assets. This alternative would eliminate, at least in respect to large estates, the inequity of a reward for retaining appreciated assets until death. Recognition of gains would be deferred, but the tax would not be lost forever.

The addition of more complex Internal Revenue Code sections, as would be unavoidable if the 1969 proposals for immediate at-death taxation were adopted with their special provisions for property transferred to a spouse, an orphan beneficiary, or a charitable organization, should be avoided. The allocated carryover approach would avoid such complexity.

While there would be basis determination problems under the allocated carryover approach, they would not be as difficult to solve as those which would result, under the 1969 proposals, from the necessity of determining basis as of the date of enactment. Furthermore, the hardship which would be suffered by non-liquid estates if death were treated as a taxable event for gains tax purposes would be avoided under the allocated carryover approach. Such hardship and the economic concentration which the liquidity problem might cause justify the rejection of gains taxation at death.

Nevertheless, complete gains tax forgiveness at death is no longer

106. In other cases the surviving spouse's basis may be increased. For instance, in the above example, if the decedent's bases for his separate and community property is reversed so that his basis in the separate property is \$30,000 and in the one-half community interest is \$10,000, then the decedent's share of community property will still have an allocated basis of \$20,000, but this time it represents an increase from the \$10,000 actual basis in the decedent's share of community property.

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acceptable. It is too inequitable, too unjustified, and too expensive. Hopefully, Congress will give strong consideration to the allocated carryover alternative and the recommended exemption method.

APPENDIX

PROPOSED AMENDMENTS TO THE INTERNAL REVENUE CODE

Section 1014 (relating to basis of property acquired from a decedent) is amended to read as follows:

Sec. 1014(a) IN GENERAL—Except as otherwise provided in this section, the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall, if not sold, exchanged or otherwise disposed of before the decedent's death by such person, be the sum of any money so received plus the allocated portion of the lesser of—

- 1) (a) the decedent's tax basis at the date of the decedent's death, and
(b) \$60,000,

OR

- 2) the fair market value of the decedent's property (including money) at the date of the decedent's death, or, in the case of an election under section 2032 its value at the applicable valuation date prescribed by that section.¹⁰⁷

Section 1014(b)¹⁰⁸

Section 1014(c)¹⁰⁹

107. The term "money" is used in this proposed amendment to IRC § 1014, rather than the term "cash," as used in discussion under part IV, *supra*, since this is more consistent with the language of IRC § 1001(b). What constitutes "money" for purposes of this proposed amendment should be enumerated in United States Treasury Department regulations consistent with the notion that the face value and the fair market value of "money" are inherently regarded as equal. It seems that IRC § 7805, pertaining to the prescription of rules and regulations for the enforcement of the Internal Revenue Code, would continue to provide sufficient machinery for the enforcement of IRC § 1014, as amended by this Appendix. Cf. IRC § 508(b), as amended on Dec. 30, 1969, which typifies sublegislative authority as distinguished from the interpretative authority delegated in IRC § 7805.

108. IRC § 1014(b), defining property acquired from the decedent for purposes of IRC § 1014(a), should be retained. However, *see* text accompanying notes 104-106, *supra*, relating to the possible repeal of IRC § 1014(b)(6).

109. IRC § 1014(c), relating to property representing income in respect of decedent, should be retained in present form.

Section 1014(d) ALLOCATED PORTION—

- 1) For purposes of subsection (a), “allocated portion” shall equal the fair market value of the asset in question divided by the fair market value of the entire adjusted gross estate. For purposes of this subsection, the fair market value shall be determined as of the date of the decedent’s death, or, in the case of an election under 2032 its value at applicable date prescribed by that section.
- 2) ADJUSTED GROSS ESTATE—For purposes of subsection (d)(1), the adjusted gross estate shall be computed by subtracting from the entire value of the gross estate, as defined by section 2031, the aggregate of—
 - (a) the deductions allowed by sections 2053 and 2054,
 - (b) the tax imposed by section 2001, and
 - (c) all money included in the gross estate, as defined by section 2031.

Section 303(a) (relating to redemption of stock to pay death taxes) is amended by adding the following new subsection:

Sec. 303(a) . . .

- (2) . . . , and
- (3) the capital gains tax imposed because of this section 303 distribution to the extent authorized under subsection (a)(1) and (a)(2),

. . . . ¹¹⁰

*Rodney J. Waldbaum**

¹¹⁰. The discussion in note 107, *supra*, relating to IRC § 7805 is also applicable to IRC § 303(a), as amended by this Appendix.

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