Duquesne Law Review

Volume 16 | Number 1 Article 8

1977

The Operation of Section 1023

Barry L. Isaacs

Follow this and additional works at: https://dsc.duq.edu/dlr

Part of the Law Commons

Recommended Citation

Barry L. Isaacs, *The Operation of Section 1023*, 16 Duq. L. Rev. 45 (1977).
Available at: https://dsc.duq.edu/dlr/vol16/iss1/8

This Article is brought to you for free and open access by Duquesne Scholarship Collection. It has been accepted for inclusion in Duquesne Law Review by an authorized editor of Duquesne Scholarship Collection.

THE OPERATION OF SECTION 1023

BARRY L. ISAACS*

INTRODUCTION

While examining the thought processes of individuals and groups who endeavor to procure those tax laws in which they might take particular delight, Louis Eisenstein noted that each employs an ideology endemic to its parochial needs, complete with its own style of thought and collection of platitudes repeatedly echoed as if "divinely inspired."[1] Thus, to one set of sensibilities, tax revision may mean reform and equity, while to another, it is tantamount to regression and confiscation. The debate over whether to change the Internal Revenue Code's long-standing treatment of basis in property acquired from a decedent illustrates the clash.[2]

Congress altered the traditional treatment of such property in the Tax Reform Act of 1976. This article will not evaluate the merits of this Congressional action nor the other leading proposals addressing the basis problem. It will, rather, explain the alteration and explore its effects.

LEGISLATIVE HISTORY

The Treasury Department had long expressed dissatisfaction with the failure of our income tax structure to reach the appreciation of assets transferred at death.[3] Prior to the Tax Reform Act of 1976, a

---

* B.A., New York University (1972); J.D., Washington University (1976); LL.M. Washington University (1977); Member, Missouri Bar, Illinois Bar.

1. L. EISENSTEIN, THE IDEOLOGIES OF TAXATION 224 (1961), *as cited in* Heckerling, *The Death of the "Stepped-Up" Basis at Death,* 37 S. CAL. L. REV. 247, 273 (1964).

2. *See generally* Panel Discussions on General Tax Reform Before the House Comm. on Ways and Means, 93d. Cong., 1st Sess. (1973); Covey, Surrey & Westfall, *Perspectives on Suggested Revisions in Federal Estate and Gift Taxation,* 28 REC. A. B. CITY N.Y. 42, 42-65 (1973); Kurtz & Surrey, *Reform of Death and Gift Taxes: The 1969 Treasury Proposals, the Criticisms, and a Rebuttal,* 70 COLUM. L. REV. 1365 (1970); Comment, *Taxing Appreciated Property at Death: The Case for Reform,* 51 ORE. L. REV. 364 (1972); Hoffman, *Stepped-up Basis at Death: The Defense,* 4 TAX ADVISOR 466 (1973) [hereinafter cited as Hoffman]; Graetz, *Taxation of Unrealized Gain at Death—An Evaluation of the Current Proposals,* 59 U. VA. L. REV. 830 (1973); Wormser, *The Case Against a Capital Gains Tax at Death,* 51 A.B.A.J. 851 (1965).

3. *Hearings on Revenue Revision of 1942 Before the Comm. on Ways and Means of the*

beneficiary acquired property from a decedent with a "stepped-up" basis equal to the fair market value of the property at the date of the decedent's death.[4] The tax laws, therefore, amounted to a forgiveness of otherwise taxable capital appreciation represented by the difference between the decedent's basis and the final valuation for estate tax purposes. Also, any loss due to depreciation of the asset's value over the same period of time was not recognized. In contrast, the donee of an inter vivos gift took the donor's original cost as his basis—a "carryover" basis—for determining gain, and the lesser of either the donor's basis (adjusted under section 1016[5]), or the gift's fair market value at the time of transfer, for determining loss.[6]

In 1942, the Treasury Department suggested that a donee take a carryover basis, similar to that taken in an inter vivos transfer, in the property he inherited.[7] By 1969, however, the Treasury Department had abandoned the carryover concept in favor of a proposal to tax the appreciation of the decedent's capital assets in his final income tax return. The assets would be taxed as if they had been held for six months and sold prior to death, thereby receiving capital gain treatment.[8] The estate would have been permitted to deduct the tax placed on the appreciation of the assets.[9]

President Kennedy announced a similar proposal in his message to Congress in 1963.[10] In 1969 and 1972, bills reflecting the capital

---

House, 77th Cong., 2d Sess. pt. 1 (1942) [hereinafter cited as *Hearings*].

4. I.R.C. § 1014(a). Unless otherwise specified, all references are to the Internal Revenue Code.

5. I.R.C. § 1016.

6. I.R.C. § 1015(a). An increase in basis for any gift taxes paid on the transfer was also provided. I.R.C. § 1015(d). This has now been modified to limit the increase in basis to the tax attributable to net appreciation of the asset, rather than to the entire gift tax paid. I.R.C. § 1015(d)(6). Prior to the Revenue Act of 1921, a donee of an inter vivos gift of appreciated property took, as his basis, the fair market value of the asset on the date of transfer. The 1921 law required that basis for gains and losses be calculated with reference to the basis in the hands of the donor or the last preceding owner who had not acquired the property by gift. The requirement that losses be computed by substituting the fair market value of the gift on the transfer date for the donor's basis, whenever the fair market value is lower, was added in 1934. Wells, *Legislative History of Treatment of Capital Gains Under the Federal Income Tax, 1913-1948*, 2 NAT'L TAX. J. 16, 22 (1949).

7. *Hearings, supra* note 3, at 89 (statement of Randolph Paul).

8. *See generally* U.S. TREASURY DEPT., TAX REFORM STUDIES AND PROPOSALS, 91st Cong., 1st Sess., pt. 3, at 329-409 (Comm. Print 1969).

9. *Id.* at 360.

10. *Hearings on the President's 1963 Tax Message Before the House Comm. on Ways and Means*, 88th Cong., 2d Sess., 20, 49, 122 (1963). A comparison between the 1963 and 1969

gains approach were introduced in both houses of Congress.[11] Bills reflecting a carryover basis approach were simultaneously introduced, but both approaches were rejected.[12]

The American Banker's Association, having originally advocated a carryover basis concept as an alternative to the existing system, devised the Additional Estate Tax (AET). This concept was distinct from both the immediate capital gains tax at death and the carryover basis.[13] Basically, AET would have taxed the appreciation of assets at death at the fixed rate of 14%, arrived at by "multiplying the complement of the postulated highest transfer tax bracket (60%) by the highest capital gains rate (35%)."[14] Congress also rejected this proposal in 1973.[15] Three years later, however, as part of the Tax Reform Act of 1976, Congress enacted section 1023 which creates a carryover basis system by providing that property acquired from a decedent dying after December 31, 1976 will have the adjusted basis of the decedent immediately prior to his death,[16] subject to further adjustments to be discussed hereafter.

Purpose of the Carryover Basis Provisions

Prior to the Tax Reform Act of 1976, those who sold their assets before death were required to pay a capital gains tax on any appreciation in value, but those whose assets were sold after death escaped such taxation. Congress viewed this discrimination as unwarranted as well as inequitable.[17] Additionally, a substantial "lock-in"

proposals can be found in Note, *Taxation of Capital Gains at Death,* 38 GEO. WASH. L. REV. 138 (1969).

11. H.R. 8757, 91st Cong., 1st Sess. (1969); S. 3378, 92d Cong., 2d Sess. § 113 (1972).

12. H.R. 13857, 92d Cong., 2d Sess. (1972); H.R. 11058, 92d Cong., 1st Sess. § 113 (1971); H.R. 5250, 91st Cong., 1st Sess. (1969); H.R. 13270 (Senate Amend. No. 333), 91st Cong., 1st Sess., 115 CONG. REC. 37305-06 (1969); S. 15861-S.15866, 91st Cong., 1st Sess. (1969). The House bills are virtually identical although the Senate bill is at variance with them in important respects. *See* Covey, *Possible Changes in the Basis Rule for Property Transferred by Gift or at Death,* 50 Taxes 831, 832-34 (1972) [hereinafter cited as Covey]. Covey provides a particularly good summary of all the proposals as well as a critique of them.

13. I have taken the views of the ABA as presented in *Hoffman, supra* note 2, at 470-74. It should be pointed out that the ABA favored retention of the then current taxing system over any of the proposals and only devised the AET as the least drastic alternative.

14. Hoffman, *supra* note 2, at 473.

15. *See Panel Discussion Before House Ways and Means Comm.,* 93d Cong., 1st Sess., pt. 10, 1541-61 (1973) (statement of Richard Covey).

16. I.R.C. § 1023.

17. H.R. Rep. No. 1380, 94th Cong., 2d Sess. 36-37, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3356, 3389-90 [hereinafter cited as House Committee Report].

effect arose that distorted the allocation of capital between competing sources.[18] Those who might otherwise have sold their property prior to death realized that a sale would trigger taxation which could be avoided merely by holding on to the property until death.[19] By providing that lifetime and post-mortem gratuitous transfers generally be treated alike, Congress hoped to eliminate these problems.[20]

WHAT CONSTITUTES CARRYOVER BASIS PROPERTY

Carryover basis property is defined more by what it is not than by what it is. The statute defines carryover basis property as all property acquired or passed from a decedent except: (1) income with respect to a decedent under section 691; (2) life insurance on the decedent's life; (3) joint and survivor annuities taxed under section 72; (4) certain payments and distributions under a deferred compensation plan or a stock option plan, when such payments would be taxable to the decedent's beneficiary; (5) stock or securities of a foreign personal holding company; and (6) property included in the decedent's gross estate by reason of sections 2035, 2038, or 2041 in which gain or loss has already been recognized, as in a transfer of the property within three years of the decedent's death, or the relinquishment or exercise of a power of appointment, or revocable transfer.[21] Other than life insurance, the exceptions involve property that need not be subject to the carryover basis rules because it is already taxed to the recipient.[22] The practical effect of

18. *Id.* at 3391.

19. *Id.*

20. *Id.* Whether carryover basis treatment of a decedent's assets will alleviate any "lock-in" effect is questionable; the effect may even be exacerbated. Professor Wallich once commented that "[t]he lock-in effect of the capital gains tax has been enveloped in a great deal of controversy, but of evidence there is not much." Wallich, *Taxation of Capital Gains in Light of Recent Economic Developments,* 18 NAT'L TAX J. 133, 146-47 (1965); *see also* Note, *Transfer of Decedent's Basis at Death: The Allocated Carryover Approach,* 46 WASH. L. REV. 121, 128 (1970-71) [hereinafter cited as *Carryover Approach*]. Assuming, nevertheless, that the lock-in effect exists, the carryover basis approach allows for virtually an indefinite postponement of the tax on appreciated property. Depending on the amount of gain that would have to be realized if the property were sold, there might be greater reluctance now for a beneficiary to sell appreciated property and pay the tax on the gain.

21. I.R.C. § 1023(b).

22. House Committee Report, *supra* note 17, at 38. The pre-1976 Regulation under § 1014 (relating to stepped-up basis) had no application to classes of property governed by §§ 72, 402, 403, 423(c), 424(c)(1), 691 and 1014(b)(5), (9). Treas. Regs. §§ 1.1014-1(c), 1.1014-2(b)(3), 1.1014-2(c) (1957). Thus, for example, the basis of stock or securities in a foreign personal holding company in the hands of one acquiring such property from a dece-

such a definition, however, is to include such hitherto unthought-of capital items as cash,[23] flower bonds,[24] and personal and household effects.[25]

Household and Personal Effects

Congress fully intended to permit losses as well as gains to be tax affected in the hands of the decedent's beneficiary. But, Congress did not believe that losses associated with household and personal items, such as clothing, jewelry, and furniture, normally treated as non-deductible personal expenses, should be used to offset gains from the decedent's investment assets.[26] Section 1023 therefore provides that, for purposes of computing losses on the disposition of household or personal effects, the basis cannot exceed its fair market value on the applicable valuation date.[27] Where the amount realized on disposition exceeds the fair market value on the applicable valuation date, but is less than the decedent's basis in the asset, neither gain nor loss will be recognized.[28] Realizing the difficulty of establishing a basis in such items, Congress drafted section 1023 with a provision that the decedent's executor may elect to exempt up to $10,000 of personal effects from carryover basis rules. The items which the executor designates as excluded[29] will receive a

dent dying after August 26, 1937, is the fair market value of the property on the date of the decedent's death or the adjusted basis of the decedent, whichever is lower. Treas. Reg. § 1.1014-2(c) (1957). Income with respect to a decedent, however, retains the same character in the hands of the recipient that it had in the decedent's hands. I.R.C. § 691(a)(3). Treas. Reg. § 1.691(a)(3) (1965).

23. It is absurd that cash should have a tax basis and that the spending of cash by a beneficiary should be a taxable event.

24. Certain United States treasury bonds, the so-called flower bonds, otherwise valued at their fair market value on the applicable valuation date, Treas. Reg. § 20.2031-2 (1976), nevertheless may be redeemed at par in payment of federal estate taxes. Treas. Reg. § 20.6151-1(c) (1960). Insofar as the carryover basis rules now affect them, their benefits have been diminished, particularly when coupled with the increase in the capital gain holding period under I.R.C. § 1222. Without a step-up basis, gain equal to the difference between the cost basis of the bonds and their par value will have to be recognized on redemption. Additionally, after 1977, unless the bonds are held in excess of one year prior to redemption, the gain realized on them will be short term gain.

25. Houshold and personal effects receive special treatment under I.R.C. § 1023. See notes 26-30 and accompanying text *infra*.

26. House Committee Report, *supra* note 17, at 38.

27. *Id.*

28. *Id.*

29. I.R.C. § 1023(b)(3)(A), (B).

basis equal to their fair market value at the decedent's death. Household items and personal effects not exempted will be subject to the carryover provisions of section 1023.[30]

BASIC WORKINGS OF THE STATUTE

By employing a carryover or substituted basis, section 1023 effectively taxes the decedent's beneficiary on the gain from the sale of transferred property in the same manner as if the decedent had disposed of it himself.[31] The beneficiary takes the decedent's basis in the property, modified by four adjustments required under section 1023 in the following order: (1) the adjusted basis of property which the decedent is treated as holding on December 31, 1976 is increased by the amount its fair market value exceeded its adjusted basis on that date[32] (this "step-up" is referred to in the Committee Reports as the "fresh start" rule,[33] since it basically permits appreciation prior to January 1, 1977 to be governed by the pre-1976 Tax Reform Act law under section 1014); (2) the basis of carryover basis property is increased by a portion of the federal estate taxes attributable to the appreciation of the assets;[34] (3) the aggregate bases of all carryover basis property is increased to a minimum of $60,000;[35] and (4) the basis of carryover basis property is increased further by a portion of any state inheritance, estate, legacy, or succession taxes

30. I.R.C. § 1023(b)(3)(B). In distinguishing investment assets from personal and household assets, the Committee Report lists items in the latter category as "generally" including "clothing, furniture, sporting goods, jewelry, stamp and coin collections, silverware, china, crystal, cooking utensils, books, cars, televisions, radios, stereo equipment, *et cetera.*" House Committee Report, *supra* note 17, at 38. It is certainly demonstrable that many of the items listed in the Committee Report, depending on their owners, can be investment assets as well. Perhaps the use of the qualifier "generally," which precedes the list, can be interpreted as a possible sword to be used by the Service as well as the estate.

31. The Committee Reports state that unrealized appreciation of property which, upon sale or other disposition, would have been subject to recapture (under §§ 1245 and 1250), and characterized as ordinary income to the decedent, will be so characterized in the hands of his beneficiary. House Committee Report, *supra* note 17, at 39. If the decedent's basis is unascertainable, the statute provides that the fair market value of the property when the decedent acquired it will be deemed its carryover basis, subject to the adjustments hereinafter described. I.R.C. § 1023(g)(3).

32. I.R.C. § 1023(h).

33. H.R. Rep. No. 1515, 94th Cong., 2d Sess. 612-13, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 4253 [hereinafter cited as Conference Committee Report].

34. I.R.C. § 1023(c).

35. I.R.C. § 1023(d).

paid by the donee of the property.[36] While the statute is silent as to maximum adjustments, the Committee Report states that under no circumstances should the basis of any asset exceed its fair market value on the date of the decedent's death as a result of these adjustments.[37]

A. *Adjustments to Basis for December 31, 1976 Fair Market Value, Section 1023(h)*

For purposes of determining gain, assets acquired by the decedent on or before December 31, 1976 and held by him at his death will receive a limited step-up in basis. The step-up is equal to the difference between the December 31, 1976 value and the adjusted basis on that date.[38] All property held on December 31, 1976, whether acquired in a taxable or non-taxable exchange, is eligible for this "fresh start" treatment.[39]

The adjustment is easily determined if the carryover basis assets are marketable bonds and securities. The decedent's adjusted basis, if less than the fair market value on December 31, 1976, is raised to the value on that date.[40] The Regulations define fair market value as the mean between the highest and lowest sale prices on the valuation date.[41] Not all stocks, however, can be handled in this manner; the term "marketable bond or security" apparently excludes items such as stock in closely held corporations and stock subject to buy-

---

36. I.R.C. § 1023(e).

37. House Committee Report, *supra* note 17, at 39.

38. A proposed technical amendment to § 1023 would make it clear that only one "fresh start" adjustment would be permitted with respect to any particular carryover basis asset "to be made with respect to the first death-time transfer of the eligible property after 1976." H.R. 6715 § 3(c)(3), 95th Cong., 1st Sess. (1977), *as described in* [1977] 6 FED. TAXES (P-H) ¶ 59,415.1 at 59,416.59.

39. Conference Committee Report, *supra* note 33, at 613. The Committee Report also states that regulations will be issued to govern situations where the decedent has made substantial improvements to property held by him on December 31, 1976, in order that the improvements be treated as separate property for carryover basis purposes. *Id.*

40. I.R.C. § 1023(h)(l). Since depreciation is not allowable with respect to such property, the decedent's adjusted basis on December 31, 1976 is equal to the unadjusted basis on the date of the decedent's death. The difference between the fair market value on December 31, 1976 and the unadjusted basis on that date is therefore equal to the difference between the December 31, 1976 fair market value and the unadjusted basis as of death. Adding this difference to the unadjusted basis at death is, therefore, equivalent to raising the basis to the December 31, 1976 fair market value.

41. Treas. Reg. § 20.2031-2(b) (1976) (as amended prior to the Tax Reform Act of 1976).

sell arrangements.[42]

To determine the adjustment to property other than marketable bonds and securities whose value on the date of the decedent's death[43] exceeds the adjusted basis just prior to the decedent's death, a special rule has been introduced which obviates the need for obtaining appraisals of the December 31, 1976 value. The rule assumes that all appreciation since the decedent's acquisition of the property occurred at a uniform rate.[44] Essentially, the special rule is a two-fold calculation. First, the depreciation, amortization or depletion allowed or allowable with respect to the property during the period the decedent held the property prior to January 1, 1977 is calculated. All depreciation, amortization or depletion allowed or allowable during the entire period the decedent held the propety is multiplied by a fraction; the numerator of the fraction is the number of days in the decedent's holding period prior to January 1, 1977 and the denominator is the number of days in the entire holding period. Second, the appreciation attributable to the period the decedent held the property prior to January 1, 1977 is calculated. The actual appreciation of the asset, defined as the excess of the asset's fair

---

42. I.R.C. § 1023(h)(2)(E)(i) defines "marketable bond or security" as "any security for which, as of December 31, 1976, there was a market on a stock exchange, in an over-the-counter market, or *otherwise*" (emphasis added). It has been suggested that the use of the term "otherwise" would permit, for example, stock in a closely held corporation to be treated as a marketable security. *See* Stansbury & Blazek, *Revamped Basis Rules for Inherited Property Have Far-Reaching Implications*, 46 J. Tax 14, 15 n.1 (1977) [hereinafter cited as Stansbury & Blazek]. This would seem particularly doubtful, though, insofar as the Committee Report refers to marketable bonds and securities as those 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 be readily obtained from established brokerage firms; and units in a common trust fund." Conference Committee Report, *supra* note 33, at 613.

43. Only the fair market value of property on the date of decedent's death is used for purposes of determining adjustments in the carryover basis of property and not the alternate valuation date of I.R.C. § 2032. When qualified real property is involved, however, the special valuation rule for farms or other closely held businesses, I.R.C. § 2032A, can be elected. Conference Committee Report, *supra* note 33, at 613. The decedent's holding period until his death is tacked on to that of the recipient's. I.R.C. § 1023(h)(2)(E)(ii).

A proposed conforming technical amendment to § 1023 would be added to provide that, notwithstanding a shortened combined actual holding period of a decedent, his estate and the heir, all carryover basis assets would be deemed to have been held for the requisite period sufficient to warrant long term capital gain treatment. H.R. 6715 § 3(c)(4), 95th Cong., 1st Sess. (1977), *as described in* [1977] 6 FED. TAXES (P-H) ¶ 59,415.1 at 59,416.59.

44. Conference Committee Report, *supra* note 33, at 612.

market value at death over the recomputed basis (adjusted basis at death plus all depreciation actually taken, thus roughly equivalent to the purchase price), is multiplied by the same fraction. The sum of the two calculations equals the addition to the decedent's basis under the first adjustment.[45] Congress has made this special valuation mandatory for all property other than marketable bonds and securities, even when the December 31, 1976 fair market value can be established.[46]

Example 1[47]

Assume these facts: Depreciable property was acquired ten years before decedent's death and six years before January 1, 1977. It was acquired at a cost of $19,000 and was depreciated at a constant rate of $900 per year. The fair market value at date of death was $36,000.

1.	Fair market value at date of death	$36,000
2.	Adjusted basis at date of death	$10,000
3.	Excess of fair market value over adjusted basis	$26,000
4.	Depreciation, amortization, or depletion to date of death	$9,000
5.	Appreciation of property until date of death (line 3 less line 4)	$17,000
6.	Number of days in holding period of asset before January 1, 1977	2,190
7.	Number of days in total holding period of asset	3,650

45. I.R.C. § 1023(h)(2)(B).

46. Conference Committee Report, *supra* note 33, at 613.

47. [1977] 4 FED. TAXES (P-H) ¶ 31,556 (unofficial example). The mandatory nature of the special adjustment for property other than marketable bonds and securities eliminates the need for obtaining an appraisal of property prior to January 1, 1977; nevertheless, many taxpayers will wish they could trace back, because the assumption of uniform appreciation of an asset may work an enormous hardship. Assume, for example, that the decedent went into business in 1946 at a cost to himself of $500,000. For the purpose of this example, we can disregard any depreciation. The business prospered in the post-war boom and by 1974 was worth $5,000,000. Thereafter, it topped out, and when the decedent died in 1977, it was still worth $5,000,000. His son inherited the business and stayed at it until 1996, when he sold it. Employing the special calculation, only 60% of the $4,500,000 appreciation will be attributable to the pre-January 1, 1977 period, whereas tracing would reveal that in fact all of it occurred prior to 1976. Similar calculations over shorter periods of time can also be constructed showing a taxpayer realizing substantial appreciation of an asset prior to January 1, 1977, with the period thereafter contributing not at all to the enhancement in value of the asset.

8. Fraction composed of line 6 over line 7 .... $\frac{2190}{3650}$ = 3/5

9. Appreciation of the property before January 1, 1977 (line 5 multiplied by line 8) $10,200

10. Depreciation, amortization, and depletion attributable to holding period before January 1, 1977 (line 4 multiplied by line 8) $5,400

11. First adjustment to basis (line 9 plus line 10) $15,600

B. *Adjustment for Federal and State Estate Taxes, Section 1023(c)*

The basis of each carryover basis asset is increased by the portion of federal and state estate taxes[48] which is attributable to the appreciation of that asset. The total amount of such taxes is multiplied by a fraction—the "net appreciation",[49] or the excess of the fair

48. The term "federal and state estate tax" includes the tax imposed by § 2001 or § 2101, reduced by any credits allowable against the tax. I.R.C. § 1023(f)(3)(A). There is an additional requirement that the estate actually pay the tax or be liable for it. I.R.C. § 1023(f)(3)(B). If someone other than the estate is liable for or pays the tax this adjustment is not allowed.

49. "Net appreciation" is defined in I.R.C. § 1023(f)(2) as the amount by which the fair market value of such property exceeds the adjusted basis of such property immediately before the death of the decedent for purposes of computing the adjustment to basis for the fair market value of the asset on December 31, 1976 (first adjustment). Thereafter, the adjusted basis of the asset is further adjusted to take into account any previous adjustments. In other words, the adjusted basis of an asset fluctuates to take into account whatever adjustments to basis have preceded it. The example given in the Committee Report to illustrate the application of the adjustments to each successive adjustment in determining the carryover basis is as follows:

> Assume that the decedent dies in 1977 with personal effects with a fair market value of $10,000 and an adjusted basis of $50,000 and stock with a fair market value of $390,000 and a basis of $39,000. His will leaves his entire estate to his surviving spouse. If it is assumed that there are no funeral or administration expenses, there will be a gross estate of $400,000, a marital deduction of $250,000, and a taxable estate of $150,000. In this case, there is a basic tax of $38,800 less a credit of $30,000 leaving an estate tax of $8,800.
>
> Assume in this example that the State death taxes paid by the widow are equal to the maximum State death tax credit and that the entire amount is subject to tax. Since the taxable estate in this case is $150,000, the "adjusted taxable estate" will be $90,000. Consequently, the maximum amount of the State death tax credit is $400 and the net estate tax is $8,400.
>
> Assume that the executor makes the election to exclude all of the personal assets from carryover basis property. Because of the marital deduction, $250,000 of the $400,000 of gross estate is deemed to be not subject to tax. Of the remaining $150,000, $3,750 ($10,000 multiplied by $150,000 divided by $400,000) is deemed to be personal effects. Thus, the portion of the carryover basis property (i.e., the stock) which is

market value over the adjusted basis being the numerator, and the fair market value of all carryover basis property subject to such taxes being the denominator.[50]

Example 2

In Example 1, the "net appreciation" is obtained by subtracting the net adjusted basis (line 11) from the property's fair market value—$36,000 minus $15,600 equals $20,400. Assume that the total amount of federal and state estate taxes is $2,000 and that the total amount of carryover basis property subject to taxes is $36,000. The computation for the second adjustment is:

$$\$2,000 \times \frac{\$20,400}{\$36,000} = \$1,133.33$$

Thus, the basis of the carryover basis property is increased by $1,133.33 to $21,533.33.

C. *Minimum Basis Adjustment, Section 1023(d)*

The basis of all carryover basis assets is increased to a minimum of $60,000 in the aggregate.[51]

---

subject to tax is $146,250 ($150,000 minus $3,750). The adjusted basis of that carryover basis property is $14,625 ($146,250 multiplied by $39,000 divided by $390,000). Consequently, the amount of appreciation in the carryover basis property is $131,625 ($146,250 minus $14,625). Thus the basis of all carryover basis property is increased by $7,371 ($131,625 multiplied by $8,400 divided by $150,000) to $46,371 ($39,000 plus $7,371).

The basis of all carryover basis property is then increased to a minimum basis of $60,000. Since the personal effects are not considered carryover basis property by reason of the executor's election, the basis of these assets does not count toward the minimum basis of $60,000. As a result, the basis of the stock is increased by $13,629 to $60,000.

Finally, the basis is further increased by any State inheritance or estate taxes paid by the recipient with respect to the appreciation on the carryover basis property. After the other adjustments permitted under your committee's bill, the appreciation in the carryover basis property is $330,000 ($390,000 less $60,000). The portion of the State death tax allocable to the appreciation in the carryover basis property is $330 ($330,000 multiplied by $400 divided by $400,000). Consequently, the basis of the carryover basis property is increased from $60,000 to $60,330.

House Committee Report, *supra* note 17, at 42-43.

50. House Committee Report, *supra* note 17, at 39.

51. I.R.C. § 1023(d).

Example 3

Assume that the adjustments in Examples 1 & 2 were to the only asset in the decedent's estate. The carryover basis would be increased to $60,000.

If there is more than one asset, and if the aggregate bases of all carryover basis assets are less than $60,000, the amount by which $60,000 is greater than the aggregate bases will be allocated to each asset. The excess of $60,000 over the aggregate bases is multiplied by a fraction, the numerator being the net appreciation in value of the specific item for which the adjustment is being calculated, and the denominator being the net appreciation in value of all carryover property.[52] Only assets which are in fact carryover basis assets are used to determine the "aggregate bases." Neither personal property and household effects up to $10,000, excluded pursuant to the executor's election, nor insurance on the decedent's life will be included in computing the aggregate bases.[53]

Example 4

Assume that a decedent held three carryover basis assets at his death with aggregate bases of $40,000. Assume further that the net appreciation of asset A, after the first and second adjustments, was $15,000, while the net appreciation in value of all three assets, after the first and second adjustments, was $50,000. The amount of minimum bases allocated to asset A would be computed as follows:

$$(\$60{,}000 - \$40{,}000) \times \frac{\$15{,}000}{\$50{,}000} = \$6{,}000$$

The third adjustment, $6,000, is added to the basis of the asset as adjusted by the first two steps. The adjusted basis of asset A after the third adjustment is $21,000 ($15,000 plus $6,000).

Naturally, if the first two adjustments boost the aggregate bases

52. I.R.C. § 1023(d)(1). For purposes of this adjustment, as mentioned earlier, the basis of household property or personal effects can never be greater than their fair market value. I.R.C. § 1023(d)(2). Additionally, for purposes of this adjustment, if the decedent was a nonresident alien at the time of his death, the carryover basis property acquired from him is not eligible to receive any increase in basis under the third adjustment. I.R.C. § 1023(d)(3).

53. House Committee Report, *supra* note 17, at 8.

of all carryover basis property to $60,000 or more, no further adjustment is allowed under the minimum basis rule.

D. *Adjustment for State Succession Taxes, Section 1023(e)*

The fourth and final adjustment to the basis of carryover basis property is an increase by an amount equal to the estate, inheritance, legacy or succession taxes the recipient actually pays on that portion of the property attributable to the net appreciation.[54] This adjustment is calculated by multiplying the aggregate amount of such taxes by a fraction in which the numerator is the net appreciation in the value of the property and the denominator is the fair market value of all taxable property acquired by the recipient.[55] Section 1023(e) requires that the recipient of the property actually pay the tax to be eligible for an adjustment. If, under the terms of a will, the succession taxes are to be paid out of the residue, there will be no fourth adjustment.

Example 5

Assume the adjusted basis of a single carryover basis asset, Asset B, is raised because of the minimum basis adjustment to $60,000. Assume further the fair market value at the decedent's death of the asset in question is $240,000 and the total amount of state succession taxes paid by the recipient of the asset is $300. The portion of the state taxes allocable to the appreciation is computed as follows:

$$\$300 \times \frac{(\$240{,}000 - \$60{,}000)}{\$240{,}000} = \$225$$

Thus, the fourth adjustment to Asset B raises its adjusted basis to $60,225 ($60,000 plus $225).

Overall Limitations on Adjustments to Carryover Basis Property

Each carryover basis asset must be separately taken through these four adjustments.[56] Thus, netting of appreciated and depre-

54. I.R.C. § 1023(e).
55. I.R.C. § 1023(e)(2)(A), (B).
56. House Committee Report, *supra* note 17, at 38.

ciated property so as to reach an aggregate unrealized appreciation for the whole estate is impermissible.

When an adjustment does not apply, the asset is taken directly to the next adjustment.

Example 6

Assume that the aggregate bases of the carryover basis assets in the decedent's estate is $100,000. The third adjustment, the minimum basis adjustment, is unnecessary, and the computation would advance to the fourth adjustment.[57]

Section 1023 adjustments to the carryover basis for any taxes paid by either the estate or the beneficiary can only be made if the property is "subject to tax."[58] Property which passes under a charitable or marital deduction is not considered "subject to tax."[59] Therefore, the taxes which are attributable to such property cannot be used to increase the basis.

Example 7

Assume that the decedent's adjusted gross estate is $1,500,000 and that he has provided in his will for the maximum marital deduction allowable under section 2056 for his surviving spouse. Provided that no inter vivos gifts have been made to reduce the estate tax marital deduction, the decedent would be permitted a marital deduction of $750,000. This amount, to the extent it is actually used to fund the marital bequest, will not be deemed "subject to tax" for purposes of determining the increase to the carryover basis of the decedent's assets under adjustments two and four.

Example 8

Assume in Example 7 that the decedent left one-half of his estate to his church and that the total amount qualified for a charitable deduction under section 170. Only the federal estate taxes or state inheritance taxes attributable to the appreciation of the remaining 50% of the decedent's estate, the portion

57. Stansbury & Blazek, *supra* note 42, at 15.

58. I.R.C. §§ 1023(c), (e).

59. I.R.C. § 1023(f)(4). The Committee Report states that only property "actually used to fund the charitable or marital bequest will [not] be deemed 'subject to tax.'" House Committee Report, *supra* note 17, at 40.

deemed "subject to tax," can be used to increase the basis of the decedent's carryover basis property.

Example 9

Assume the decedent made specific bequests to his children and left the residue of his estate to his surviving spouse, but provided that all administrative expenses and estate taxes were to be paid out of the residue. Even though the expenses and taxes are satisfied from the residue bequeathed to the wife, property used to pay the expenses does not qualify for the marital deduction, and consequently such property is "subject to tax" for purposes of the second adjustment.[60]

The Committee Report indicates that, in addition to marital and charitable deduction property, a surviving spouse's one-half interest in community property will not be considered "subject to tax" since it is not includable in the decedent's gross estate.[61] Thus, no adjustments can be made to the basis of such property.[62] Property qualifying for the exclusion for transfers to orphans under section 2067, however, apparently will be considered "subject to tax."[63]

The allowable adjustments under section 1023 are also affected when property subject to a mortgage is devised. Section 2031 defines gross estate, for purposes of computing the federal estate tax, as including the full fair market value of the property. Section 2053 permits the amount of the mortgage for which the estate is liable to be deducted from the gross estate for purposes of computing federal estate tax. If, however, the estate is not liable for the mortgage, for example, on a non-recourse debt, the property is included in the gross estate net of the indebtedness, that is, the fair market value of the property is reduced by the amount of the mortgage.[64]

---

60. House Committee Report, *supra* note 17, at 40.

61. *Id.*

62. *Id.* Prior to 1977, the surviving spouse's one-half interest in community property received a stepped-up basis equal to the stepped-up basis given the half received from the decedent. I.R.C. § 1014(b)(6). It has been suggested that the effect of allocating the entire basis adjustment to the decedent's half of community assets penalizes the survivor insofar as "under existing practice, sales of community assets to raise funds for taxes, administration expenses and community debts involve both halves of the community assets and the surviving spouse is involuntarily burdened with reported gain realized as to her community half of each community asset sold by the personal representative." Covey, *Estate and Gift Tax Revision (Part 1)*, 4 TAX ADVISOR 219 (1973) [hereinafter cited as *Estate and Gift Tax Revision*].

63. House Committee Report, *supra* note 17, at 40.

64. *Id. But see* H.R. 6715 § 3(c)(2), 95th Cong., 1st Sess. (1977), *as described in* [1977]

Section 1023 similarly provides that when the estate is not liable for the mortgage, the fair market value of the property will be reduced by the amount of the mortgage or indebtedness (for purposes of calculating the second, third, and fourth adjustments).[65]

Example 10

Assume the decedent's gross estate contained a parcel of real estate with a fair market value of $100,000, a basis of $20,000 and subject to a mortgage of $25,000. Assume further that the decedent's estate was not liable for the mortgage. For purposes of computing the adjustments for taxes paid, only $75,000 will be treated as includible in the decedent's gross estate. The fair market value, $100,000 minus the amount of the non-recourse mortgage, $25,000, equals $75,000.

Example 11

Assume that in the preceding example the decedent's estate had been liable for the mortgage. Section 1023 would treat the full fair market value of the property, $100,000, as includible in the decedent's gross estate for purposes of computing the adjustment to the basis of the property as a result of the taxes paid thereon, with no diminishment.[66]

SECTION 1023 AND RELATED SECTIONS

A. *Pecuniary Bequests Satisfied with Carryover Basis Property*

Prior to the Tax Reform Act of 1976, the satisfaction of a pecuniary legacy with appreciated property was considered a taxable exchange resulting in a gain or loss to the estate.[67] The legatee took a basis in the property equal to its value at the time of distribution and the estate received a step-up in basis to the date of death. Thus,

---

6 FED. TAXES (P-H) ¶ 59,415.1 at 59,416.58, which would provide that nonrecourse debts are not to be taken into account for purposes of the second adjustment, as a reduction either of the appreciation of the property or its fair market value includable in the gross estate.

65. I.R.C. § 1023(f)(4). The House Committee Report states that the value of the asset is determined net of any indebtedness *regardless* of whether the estate is liable or not on that amount. House Committee Report, *supra* note 17, at 40.

66. Though not expressly stated, this is the logic of I.R.C. § 1023(g)(4)(B). Since under the Committee Report it is irrelevant whether the estate was personally liable for the debt, the result in this case, according to the Committee Report, would be the same as in Example 10.

67. Treas. Reg. § 1.1014-3(a) (1960).

the estate recognized only the gain attributable to the period between the decedent's death and distribution.

Section 1040, adopted in the Tax Reform Act of 1976, similarly provides that the only gain an estate will recognize by satisfying a pencuniary legacy with appreciated carryover basis property is the amount by which the fair market value on the date of distribution is greater than the value of the property for estate tax purposes.[68] The result is the same when a trustee of a trust satisfies a pecuniary legacy with carryover basis assets.[69] The legatee in both situations will take as his basis the carryover basis of the property, plus an amount equal to any gain recognized to the estate or trust on the exchange.[70]

Example 12

Assume the decedent's executor receives negotiable bonds owned by the decedent at his death with a basis of $5,000. At the decedent's death, these bonds had a value of $10,000. The date of the decedent's death is also the estate tax valuation date in this case. Thereafter, the value of the bonds increased; on the date they were distributed to the decedent's legatee, they were worth $15,000. Under Section 1040, the estate will realize a capital gain of $5,000, the gain which occurred after the decedent's death.

This rule will also apply where the estate satisfies a "pecuniary bequest formula"[71] with appreciated carryover basis assets.[72]

B. *Limitation on Increasing Basis for Inter Vivos Gifts*

After December 31, 1976, the basis of inter vivos gifts in the hands of the donee will parallel[73] the basis in gifts received from a dece-

68. I.R.C. § 1040(a). Thus, the harshness of the result which would otherwise befall the estate is avoided (for example, without the old step-up in basis, the estate would have to recognize gain or loss on the transaction, as before, without the mitigating effect of the stepped-up basis in the decedent's assets).

69. I.R.C. § 1040(b).

70. I.R.C. § 1040(c).

71. Under a pecuniary bequest formula, the surviving spouse is given the right to receive a certain dollar amount represented as a percentage of the decedent's entire estate. House Committee Report, *supra* note 17, at 44-45.

72. No loss that may have occurred between the estate tax valuation date and the date of distribution, however, is recognized. *Id.* at 37.

73. Inter vivos gifts are not entitled to a basis adjustment to their fair market value as of December 31, 1976, because such property is not acquired from a decedent.

dent. Thus, the donee of an inter vivos gift will no longer take the donor's basis increased by the full amount of any gift taxes paid thereon. An increase to the donor's basis will only be allowed on the portion of the gift tax attributable to the net appreciation of that gift.[74] For gift tax purposes, the net appreciation is the difference between the gift's fair market value and the donor's adjusted basis immediately prior to making the gift.[75]

Example 13

Assume that the donor's adjusted basis in stock given to his sister is $10,000 and that the fair market value of the stock at the time of the gift is $20,000. Since the net appreciation of the gift is one-half of the total value, only the taxes attributable to one-half the value may be added to the donor's basis by the donee.

C. *Information Required to be Furnished by Decedent's Executor*

Prior to the Tax Reform Act of 1976, a beneficiary had little reason to inquire into the basis of the decedent's assets, since the beneficiary would receive a basis stepped-up to the fair market value at the applicable estate tax valuation date. Under section 1023, however, knowledge of the decedent's basis has become important. Congress requires, therefore, that each executor provide both the Internal Revenue Service and the decedent's heirs with information as to the adjusted carryover basis of every asset in the estate.[76]

---

74. I.R.C. § 1015(d)(6)(A).

75. I.R.C. § 1015(d)(6)(B).

76. I.R.C. § 6039A. The statement required to be furnished to those acquiring property from a decedent's estate must be in writing. I.R.C. § 6039A(b). Unless the regulations will provide otherwise, every executor of every estate, no matter how small, will have to provide information concerning the decedent's adjusted basis in his assets.

As related *infra,* in recognition of the difficulty involved in ascertaining the decedent's unadjusted carryover basis before his death, § 1023(g)(3) provides that where such basis is unknown, the fair market value of the property on the decedent's acquisition date will serve as his basis. But even the approximate date of purchase may be unascertainable. A technical amendment to § 1023 has, therefore, been proposed which would eliminate the need to ascertain the decedent's unadjusted basis in tangible personal property for purposes of the "fresh start" adjustment. The formula proposed in the bill would require that after determining the value of the property on the date of the decedent's death, the minimum basis would be determined by discounting the value of each asset at an assumed rate of appreciation occurring after December 31, 1976. The rate proposed in the bill was set at approximately eight per cent annually. H.R. 6715 § 3(c)(1), 95th Cong., 1st Sess. (1977), *as described in* [1977] 6 FED. TAXES (P-H) ¶ 59,415.1 at 59,416.57.

Nevertheless, the implication of such a technical amendment is that every executor, re-

Failure to provide the Service with such information, unless due to reasonable cause rather than willful neglect, will subject the executor to a penalty of $100 per failure, up to a maximum aggregate penalty of $5,000.[77] Failure to inform decedent's beneficiaries will subject the executor to a penalty of $50 per failure, up to a maximum aggregate penalty of $2,500.[78] The Service is expected to define what constitutes a reasonable effort to provide the necessary information, thus relieving the executor who makes a good faith attempt but fails.[79]

SOME PROBLEMS UNDER SECTION 1023

A. *Determining Decedent's Basis*

The starting point for determining the section 1023 carryover basis is the decedent's unadjusted basis. As previously indicated, section 1023 simply states that the executor shall determine the decedent's basis prior to his death; if that is not known, the fair market value of the property on the date of decedent's acquisition will serve as his unadjusted basis.[80] Unfortunately, most taxpayers have not maintained adequate records of their basis in particular assets since proof of actual cost basis had little utility before the Tax Reform Act of 1976.[81] Thus, the central problem for an executor under a carryover basis system is to determine the decedent's unadjusted or cost basis in specific assets.[82]

---

gardless of the estate's size, will still have to provide information concerning the decedent's adjusted basis in his assets, albeit relieved to a certain extent of his statutory requirement to ascertain the decedent's actual cost basis through the employment of yet another calculation. It is unclear from the description whether the use of the formula will be elective or mandatory.

77. I.R.C. § 6694(a). It is unclear from the statute and the Committee Reports whether a penalty for each failure refers to a failure with respect to each asset or each individual acquiring assets from the decedent's estate, though probably the former is meant.

78. I.R.C. § 6694(b).

79. House Committee Report, *supra* note 17, at 46.

80. I.R.C. § 1023(g)(3).

81. Under the new carryover manner of handling a decedent's assets, it cannot be gainsaid that taxpayers without good counseling, either from an attorney or an accountant, will be penalized as a result of their insouciant attitude towards maintaining records.

82. The Service and Congress are keenly aware of this problem, yet the proposed method of handling an unknown basis in tangible personal property is to resort to further calculation. The executor who finds himself unable to ascertain the decedent's unadjusted basis but able to determine the fair market value at acquisition will be required to take each asset through four separate calculations while the less fortunate executor who can ascertain neither the decedent's basis nor its fair market value when acquired, will employ five calculations. *See*

The tax consequences under section 1023 of liquidating a decedent's assets also require an executor to consider the decedent's basis. Prior to the Tax Reform Act of 1976, an executor could choose to liquidate the least desirable assets to pay the debts, taxes, and administration expenses of the estate without regard to their cost basis. These bases must now be determined to see what additional taxes will have to be paid.[83] The determination is time-consuming,

---

note 76 *supra*. The utility of this additional calculation, however, is questionable. Roughly 90% of all decedents die with assets whose fair market value does not exceed $60,000. This means that for at least 90% of the estates currently required to file basis statements under § 6039A, the adjustments under § 1023(b) and § 1023(c), the first two adjustments, serve no useful purpose because each estate is entitled to a minimum aggregate carryover basis of $60,000 in all its assets pursuant to § 1023(d). Whenever such an estate is comprised of assets whose basis cannot be determined by the executor, the calculations used to assign cost basis will be equally useless.

The congressional intent evident in the adjustment for a minimum basis suggests that Congress did not wish to see small estates burdened with income tax consequences upon subsequent disposition, notwithstanding the lack of any real distinction between appreciation of assets with relatively little value and appreciation of assets with great value. There is also no reason to burden them with basis calculations.

A sensible approach to the executor's problem of ascertaining the decedent's basis in his assets is to eliminate the necessity for ascertaining it in most cases. Consequently, few basis returns would actually have to be filed, analogous to the limited filing requirement associated with the estate tax return. A variant of this would be a requirement that each executor of an estate whose assets did not exceed $60,000 (actually, $70,000—$10,000 for personal and household effects excluded under § 1023(b)(3) and $60,000 of other carryover basis assets) merely file a statement with the Service listing the assets in question, with a declaration that their aggregate bases did not exceed $60,000. To the extent that the aggregate bases did not exceed $60,000, the excess of $60,000 over the aggregate bases could be ratably spread over the assets, and the portion remaining after it had been allocated to an asset whose basis equalled its fair market value further distributed among the remaining assets.

To apply the § 1023(e) increase to basis for state inheritance taxes actually paid by the recipient, some arbitrary percentage of the taxes actually paid would have to be substituted and allocated ratably among the assets because there would not be a calculation of the net appreciation of the assets. This would be a relatively insignificant adjustment; an estate of this size would not generate a great amount of tax liability, but a portion of it would have to be added to the recipient's basis. The exemption from filing a basis report could be made elective, although it is difficult to believe that it would not be used, particularly in view of the penalities now imposed for failure to furnish information concerning a decedent's basis in his assets.

As for the 10% or fewer of the estates whose assets exceed $60,000, a solution comparable to that proposed in H.R. 6715, 95th Cong., 1st Sess. (1977), *as described in* [1977] 6 FED. TAXES (P-H) ¶ 59,415.1 at 59,416.57, for tangible personal property with an unknown basis could be employed.

83. *Hearings, supra* note 3, vol. 3 at 2879, 2881 (statement of William A. Stark). It is an interesting question whether the Service or the beneficiaries will be bound by an executor's determination of basis. Assuming that they are not bound thereby, one can expect the Commissioner to argue for a lower basis while the beneficiaries will insist that the basis be higher. Assuming the unadjusted basis is finally ascertained and the adjustments to the carryover

probably futile and will undoubtedly prolong the administration of the estate.[84] Even if the cost basis of the decedent's assets could be ascertained, an executor would probably be unwilling to make any distribution prior to the auditing of all the income tax returns for the estate to insure that the basis determinations had been accepted by the Service. This would further delay the estate's administration.[85] Additionally, despite attempts to determine the decedent's basis in assets, the executor might be uncertain as to the actual cost. He might then be open to the charge that he underestimated the cost and therefore paid too much tax, which, in turn, would give rise to a beneficiary's surcharge claim against him.[86]

Since marketable stocks and securities purchased on or before December 31, 1976, receive a step-up to their December 31, 1976 value, the decedent's cost basis in such property need not be ascertained. Stocks and securities purchased after December 31, 1976, as well as other carryover basis property, however, will be subject to these basis determination difficulties.

B. *Making Distributions Under Section 1023*

Prior to the Tax Reform Act of 1976, distribution among residuary legatees of assets receiving a stepped-up basis posed minimal problems. The choice between distributing the assets in kind, or selling them and allocating the proceeds, was generally not made with tax consequences in mind. Section 1023, however, has necessitated a change in the executor's approach when the decedent has assets with differing bases.

Example 14

A husband, having provided for his wife, wishes to divide the residue of his estate equally between his son and his daughter. The residue contains stock in a closely held corporation worth

---

basis assets made, amended fiduciary income tax returns for years in which carryover basis property is sold may be necessary after the federal estate tax return has been audited.

> [S]ince the ultimate sale price will not be known on distributed assets, the executor will have to calculate and report two different possible bases for any asset held on December 31, 1976, which qualifies for the "fresh start" rule—one to be used in the event of sale at a gain and one to be used in the event of sale at a loss.

Stansbury & Blazek, *supra* note 42, at 18.

84. Stansbury & Blazek, *supra* note 42, at 18.
85. *Id.*
86. *Id.*

$1,000,000 and bonds in the same corporation with a par value of $1,000,000 and worth their par value. Assume that the decedent had received the stocks and bonds pursuant to a reorganization of the corporation. Assume further that the decedent's cost basis in the stock was zero. In the event that one child receives the bonds and the other the stock, a subsequent disposition by the one who received the stock would result in a considerable income tax bite.

Assuming that the stocks and bonds are not equally divisible, which is often the case, the only way for the executor to avoid any liability for failure to "equally" distribute the decedent's estate would be to sell all the assets prior to distribution and allocate the cash, even though this may have been contrary to the testator's wishes.[87] The decedent could, however, eliminate this problem by directing in his will which property is to be distributed to which individuals.

Similar difficulties arise when a pecuniary legacy is satisfied with appreciated carryover basis property; absent direction from the testator, an executor faces a dilemma regarding such distributions. Someone who receives low basis property in satisfaction of a pecuniary bequest may complain that the executor has breached his fiduciary duty to treat all legatees equally since others received higher basis property with the attendant tax advantages.[88] This problem has led knowledgeable estate planners to seriously consider including a clause in a will or trust to the effect that the executor, in making allocations, shall take into account the basis of property for income tax purposes.[89]

If assets have greatly appreciated between the decedent's death and the time of distribution, the residuary legatees may not want pecuniary legacies satisfied with those assets since the capital gains tax will be charged against the residuary.[90] But the tax consequences to the residuary legatee of a low basis asset may cause him to accept the above result.[91]

The executor may encounter an additional problem in the alloca-

87. *Hearings, supra* note 2, at 2886 (statement of Arthur White).
88. Stansbury & Blazek, *supra* note 42, at 17.
89. *Id.* at 19.
90. *Id.* at 17.
91. *Id.*

tion of basis to assets which he distributes. In non-community property states, it is not known at the date of the decedent's death what property will pass to the surving spouse; thus, the property entitled to the basis increase under section 1023 is unknown, although sales of carryover basis assets are being made to pay estate taxes.[92]

C. *Section 1023 and the Marital Deduction*

In the typical marital deduction trust, it may be advantageous for an executor to distribute most of the high carryover basis assets to the surviving spouse. Upon the sale of those assets, the surviving spouse will have ready cash without significant tax consequences. The estate will receive the maximum benefit from the remaining assets, since they are "subject to tax," and will be adjusted upwards for taxes paid thereon. The opposite may be true, however, when parties other than the surviving spouse are principally to be benefitted; they will receive substantially all of the high carryover basis property. If, however, the executor has discretion to allocate high and low basis assets, the estate invites an attack, albeit of dubious merit, on the theory that the interest passing to the surviving spouse is so speculative as to be deemed unascertainable at the date of decedent's death and therefore constitutes a non-deductible terminable interest.[93]

D. *Section 1023 and the "Mushroom" Effect*

When an estate consists primarily of a going business that has grown significantly since the intital investment, section 1023 may create a "mushroom effect" due to the lack of nonbusiness assets available to pay the estate tax.

---

92. *Estate and Gift Tax Revision, supra* note 62, at 219.

93. This is the argument posed in Rev. Proc. 64-19, 1964-1 C.B. 682, with respect to a pecuniary marital bequest formula permitting or requiring the executor to satisfy the bequest in kind with assets whose values are to be determined according to their final estate tax values. It is true, however, that Rev. Proc. 64-19 dealt only with fair market value and not with basis allocation. *See* Estate of Charles W. Smith, 66 T.C. 415 (1976), where the Tax Court, in approving the use of an "equalization clause," said that interests are terminable when "the indefeasible quality or character of the surviving spouse's interest cannot be determined as of decedent's death," and not simply because "the value or quantity thereof cannot be determined as of the date of death," citing Treas. Reg. § 20.2056(b)-4, which recognizes that the alternate valuation can affect the amount of the marital deduction. *Id.* at 428. The employment of this rationale would tend to limit a 64-19 type attack from applying to the situation where the executor had unlimited discretion to distribute assets irrespective of their bases.

Example 15

Assume a decedent had invested $1,000,000 during his life in a business which was worth in excess of $20,000,000 at his death. Assume that the estate taxes due at the decedent's death were $10,000,000. A portion of the business would have to be sold to pay the tax. But under section 1023, the sale would result in the recognition of a capital gain upon which a tax would have to be paid. A further sale of a part of the business to pay the capital gains tax would result in a further capital gains tax liability, and so on.[94]

E. *Section 306 Stock*

Section 306 is designed to prevent a shareholder who has received stock (for example, preferred or common) from a corporation with earnings and profits, from converting what is essentially a dividend taxable as ordinary income into a transaction where subsequent disposition of his stock would obtain capital gain treatment.[95] It accomplishes this by generally providing that the disposition of "section 306 stock," either by sale or redemption, will result in ordinary income treatment.[96] If the stock is gratuitously transferred, a carryover basis is provided and the section 306 taint "follows" the donee.[97] A commonly employed method of avoiding the section 306 stock taint, however, was for an individual to hold section 306 stock until death. The beneficiary's basis would be determined under section 1014(b) and the stock would no longer have a basis in the hands of the shareholder. The stock would, therefore, lose its taint and receive capital gain treatment upon a subsequent sale.

94. Covey, *supra* note 12, at 835. An estate in this unenviable position would be able to mitigate the problem by stretching out the payments of estate tax over a ten or fifteen year period under I.R.C. § 6166 or I.R.C. § 6166A, provided all the requirements of either section were met. If in the example posed, the estate qualified to elect payments under the installment schedule provided by I.R.C. § 6166, no tax at all would be due for the first five years, but only interest at the rate of 4% on the first one million dollars and the regular rate (now 7%) on the balance. Even this method of payment, requiring only interest to be paid during the first five years, results in an annual charge of $630,000, which could require, though on a lesser scale, the selling off of a portion of the business with the concomitant capital gains tax consequences.

95. I.R.C. § 306.

96. I.R.C. §§ 306(a), (b).

97. I.R.C. § 306(c)(1)(C).

Example 16

A retiring shareholder of a closely held corporation could transfer ownership to his children by selling them the common stock and keeping the preferred stock until his death, at which time it would lose its taint, and the earnings and profits of the corporation could be bailed out at capital gains rates.

With the introduction of section 1023, the mechanism by which section 306 stock formerly lost its taint, namely, the stepped-up basis to fair market value at death, no longer exists. The Commissioner may argue, therefore, that after December 31, 1976, this stock no longer loses its taint at death.[98]

F. *Section 303 Redemptions*

Section 303 generally permits capital gain treatment on distributions of property to a shareholder by a corporation in redemption of stock to pay death taxes, even though the redemption might not qualify for capital asset treatment under section 302. Section 303 is applicable only to the extent the distribution does not exceed the sum of the death taxes, funeral expenses, and estate administration costs. Furthermore, the decedent's corporate holdings must comprise more than 50% of his taxable estate.[99] The use of section 303 has been a valuable estate planning tool since it provides necessary assets with which to pay the tax and administrative expenditures of the decedent's estate. Under the old rules, neither gain nor loss would be recognized on the transaction, provided that the redemption price equaled the value of the shares as of the date of the decedent's death.[100] Under secton 1023, however, it is possible to

---

98. The Committee Report states that the Treasury is supposed to issue regulations concerning the applicability of the "fresh start" rule to certain property the sale of which subjects it to ordinary income treatment, as with property to which §§ 306, 1245, and 1250 apply. Conference Committee Report, *supra* note 33, at 613. Among the proposed technical changes in the Tax Reform Act of 1976 is a provision which will give the Commissioner statutory authority under § 306 to treat the sale or redemption of 306 stock after January 1, 1977, as dividend income to the extent of the decedent-shareholder's ratable portion of the corporation's earnings and profits in excess of the stock's adjusted basis. Since, in virtually all cases, the decedent will not have had any basis in his § 306 stock, the "fresh start" rule will not provide any relief. H.R. 6715 § 3(a)(1), 95th Cong., 1st Sess. (1977), *as described in* [1977] 6 FED. TAXES (P-H) ¶ 59,415.1 at 59,416.56.

99. I.R.C. §§ 303(a), (b)(2).

100. B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 9.40 (3d ed. 1971). I.R.C. § 303(b)(3) now provides that only those with liability to pay or contribute towards taxes or expenses can benefit from section 303.

take a basis in the stock which is less than its fair market value on the date of the decedent's death. Such a redemption will, therefore, cause a taxable gain to the beneficiary or the estate.[101] Although Congress may not have intended this result, a technical amendment apparently will be required to change it.[102]

G. *Partnership Interests Acquired from a Decedent*

A current regulation under section 742, pertaining to the basis of a transferee partner in a partnership interest, provides that the basis of such an interest acquired from a decedent is the fair market value at the applicable valuation date, increased by the decedent's estate's share of the partnership liabilities on that date and reduced to the extent that the value is attributable to items constituting income in respect of a decedent under section 691.[103] Since under section 1023 there is no step-up in basis to the fair market value at death, this regulation is apparently invalid. The net effect of its invalidity would be that the successor to the partnership, unable to increase his basis, could have to recognize gain, on termination of his interest, to the extent of the reduction in liabilities, without having had the benefit of a deduction from ordinary income.[104]

Example 17

Suppose that a decedent's basis in his partnership interest is $110,000, composed of a cash contribution to the partnership of $20,000 and his estate's share of partnership liabilities of $90,000. The date of death value of his partnership interest is $100,000 and there were no net distribution share losses. As-

---

101. *See Carryover Approach, supra* note 20, at 142.

102. A possible alteration of § 303 which would remedy the situation would be:

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

Id. In an attempt to clarify the extent to which § 306 stock would receive capital gain treatment if used in a redemption to which § 303 applies, the proposed technical amendments to § 303 make it clear that, unless the § 306 stock is received by a decedent's estate in a reorganization as a substitute for common stock which would have been eligible for capital gain treatment under § 303, the use of § 306 stock in a redemption to pay death taxes pursuant to § 303 will receive ordinary income treatment. However, no mention was made in the technical changes of property other than § 306 stock used in a § 303 redemption. H.R. 6715 § 3 (a)(2), 95th Cong., 1st Sess. (1977), *as described in* [1977] 6 FED. TAXES (P-H) ¶ 59,415.1 at 59,416.54.

103. Treas. Reg. § 1.742-1 (1960).

104. I.R.C. §§ 731, 752(b).

sume further that the decedent's basis had been reduced by $30,000 for deductions taken after his death, leaving a final adjusted basis of $80,000. Under the new carryover rules, the transferee partner's basis would be the same as the decedent's final adjusted basis, or $80,000. Thus, in the event that the transferee partner decided to sell his partnership interest for $1000, he would have a gain of $11,000, computed as follows:

1.	Gain recognized to the extent of a reduction in partnership liabilities	$90,000
2.	Transferee's basis in partnership interest	$80,000
3.	Excess of gain recognized over adjusted basis (line 1 less line 2)	$10,000
4.	Amount received on sale of partnership interest	$1,000
5.	Gain realized on sale of partnership interest (line 3 plus line 4)	$11,000

Congress was probably not particularly concerned about the practical effects of section 1023 on the disposition of partnership interests; it was the inability to tax appreciation, rather than the desire to recapture tax reductions in basis, which provided the impetus for the new legislation. Congress, nevertheless, did not make such a distinction, and it is therefore likely that the Service will take the position that virtually any event, sale, liquidation, foreclosure, etc., triggers a constructive distribution of cash to the extent that liabilities are reduced. It should be pointed out, however, that such an eventuality is consistent with the notion that an individual acquiring property from a decedent, albeit a partnership interest in this case, for better or worse, will indeed step into the shoes of his predecessor.

Conclusion

The step-up treatment of basis in a decedent's assets was a paradigm of simplicity compared to the current carryover treatment. Although problems of valuation exist under either method, these difficulties are now compounded by extending the valuation inquiry beyond the date of death values. As has been pointed out, however, simplicity and equity are often competing rather than complemen-

tary goals of taxation.[105] Believing that it is more equitable to carryover and adjust a decedent's basis, so that a sale by the donee will trigger the income taxation the decedent avoided, Congress has adopted an exceedingly complex set of rules and calculations to tax the assets in the hands of the donee. Although it is too early to assess the workability of the carryover basis rules, estate planners hope that the regulations and procedural guidelines which have been commissioned in this area will help the many who have grown accustomed to the gentler ways of the recent past.

---

105. Surrey & Brannon, *Simplification and Equity as Goals of Tax Policy*, 9 WM. & MARY L. REV. 915 (1968).