TESTIMONY OF HOWARD E. ABRAMS BEFORE THE SENATE FINANCE COMMITTEE: SUBCOMMITTEE ON TAXATION AND IRS OVERSIGHT

Chairman Nickles, Senator Breaux, and Members of the Senate Finance Committee: Subcommittee on Taxation and IRS Oversight.

Thank you for inviting me to speak with you today on the issue of the income tax consequences of repeal of the federal estate, gift, and generation-skipping taxes. I am a professor of law at Emory University specializing in the taxation of corporations and partnerships. These comments are my own. However, I undertook this study at the request of The Real Estate Roundtable.

There is broad bipartisan support for repeal of the federal estate and gift taxes. If repeal is forthcoming, though, and a change is not made to the rules governing the basis of property received through the estate of a decedent, repeal of the death taxes will have the effect of exempting substantial unrealized appreciation from all federal taxation, income as well as estate. Accordingly, Congress may seek to preserve taxation of this unrealized appreciation by providing, as to property passing through the estate of a decedent, that the donee will take a carry-over basis in such property, much like a gift is treated under current law rather. In general, such a rule will tax the heirs on the eventual sale of devised property as the decedent would have been taxed had he sold it prior to death; that is, the heirs will step-in-the-shoes of the decedent for income tax purposes.

If the property transferred is encumbered, application of current doctrine to this new regime might impose taxation not when the heirs sell the property but rather when it passes to them from the decedent or from the decedent's estate. Such a result can be easily avoided by enacting language applicable to death-time transfers modeled after current code section 1041, the Code section currently applicable to transfers of property between spouses or ex-spouses. Section 1041, another step-in-the-shoes rule, accomplishes in the context of divorce precisely what a carry-over basis at death rule is intended to accomplish in the context of death-time transfers. The discussion that follows includes a proposal for such statutory language.

A carry-over basis rule can impose substantial hardship on the heirs if devised property is encumbered. Especially in the context of family farms and other real estate holdings, substantial encumbrances are the norm. When such property is transferred in a carry-over basis regime, upon eventual sale of the property the heirs will be required to pay both the lender and the taxes. If the debt is relatively high and the carry-over basis relatively low, it could be the case that these two payments *exceed* the full value of the property. In such circumstances, the heirs would have in fact received *negative value assets*. To ensure that the death-time transfer of property does not result in a net detriment to the beneficiaries, either the amount of the gain could be limited or a partial step-up in basis could be provided for certain specified debt. The discussion that follows includes alternative proposed statutory language for reducing the hardships imposed on the heirs in either of these ways.

Thank you.

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Implications to Real Estate Owners of Estate Tax Repeal and Carry-Over Basis at Death

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Overview

Any tax lawyer will tell you that the best way to minimize income taxes is to die, though few clients are willing to act on that advice. But even those clients who seek to prove their immortality can take comfort that if they depart, the income tax man may be left behind. For individuals with substantial assets and insubstantial planning, the grim reaper can bring a potentially crippling estate tax liability. But for astute taxpayers who hold appreciated assets until death, gains so far deferred become gains forever exempted.

This favorable outcome results from the step-up basis at death rule.[2] Under our current income tax system, death is not a taxable event,[3] which means that those who die

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[2] *See* §1014(a)(1).

[3] *E.g.*, Rev. Rul. 73-183, 1973-1 C.B. 364.

owning appreciated assets are not by the fact of death alone taxed on their accumulated gains. Taxes not visited on the dead, though, would be visited on the survivors were it not for the statutory step-up basis at death.

Thus, if I purchase real estate for $1,000,000 and hold it throughout my life as it appreciates to $5,000,000, I pay no taxes on that appreciation because I have yet to sell or exchange the property. If I continue to hold that property at my death, I will never pay income tax on the $4,000,000 of increased value. Further, my heirs will be treated as if they bought the property for $5,000,000, ensuring that when they sell the property they will pay taxes, if any, only on the increase in value of the property occurring after my death: the $4,000,000 of gain that accrued in my hands is simply untaxed forever. Of course, whether the $4,000,000 of accrued gain escapes the income tax or is captured by it because I sell the property prior to my death, the entire $5,000,000 value of the property will be ensnared by the federal estate tax.

Estate Repeal May Include Carry-Over Basis at Death

President Bush has proposed repeal of the existing federal estate, gift and generation-skipping taxes. By itself, this represents substantial tax reduction benefiting a variety of taxpayers including all those owning assets at death sufficient to generate an estate tax liability; under current law, those are taxpayers with estates of more than $675,000. The current estate tax rates range from 18 percent to 55 percent, with the 55 percent rate applying to estates of $3 million and over. Estates between $10 million and $17,184,000 pay a 5 percent surcharge on amounts in excess of $10 million in order to phase out the benefit of the graduated rates.

There exists broad bipartisan support for repeal of the federal estate and gift taxes not only because repeal represents tax reduction but more generally because of a shared sentiment that taxing income when it is earned and second time when it is transferred is inappropriate double taxation. In addition, by taxing wealth when it is transferred, the federal estate and gift taxes can impose a tax burden when there are no liquid assets with which to pay the tax liability, forcing a sale of farms and small businesses.

However, political realities suggest that repeal of the estate, gift and generation-skipping taxes likely will bring with it some form of income tax alternative to the step-up basis at death rule. Otherwise, untaxed appreciation would escape estate *and* income tax entirely. A *carry-over basis at death rule* would treat my heirs not as if they bought the property for its death-time value of $5,000,000 but rather for the $1,000,000 I actually paid**.** This carry-over basis rule would mean that my heirs step-in-my-shoes for income tax purposes: when they sell the property, they are taxed on the amount of gain that I would have been taxed on had I sold it during life. As a result, if the sale proceeds amount to $5,000,000, the taxable gain will be $4,000,000.

The step-up basis rule likely will be repealed only in part, with some limited step-up continuing to be available. For example, the Kyl-Breaux bill (S. 275) proposes a $2,800,000 step-up cap; other limits, both lesser and greater, have been suggested. Under the Kyl-Breaux bill, for example, if I die holding a piece of real estate with a basis of $1,000,000 and a value of $5,000,000 at my death, my heirs would take a basis in this property of as much as $3,800,000,[4] leaving the heirs with a taxable gain of as little as $1,200,000.

Ensuring Death is Not a Recognition Event

For decedents whose estate consists exclusively of cash and unappreciated property, estate tax repeal is pure tax reduction and the basis rule is irrelevant. Indeed, for taxpayers leaving large estates with significant basis, the trade-off of carry-over basis in exchange for estate tax repeal will be favorable. Even for taxpayers with moderate estates comprised of low-basis assets, the trade-off can be positive. For example, consider the case of a taxpayer who dies leaving a single piece of real estate valued at $5,000,000 and having an adjusted basis of $1,000,000. Under current law, the estate tax burden should be about $2,169,450.[5] If the estate tax is repealed and in exchange the heirs are forced to take a carry-over basis in the property, the income tax burden on a subsequent sale will amount to $800,000 if the gain qualifies as long-term capital gain (or more if the property is subject to the 25% depreciation recapture capital gain rate). Thus, estate tax repeal saves $1,369,450 in federal taxes even with the carry-over basis change. Of course, carry-over basis will also force the taxpayer to recognize gain for state income tax purposes (in

[4] Senate bill 275 proposes a partial step-up basis rule limited to $2,800,000 of step-up apportioned over all property gratuitously transferred by the decedent at death and during life (and still held by the donee at the moment of the donor's death). Without knowing the gross unrealized appreciation in all property transferred by the donor, it is impossible to know the precise basis that any particular asset will take in the hands of the donee under the terms of this bill.

[5] The estate tax liability on $5,000,000 is $2,390,000 less the current credit of $220,550, for a net estate tax liability for $2,169,450. This liability might be reduced if the decedent devised some of the property to charity or to a surviving spouse; it could be greater if the decedent made significant life-time transfers.

those states having an income tax), so that the effective rate of taxation on the gain might be somewhat larger.

If the property is encumbered, though, repeal of the estate tax coupled with carry-over basis can be much worse for the heirs. Suppose this piece of real estate is encumbered by a nonrecourse debt of $4,500,000, so the decedent's equity is but $500,000. In such circumstances there is no estate tax liability at all under current law because the decedent’s taxable estate value is determined net of the debt, and estates less than $675,000 in net value are not subject to estate tax under current law. However, if the heirs were burdened by a carry-over basis, the income tax liability again would be at least $800,000. That is, repeal of the estate tax and imposition of a carry-over basis rule would increase net taxation from $0 to at least $800,000. Even under the Kyl-Breaux partial step-up bill, the heirs would be saddled with an income tax liability of at least $240,000 despite receiving no benefit from the estate tax repeal.

And what is worse, *much of that tax liability might be due not when the heirs sell the property but rather at the moment of the decedent's death*. To be sure, no one yet is proposing to treat death as taxable event under the income tax. However, if the current step-up basis rule is changed to a carry-over basis rule, death likely will be a taxable event for those who die holding heavily mortgaged property. And while Congress could avoid that result by enacting specific language to the contrary, such a fix might (in limited circumstances) be worse than the cure. To understand why, we must first look at the tax treatment of sales and gifts of mortgaged property under current law.

When property is encumbered by indebtedness in excess of adjusted basis, transfer of the property can result in uncomfortable tax consequences for the transferor. Debt may exceed adjusted basis because the owner has borrowed against unrealized appreciation in the property, because depreciation has been claimed at a rate faster than the mortgage has been paid down, or by a combination of the two. Regardless of the cause, transfer of such excess mortgaged property generally will produce gain to the transferor.[6]

Thus, if a taxpayer owns property with adjusted basis of $1,000,000, current fair market value of $5,000,000, and subject to a nonrecourse debt of $4,500,000, sale of the property for $500,000 cash (subject, of course, to the debt) yields a gain to the seller of $4,000,000 because, for computing the seller's gain, both the actual cash received as well as the debt transferred are treated as sales proceeds.[7] This taxation is appropriate because the seller has pocketed not only the $500,000 cash received at closing but also the $4,500,000 received previously as loan proceeds, loan proceeds that were not taxable when received and which will no longer have to be repaid because the debt has been transferred along with the property.

Essentially the same analysis applies if the owner makes a gift of the property rather than selling it. To be sure, if the property is gifted rather than sold the owner will not receive any cash at closing. Equally true, though, is that the owner received $4,500,000 tax-free when the loan was taken out, and because the loan again goes with

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[6] *See generally* New York County Lawyers' Assn., Committee on Taxation, *Excess Mortgaged Property*—Caveat Venditor: *A Report on Some of the Consequences of the Carryover Basis Rules on Inherited Excess Mortgaged Property*, 33 TAX. L. REV. 139 (1977).

[7] *Commissioner v. Tufts*, 461 U.S. 300 (1983).

the property, those tax-free proceeds will not have to be repaid by the donor. As a result, the law is clear that if property is gifted having adjusted basis of $1,000,000 and subject to a nonrecourse debt[8] of $4,500,000, the donor must recognize income of $3,500,000, that being the excess of the loan proceeds over the donor's adjusted basis in the property.[9]

Because the donor is taxed on some of the accrued appreciation, the donee's basis must be adjusted upward to ensure that this appreciation will not be taxed a second time. Despite the general carry-over basis rule for gifted property, the regulations properly provide that the donee may increase his basis for any gain recognized by the donor on the transfer.[10] Thus, in this example the donee will take a basis of $4,500,000 in the property, so that if the donee eventually sells the property for $5,000,000, there will be only $500,000 further gain to be recognized.

If the current step-up basis rule at death is changed to a carry-over basis rule, the taxation of death-time transfers becomes virtually identical to that of gifts. And because we know that gifts of heavily mortgaged property are taxable to the donor when the gift is made,[11] presumably the same rule would be applied to transfers at death. Thus, a carry-over basis rule at death not only preserves substantial gain not taxed under current law but likely accelerates taxation of that gain to the moment of the decedent's death.

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[8] If the debt is with recourse, then the loan will have to be repaid by the estate prior to the transfer to any heir, either forcing the taxable sale of the property or consuming other assets of the estate so that the property can be passed on unencumbered.

[9] *Levine v. Commissioner*, 634 F.2d 12 (2d Cir. 1980); s*ee Diedrich v. Commissioner*, 457 U.S. 191 (1982). If the gift is to a charitable organization, the taxation is even greater by reason of §1011(b). *Ebben v. Commissioner*, 783 F.2d 906 (9th Cir. 1986).

[10] Treas. Reg. §1.1015-4(a) (1972).

[11] See sources cited at note 9 above.

In the context of death-time transfers under a carry-over basis regime, it might be the case that transfer from decedent to executor is ignored and that the recognition event for heavily mortgaged property does not occur until transfer from the executor to the ultimate beneficiary. This does not solve the problem of accelerating recognition but merely postpones it slightly. Indeed, in some jurisdictions real property is not treated as passing through the executor's hands; rather, title is treated as flowing directly from decedent to beneficiary, and in such cases the recognition event would have to be the time of death. In the following discussion when I refer to taxation at the time of a decedent's death, it should be understood that this reference includes the possibility that such taxation might not occur until the property passes through the hands of the executor.

Death as a recognition event would also arise, if property is not given a full step-up in basis at death, upon the death of a partner having a negative capital account. For example, suppose four individuals contribute $100,000 to a partnership, and the partnership uses its $400,000 of equity plus a loan of $1,600,000 to purchase improved real estate for $2,000,000. After 10 years, the partnership has claimed depreciation of about $800,000, so the partnership's adjusted basis in its property equals $1,200,000. The outstanding balance on the loan is about $1,400,000 (assuming a 30-year amortization schedule), which means that each partner's capital account is negative by about $50,000.

Current law's step-up basis at death ensures there is no taxation to a partner who dies at this point, and his share of appreciation in the partnership assets escapes income taxation, now and forever. But if Congress enacts a carry-over basis at death rule, the partner who dies presumably will be taxed at once on a gain of about $50,000.[12] *And this taxation is imposed independent of the current value of the property.* This problem of negative capital accounts is especially likely to arise in connection with highly-leveraged real estate contributed to an umbrella partnership as part of an UPREIT roll-up.

Congress could, of course, carefully specify that death-time transfers will not be taxable to the decedent even if the property is encumbered. Such language would ensure that if I die holding property with value of $1,000,000, adjusted basis of $100,000, and subject to a nonrecourse debt of $850,000, I would not be taxed on the death-time transfer.[13] Indeed, since my estate may have no liquid assets with which to pay a substantial income tax liability, failing to prevent acceleration of the gain risks forcing an immediate and distressed sale of assets by the estate.

Unfortunately, no current legislative proposal actually includes language to ensure this result. If such language were included, however, it would then be the case that whoever inherited the property would receive a basis of only $1,000,000, precisely the result that a carry-over basis regime presumably intends. To accomplish this result, Congress should amend section 1014 as follows:

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[12] Upon the sale or exchange of a partnership interest, the transferor partner's share of liabilities are treated as part of the amount realized. Treas. Reg. §1.752-1(h).

[13] This is how property is treated when transferred between spouses or between ex-spouses incident to divorce. *See* §1041.

§1014. Property acquired from a decedent [carry-over basis]

(a) **In general. —** In the case of property acquired from a decedent within the meaning of subsection (b)—

1. No gain or loss shall be recognized by the decedent or the decedent's estate on such transfer; and

2. The basis of such property in the hands of the person acquiring it from the decedent shall be the basis of such property in the hands of the decedent immediately prior to death.

(b) **Property acquired from the decedent.—**

[no change to existing law]

Highly Mortgaged Property Can Be Underwater to the Heirs

But now consider the hapless beneficiary who has just inherited property with current value of $5,000,000, carry-over basis of $1,000,000, and subject to a debt of $4,500,000. This inheritance may not be quite so good as getting the property free and clear, but the equity of $500,000 is still real money. Or so it seems.

If the property is sold for its current value of $5,000,000, the loan must be paid off before the new owner is entitled to keep any of the proceeds. Thus, of the $5,000,000 received for the property, $4,500,000 must be given to the lender, leaving the new owner with only the equity value of $500,000. That would still be a good day's work were it not for the pesky carry-over basis rule; because the new owner's basis in the property was carried over from the decedent, the sale is taxable to the tune of $800,000.[14] As a result, the new owner now not only owes the bank $4,500,000 but the IRS some $800,000 as

[14] Sale for $5,000,000 with a carry-over basis of $1,000,000 yields a taxable gain of $4,000,000. Taxed at the lowest income tax rate applicable to long-term capital gain produces a tax liability of $800,000. State taxes would add to this amount.

well, so that the inheritance of $500,000 in equity is in reality worth *negative $300,000*. Well advised individuals might know to reject an underwater bequest, but who without a tax lawyer in the family would suspect that receiving property with $500,000 in equity puts you out-of-pocket by $300,000 or more?

Not all highly mortgaged property will be underwater in the sense that a sale yields proceeds insufficient to both pay of the mortgage holder and pay the income taxes on the gain. For example, property with current value of $5,000,000, adjusted basis of $1,000,000, and encumbered by a debt of $3,000,000 offers net value to a donee who takes this property with a carry-over basis. Assuming capital gains are subject to a total federal and state tax burden of 25%, our donee can sell the property for $5,000,000, pay off the debt of $3,000,000 as well as the tax burden of $1,000,000, and still have $1,000,000 in hand. Heavily mortgaged property will only be underwater if the amount of the outstanding encumbrance plus the tax burden on the unrealized appreciation exceeds the value of the property.

What should Congress do? Under current law, this problem is solved by the step-up basis rule at death by eliminating the income tax liability. A carry-over basis rule, though, leaves the income tax liability intact, which means someone – decedent, heirs, or a combination of the two – must both pay off the loan and pay off the taxes.

Current legislative proposals include only a partial repeal of the step-up basis at death rule. The Kyl-Breaux bill (S. 275), for example, eliminates current death taxes yet retains the step-up basis rule to the extent of $2,800,000 in unrealized appreciation. It thus provides complete tax relief for individuals whose assets at death include appreciation of $2,800,000 or less, regardless of any encumbrance. For an individual who dies owning property with value of, say, $10,000,000 subject to a debt of $9,000,000 and with adjusted basis of $500,000, this relief will be partial at best even though the net value of the estate is well under the $2,800,000 amount. That is, there will still be taxable gain of $6,700,000 (value of $10,000,000 less carryover basis of $500,000 plus step-up basis of $2,800,000), of which most presumably will be imposed on the decedent at death (gain at death presumably will equal outstanding loan amount of $9,000,000 less total basis of $3,300,000, or $5,700,000 of taxable gain).

Imposing a heavy tax burden on the decedent both accelerates the tax liability and imposes it at a time when there may be no funds with which to pay the taxes. Letting the decedent escape taxation shifts that burden to the heirs who, when they sell the property, will end up with far less than the equity they anticipate. Indeed, they might even end up out-of-pocket.

The most direct solution to this dilemma would be to defer taxation of the unrealized gains until the heirs sell the property – that is, provide by statute that no gain is recognized on the devise of encumbered property – and then limit the tax liability to ensure that the heirs are not out of pocket by reason of the inheritance. Putting such a limitation into law would require something like the following:

§1014. Property acquired from a decedent [gain limitation]

(a) **In general. —** In the case of property acquired from a decedent within the meaning of subsection (b)—

1. No gain or loss shall be recognized by the decedent or the decedent's estate on such transfer; and

2. The basis of such property in the hands of the person acquiring it from the decedent shall be the basis of such property in the hands of the decedent immediately prior to death [possible including a partial step-up].

3. Upon the disposition of such property by the person acquiring it from the decedent, any gain recognized shall not exceed the value of the property less the amount of debt encumbering such property at the time it was acquired from the decedent times the highest tax rate applicable to net capital gain.

(b) **Property acquired from the decedent.—**

[no change to existing law]

Alternatively, Congress could eliminate the problem entirely by providing that (1) the decedent is not taxed on the death-time transfer of property even if encumbered and (2) the heirs get a step-up for the amount of any encumbrance existing at the time of the debt. This would avoid the problems indicated above, but it would do so only by bringing back – at least in part – the step-up basis rule.

An astute taxpayer who owned appreciated assets could exploit such a rule by borrowing against low-basis property shortly prior to death. For example, suppose T owns land with adjusted basis of $0 and current value of $10,000,000. Under a carry-over basis at death regime, someone – decedent or heir – is supposed to be taxable on the $10,000,000 appreciation when the property is sold. Yet, if property transferred at death qualifies for a step-up basis at death to the extent of any encumbrance on the property, T should borrow as much as possible against the property immediately before dying.

For example, suppose T places a $9,000,000 mortgage on the property prior to death and then devises both the encumbered land and the $9,000,000 loan proceeds to his child. Child takes the property with a basis of $9,000,000 rather than $0 if a step-up is provided for the debt. However, Child can use the cash to retire the debt and thereby own the land free and clear. By running the debt through the decedent's estate, the carry-over basis rule has been almost entirely avoided.

This tax avoidance technique could be eliminated by providing a step-up basis only for old and cold debt; that is, for debt placed on the property more than one, two or even three years prior to the death-time transfer. Careful taxpayers could still exploit this rule by borrowing early enough, but in such circumstances the loan likely would have some business legitimacy because interest would have been paid for months or years. Nevertheless, probably the best way to limit gain recognition on heavily mortgaged assets without opening the door to wholesale tax avoidance is to provide for a basis step-up only as to excess qualified nonrecourse financing (within the meaning of §465(b)(6)(B)). By incorporating the definition of "qualified nonrecourse financing," the partial step-up is targeted to real estate activities and excludes the potential abuse areas of related party debt and seller financing. And by further limited the partial step-up to excess debt (that is, a step-up for such debt only to the extent it exceeds adjusted basis), the step-up will be limited to those cases in which the basis is low and the gain to the heirs will be substantial; that is, to cases in which the property's equity may not be sufficient to cover the eventual tax liability. To enact this result, Congress should enact language such as:

§1014. Property acquired from a decedent [debt step-up]

(c) **In general. —** In the case of property acquired from a decedent within the meaning of subsection (b)—

1. No gain or loss shall be recognized by the decedent or the decedent's estate on such transfer; and

2. The basis of such property in the hands of the person acquiring it from the decedent shall be—

   i. the basis of such property in the hands of the decedent immediately prior to death [possibly increased for a partial step-up], plus

   ii. the amount of any qualified nonrecourse financing as described in §465(b)(6)(B) to the extent the amount of such debt exceeds the adjusted basis of such property determined under subparagraph (i).

(d) **Property acquired from the decedent.—**

[no change to existing law]

Conclusion

Repeal of the estate tax is not intended to be fundamental income tax reform. Yet, if a carry-over basis rule at death replaces the current step-up basis rule, the death-time transfer of encumbered property might well include not only a new and substantial income tax liability but also an acceleration of that liability to the moment of death. Carefully drafted language can avoid that acceleration. In addition, a tailored step-up for qualified nonrecourse financing can ensure that heavily mortgaged real estate will not be a negative value asset in the hands of a decedent's heirs.