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HOLDING PERIOD OF CARRYOVER BASIS PROPERTY

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#488

College of Commerce and Business Administration
University of Illinois at Urbana-Champaign

FACULTY WORKING PAPERS

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Summary:

The paper calls attention to the fact that there was evidently an error of omission in the Tax Reform Act of 1976. New Section 1023 does not provide holding period rules for property acquired from a decedent dying after 1976. The paper suggests that it is not obvious that this oversight should be corrected if indeed it is an oversight, and also suggests what affected taxpayers might do in the interim, pending possible congressional action.

HOLDING PERIOD OF CARRYOVER BASIS PROPERTY

by

Gerald D. Brighton and Joseph L. Boyd

Before passage of the Tax Reform Act of 1976, a capital asset purchased shortly before death and passing to an estate or heir was considered to have been held for the time period required for long-term capital gain or loss treatment. However, the 1976 Act has left a "No Man's Land" situation with regard to holding period of carryover basis property acquired from a decedent dying after December 31, 1976.

Relevant Code Sections: 1014, 1223, and 1023

There are three relevant code sections. Section 1014 covers the old basis rule for decedents dying before 1977. It provides that the basis of property acquired from a decedent is fair market value at death, or at the alternative valuation date. Specifically cross-referenced to Section 1014 is Section 1223 (11) on holding period. It provides, in effect, that holding period does not matter, gains, and losses will be long-term no matter how short the ownership period. (The technical language which accomplishes this result was suitably amended by the Tax Reform Act of 1976 by substituting nine months for six months to reflect the holding period increase required for long-term in 1977.) The third relevant section is Section 1023 which covers the new rule for carryover basis of property for certain property acquired from a decedent dying after December 31, 1976.

Section 1023 Is Not Cross-Referenced to 1223

The "No Man's land" situation occurs because there is no cross-reference between Section 1223 and the new Section 1023; that is, Section 1223 is not referenced to 1023, or vice versa. Therefore, there is evidently no legislative language which would result in the automatic long-term result that obtained on disposals of property inherited from decedents dying before 1977 under Section 1014. In the absence of such language, the proper treatment would seem to flow from the general rule that basis and holding period go together. That is, similar to the gift rule, where the donee uses the donor's holding period in situations in which he uses the donor's adjusted basis, the decedent's carryover basis would seem to bring with it the decedent's holding period.

Potential Short-Term Capital Loss for Carryover Basis

The practical result of a tacking on holding period rule would be long-term holding period in most instances. Certainly by October 1, 1977, there would be a long-term result for any property the decedent acquired before 1977. The fact situations with which we are concerned are those related to property which a decedent may have acquired in 1977 before his death in 1977. For example, if a decedent acquired a capital asset on February 1, 1977, and died on April 1, 1977, the "old rule," if it applies, would give the new owner a long-term holding period, and therefore a long-term capital gain or loss regardless of how long or short a time he holds the property before disposal. However, because the new carryover basis would be the decedent's basis, originating on February 1, 1977, new Section 1023 would seem to require that February 1 would also be the start

of the holding period for the person inheriting the property. The earliest date that would result in long-term capital gain or loss would be November 2, 1977, nine months and one day past February 1.

It would be hasty to conclude that this is an inequitable situation. The advantage or disadvantage to the new owner depends entirely on whether the property decreases or increases in value. If a sale within nine months of the decedent's acquisition date is at a loss, the short-term capital loss result is favorable as compared to long-term. (It avoids direct offset against long-term capital gain, if any, thereby tending to preserve the long-term capital gain deduction, and it avoids the half-value treatment of long-term capital losses when deducted from ordinary income.) If the sale is at a gain, long-term capital gain obviously tends to be more favorable than short-term.

Was This an Error in the TRA of 1976?

Therefore, it is not an obvious point that the Congress should promptly correct its "error of omission," and cross-reference Section 1023 to Section 1223 to give automatic long-term treatment.

It is of interest that the Congress has already started that amending process. The Technical Amendment Act of 1977 proposed by the House Ways and Means Committee, H. R. 6715, April 30, 1977, contains language indicating in effect that the automatic long-term result was intended in relation to carryover basis property. The bill provides that, notwithstanding a shorter actual combined holding period by the decedent, his estate, and the heir, a capital asset which is carryover basis property is to be considered to have been held by the estate or heir for the

applicable period required for long-term capital gains treatment. This Technical Amendment Act was not included as a part of the Tax Reduction and Simplification Act of 1977, therefore, it is still pending.

We would suggest that, again, it is not obvious that this particular oversight in the Tax Reform Act of 1976 should be corrected. Short-term capital loss is better than long-term. Moreover, it is perhaps illogical that the holding period rules should be different for gifts and inherited property. Given the new unified transfer tax, with very similar basis rules for gifts and inherited property after 1976, it seems reasonable that holding period rules should also be the same.

Advice Pending Possible Amendment

Meanwhile, for situations which do arise in the interim, we would suggest that taxpayers who do inherit property in 1977 with carryover basis, and sell such property within nine months of the decedent's acquisition date, have a right to be governed by their natural biases. Losses should be reported as short-term. The authority for this treatment is the general rule that there is a relationship between basis and holding period. Because of the uncertainty, and since the Technical Amendment Act is still pending, if the property appears to be appreciating in value so that gain is likely, it might be well, unless market factors are too uncertain, to hold past the nine month point before disposing of the property.

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