CARRYOVER BASIS

HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

OF THE

COMMITTEE ON FINANCE UNITED STATES SENATE

NINETY-SIXTH CONGRESS

FIRST SESSION

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CARRYOVER BASIS

MONDAY, MARCH 12, 1979

U.S. SENATE,
SUBCOMMITTEE ON TAXATION AND
DEBT MANAGEMENT GENERALLY,
COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:05 a.m. in room 2221, Dirksen Senate Office Building, Hon. Harry F. Byrd, Jr., chairman of the subcommittee, presiding.

Present: Senators Byrd, Jr., of Virginia, Long, Bentsen, Baucus, and Dole.

[The press release announcing this hearing follows:]

[Press Release from the Committee on Finance, U.S. Senate, Jan. 31, 1979]

FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT SETS HEARINGS ON CARRYOVER BASIS

Senator Harry F. Byrd, Jr. (I-Va.), Chairman of the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance, announced today that the Subcommittee will hold hearings on March 12, 19, and 20, 1979 on the carryover basis provisions of the estate tax law.

The hearings will begin at 10 a.m. in room 2227 of the Dirksen Senate Office Building.

Senator Byrd noted that the Congress during the last session agreed to defer the effective date of carryover basis until December 31, 1979. The hearings will focus upon whether or not carryover basis should be repealed or modified, and if modified, what modifications should be made.

Senator Byrd said, "Carryover basis was placed in the 1976 Tax Reform Act in the House and Senate conference. In 1976, no hearings were held in the Senate Finance Committee nor was the matter before the House and Senate during deliberations on the tax act.

"The law, as written by the Committee on Conference, has proven to be totally unworkable.

"The Congress was wise in deferring carryover basis until December 31, 1979. Virtually everyone acknowledges that the 1976 law must be changed. Many, especially professionals who have studied the carryover basis law, feel that it should be repealed. There is much support for repeal.

"The hearings will give the Senate Finance Committee its first opportunity to explore in detail the implications and full ramifications of this significant departure from prior tax law."

The Department of the Treasury will testify on March 12, 1979.

Other witnesses who desire to testify at the hearings should submit a written request to Michael Stern, Staff Director, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D.C. 20510 by no later than the close of business on March 1, 1979.

LEGISLATIVE REORGANIZATION ACT

Senator Byrd stated that the Legislative Reorganization Act of 1946, as amended, requires all witnesses appearing before the Committees of Congress

"to file in advance written statements of their proposed testimony, and to limit their oral presentations to brief summaries of their argument."

Witnesses scheduled to testify should comply with the following rules:

(1) A copy of the statement must be filed by noon the day before the day the witness is scheduled to testify.

(2) All witnesses must include with their written statement a summary of the principal points included in the statement.

(3) The written statements must be typed on letter-size paper (not legal size) and at least 100 copies must be submitted by the close of business the day before the witness is scheduled to testify.

(4) Not more than ten minutes will be allowed for oral presentation.

(5) Witnesses are not to read their written statements to the Subcommittee, but are to confine their ten-minute oral presentations to a summary of the points included in the statement.

WRITTEN TESTIMONY

Senator Byrd stated that the Subcommittee would be pleased to receive written testimony from those persons or organizations who wish to submit statements for the record. Statements submitted for inclusion in the record should be typewritten, not more than 25 double-spaced pages in length, and mailed with five (5) copies by April 13, 1979, to Michael Stern, Staff Director, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D.C. 20510.

Senator Byrd. The hearing will come to order.

First, I want to apologize to the witnesses and to everyone in this room for being 5 minutes late. During the years that I have been chairman of this subcommittee, it is the first time that I have not started promptly on time. I was testifying earlier before the Judiciary Committee on behalf of a constitutional amendment, which I have proposed, requiring a balanced budget.

I apologize, and I am sorry to delay opening this session by 5 minutes.

One of the most important tax policy issues which will confront the 96th Congress is the question of the carryover basis in the estate and income tax law. It represents a fundamental change in the tax code.

Under carryover basis, the original cost of an asset carries over from the decedent to the beneficiary and a tax upon the appreciation of the asset is imposed whenever it is sold. Often the sale will occur during the administration of the decedent's estate.

The carryover basis law which was enacted as part of the 1976 Tax Reform Act was highly technical, and complicated adjustments to determine the appropriate basis must be made for every asset in an estate. This is a difficult task in the simplest situation. For most estates, especially those with assets such as a stamp or coin collection, the job is impossible.

Furthermore, carryover basis under the 1976 law requires taxpayers to keep extensive records over their lifetime.

During the last session of the Congress, the technical and administrative difficulties with the 1976 law were brought to the attention of the Congress and this subcommittee. As a result of the enormous sentiment expressed to both Members of the House and the Senate about the difficulties of carryover basis, the last Congress decided to defer the effective date of carryover basis until December 31, 1979.

The law, as it now stands, cannot be complied with, nor can it be administered.

With the deferral of carryover basis, the Congress now must decide which of three courses it wishes to follow, repeal of carryover basis as

enacted in 1976; modification of the current carryover basis law; or further deferral.

In my judgment, there is almost no likelihood that Congress will support any proposal more radical than carryover basis. Indeed, carryover basis would not have been approved had Congress been aware of its full implications.

For the debate in the 95th Congress centered on the technical difficulties associated with the 1976 carryover basis law and we must remember that carryover basis is not simply a problem of technical legislative drafting. It raises fundamental questions about the way and purposes for which we want to tax our citizens.

First, we must consider its impact upon individual incentive and risk taking in our economy and society. This is an era of big government, big labor, and big business. I might say parenthetically, this is one great problem with our country today; we have too much bigness.

Innovation and risk in our society are rapidly vanishing. Many studies have noted that America, once a leader in new ideas and business ventures, is rapidly losing this enterprising spirit. Small business will suffer the greatest hardship under carryover basis.

Under carryover basis, incentive to start a business or maintain a family farm will be greatly diminished. Many may say why work for a lifetime if, at death, my estate will be taxed with both an income and an estate tax?

Capital formation means jobs, greater productivity, and the potential for reducing inflation.

The impact of carryover basis upon needed capital formation must be carefully assessed. Stockholders who are willing to take the risk of investing in equity issues will be confronted with the potential of an additional tax upon their capital at death.

While Congress has reduced the capital gains taxes to encourage investors to sell stock in other assets which have been held for long periods of time and reinvest in new and productive ventures, carryover basis may counteract the incentives to sell assets, since the heirs of investors who receive assets with a very low basis will certainly not want to sell these assets and incur a large income tax.

Carryover basis adds a whole new layer of complexity and uncertainty in the tax law. Questions must be asked as to whether the relatively small potential revenue gained from carryover basis are worth its cost in terms of administratability and simplicity in the tax system. It makes the already very complex tax laws much more complex.

In this regard, some points to consider are these. Is the cost of keeping detailed records about the basis of every asset too much for the ordinary taxpayer to handle?

Will taxpayers be informed enough to follow the law's recordkeeping requirements?

Will carryover basis diminish respect for the tax code and compliance with the tax laws?

Will the Treasury and the Internal Revenue be able to administer carryover basis? It cannot now be administered. This was admitted by the Treasury Department to the Senate-House conferees last October in connection with the Revenue Act of 1978.

On this last point, proof of basis for an asset held for many years could be extremely difficult in tax litigation. Such cases could last for

weeks or years if estates had many assets and basis of each asset had to be shown.

The significance of carryover basis as a matter of tax equity must be reviewed. Taxpayers in the past have relied upon the certainty of a step-up basis of death. Grandfathering all assets held prior to the time of carryover basis would go into effect. Surely it is the only fair way to implement a carryover basis law—namely, to grandfather the assets up to that particular point.

Carryover basis imposes a double tax, an income tax, and an estate tax. We must consider carefully whether double taxation on the value of an asset for estate tax purposes but on an original cost, with an adjustment for estate taxes paid, for income tax purposes is fair and appropriate.

If one can assume that death usually is an unwelcome event—I am not impressed with the view of the Department of Treasury that death is a tax loophole. I doubt that the average American citizen follows this view, either.

Today's hearing is to give the Treasury Department the opportunity to present its precise proposal regarding carryover basis. Now, at this point, I have been to another committee so I may not have had a chance to look at it. Will the staff or a Treasury representative distribute to the Chair and to the committee a copy of the legislation on which the Treasury Department will be testifying?

Mr. Lubick, does the Treasury Department have legislation on which it is testifying?

Mr. LUBICK. Yes, we have a statement, Senator Byrd.

Senator BYRD. I read your statement. I read it on Sunday; I read it over the weekend. There is no concrete legislation in the testimony. The statement is a matter of generalities and theory.

Mr. LUBICK. There were about 11 proposals, Senator Byrd.

Senator BYRD. Do you have a bill that the committee can consider?

Mr. LUBICK. We have not finished the drafting of the legislative language for these particular proposals, but I think the concepts are easily understandable.

Senator BYRD. Thank you. But you have not completed the drafting?

Mr. LUBICK. That is correct.

Senator BYRD. Although I will consult and shall do this pending consultation with my colleagues, I am going tentatively to ask the subcommittee counsel, Mr. Edward Beck, in the next day or so, to communicate with the witnesses for next Monday and Tuesday and terminate these hearings. If the witnesses have nothing in terms of specific legislative language on which to testify, we will have to be getting the witnesses here a number of times. I hate to do this.

Now, we will have to obviously hold another hearing when you have had time to draft your proposal. I will ask Mr. Lubick, if it is satisfactory to you, if the committee counsel and you can get together some 60 to 90 days hence, and we will hold another hearing.

Obviously, we cannot act on a proposal that is not before us. Now, if you want to go ahead and make your statement, you can make whatever statement you wish, bearing in mind now that we will have to hold another hearing. I was under the impression that you would present a detailed bill today.

Mr. LUBICK. I am sorry, Senator.

Senator BYRD. Everyone who came here as witnesses today came here in good faith, so I am going to stay here as long as necessary and hear the witnesses, but I want to say frankly that it appears we will have to have another hearing at some 60 to 90 days hence.

[The subcommittee subsequently released the following press release:]

[Press Release from the U.S. Senate Committee on Finance, Mar. 13, 1979]

FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT POSTPONES FURTHER HEARINGS ON CARRYOVER BASIS

Senator Harry F. Byrd, Jr. (I., Va.,), Chairman of the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance, today announced that the hearings set for March 19 and 20, 1979, on the issue of Carryover Basis of the estate tax laws have been postponed.

Senator Byrd said that he had hoped that the Treasury Department would have proposed specific legislative proposals to the Subcommittee by this time. "Expert witnesses have been called to address the many technical issues involved in this question but without a specific legislative proposal there is nothing for these expert witnesses to testify on," said the Senator. "Without a specific proposal," the Senator continued, "the witnesses would be testifying in a vacuum."

Assuming specific legislation is proposed, the hearings will be rescheduled in May and June. The dates for such hearings will be announced as soon as they are set.

Senator BYRD. You may proceed as you wish.

STATEMENT OF DONALD C. LUBICK, ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY

Mr. LUBICK. Mr. Chairman, I thank you very much for the opportunity to be here. I appreciate your hearing us. You have always been extremely fair in listening to both sides of the issue and I thought it would be very worthwhile if we did present about 11 changes which we would suggest would be appropriate to deal with some of the issues. That has been the customary way in which the Finance Committee has proceeded before. The question of specific legislative language, I would say, particularly in light of questions you have raised, is certainly less significant than the basic concepts.

With your permission, I would like to express——

Senator BYRD. Of course, I do not agree with you. The specific language is what the attorneys and accountants who work with the law must follow. The specific language is what the executors of the estate have to follow. The specific language is what the taxpayers have to follow.

So far as this one Senator is concerned, I am going to do whatever can be done under the parliamentary situation to see that every paragraph, every sentence, and every word of any bill dealing with taxes of this magnitude are reviewed by the committee.

Mr. LUBICK. I agree with that, Senator, and it was precisely for that reason last year that we urged that the committee, during the period of deferral, adopt some language so that the bar and the practitioners would have language generally circulated. There were a number of bills which were introduced last year, one by you and one by Senator Dole, and both of them were very good bills and did have some——

Senator BYRD. Except that you did not endorse my bill.

Mr. LUBICK. We endorsed a very large part of your bill, Senator.

Senator BYRD. You did not endorse my bill. If you had endorsed my bill, we might have had a different situation.

Mr. LUBICK. We endorsed, I would say, most of your bill in our testimony. There were some things where we differed, but by and large, we thought it was an excellent bill and did respond to these problems.

Senator BYRD. Let me ask the committee. How many bills does the committee have before it dealing with this matter?

The committee has one bill before it dealing with this matter, Senator Dole's bill to repeal carryover basis.

Senator DOLE. My bill is a compromise.

Mr. LUBICK. The legislation that was drafted by you during the last Congress, the legislation that was drafted by Senator Hathaway during the last Congress, all of those bills basically embody the concepts which we are addressing and recommending today.

It seems to us that there is no lack of specific legislative language, if that is what is needed.

However, it seems to us that it is most important to deal with some of the fundamental concepts and, if I might, Senator, I would like to submit my statement for the record and then deal with a few of the high spots.

Senator BYRD. That will be fine, Mr. Secretary, yes. Your entire statement will be published in the record.

Mr. LUBICK. And may I also say that we will endeavor to complete legislative language for you as quickly as possible, that we will——

Senator BYRD. Think in the nature of 60 to 90 days, if you will.

Mr. LUBICK. I beg your pardon?

Senator BYRD. Think in the time frame of 60 to 90 days.

Mr. LUBICK. That is more than reasonable. If you would prefer it faster, we will——

Senator BYRD. That is all right. That is satisfactory.

Mr. LUBICK. May I start by stating once again the nature of the basic problem. Before the 1976 act, we operated under a system which has been variously known as step-up, or forgiveness of tax, on appreciation in property which passes through the estate of a decedent.

The 1976 act, as you have stated, provides for a continuation of the decedent's original basis in the hands of his successors with an adjustment added to that basis for the estate tax, which is paid on that appreciation, in order to reduce the gain ultimately realized on the sale of the property. The purpose of the estate tax adjustment is to give equivalent treatment for a sale before death where income tax has been paid and has reduced the estate tax. The estate tax adjustment then reduces the income tax.

The basic issue, as we see it, Mr. Chairman, is not the workability of the 1976 rules—and they do have technical problems, as you have ably and consistently pointed out. We believe we have solutions which we have offered and, as I indicated a few minutes ago, the bill which you introduced in the last Congress did, indeed, solve those technical problems as well.

The issue, as we see it, is whether the income tax liability on gains accrued by a decedent at his death is to be entirely and irrevocably forgiven. The burden, as we see it, is on the defenders of the pre-1976

forgiveness rule to make a case to go back to a rule whereby gain which is accrued is completely eliminated from the income tax.

There are a number of reasons why we believe that the forgiveness rule is not sound tax policy, and I start with an example that is familiar to you and to Senator Bentsen, I know, on page 2 of my testimony except this time, Senator Long, you heard this example once and thought that the amount was inconsequential, so I added three zeroes to each number to increase the magnitude and make it more dramatic. But this is the——

Senator LONG. You can add three more if you want to.

Mr. LUBICK. This is the case where we had the two twins, A and B, who each bought shares of stock in the same corporation on the same day for $10,000 and they both decide they are going to sell when the stock reaches a value of $110,000 and each thanks to Senator Long's legislation of last year, would pay a capital gains tax of 25 percent on any recognized gain.

One got into his broker's office and sold his shares and met the other fellow on his way out and while they were talking, the proverbial truck killed them both and the result was that one had sold his stock before he died. The heir of the second immediately sold the stock after death, and the result, as we indicated, was that on the capital gain that they each had of $100,000, the heir of the one is left with $85,000 after taxes paid and the heir of the other is left with $110,000.

The difference is——

Senator DOLE. Does that happen very often?

Mr. LUBICK. That is a good question, Senator Dole. The precise factual situation probably does not happen very often, but the exact consequences——

Senator DOLE. If your example referred to tractor instead of truck, we might be able to better understand it.

Mr. LUBICK. The exact consequence is a familiar one to every practitioner. Every practitioner is familiar with advising clients who would normally sell property not to sell because if the client holds onto the property and maintains it until his death, there is complete elimination and complete forgiveness of the income tax.

That is as common as any situation involved in the estate planning field.

So while we have taken a dramatic case to illustrate it, it is indeed a very common and usual situation and the consequence is that those taxpayers who are able to hold their property and maintain it until death without selling will escape taxation on capital gains.

Indeed, the estate tax burden and the income tax burden are illustrated in our statement. I was starting out with an assumption that there is no estate tax. In that situation, if you assume we had no estate tax and one bought his shares for $10,000 and died when they were worth $110,000, there would never be any income tax on it.

When you factor the estate tax in, as we have indicated, you have a situation where, in a normal case, you have a reduction in the combined estate and income tax burden of about 35 percent for the person who does not sell. The proposition illustrated is that the estate tax is not a substitute for the income tax.

Now, we agree with Senator Byrd that it is important to stimulate the development of small business. It is important to encourage agri-

culture. It is important to do all of these things, but there is no question but what we have a situation where the very small minority of the wealthiest taxpayers in the country are able to avoid, through the forgiveness rule, any capital gains tax on millions of dollars of appreciation.

And we have illustrated some situations on page 4 from actual cases in the courts, without going into restricted taxpayer information, where we have marketable securities—not small business, not agriculture, but securities that are traded over the stock exchange. For example, the *Owen* case cited here involved a gift of marketable securities worth $5.2 million with a basis of $1.200.

Now, that meant that $5.2 million—and that is what he gave away, and that ultimately might bear a tax. What he retained, presumably, is more than that. Most people do not give away all of their assets, or even more than 10 percent of their assets, and the result is that millions and millions of dollars is never subject to income tax. In fact, our figures indicate that there is approximately $20 billion a year of untaxed appreciation in estates.

Now, we have already talked about the lock in and that, indeed, is what I referred to, Senator Dole, in answer to your question, the fact that persons do hold onto this property and do not sell and, indeed, the reason, Senator Long, for your capital gains reform of last year, by lowering the inclusion factor to 40 percent—on which, I will confess, you did not receive a lot of cooperation from us—but nevertheless we will take you at your face that the purpose of that was to unlock assets and to encourage more sales and to produce more revenue for the Treasury and to make capital more mobile.

If we go back to step-up, we are defeating the purpose of the very measure which you fought so hard to enact.

So we are now on board with you and we are trying to protect that which you labored so hard——

Senator LONG. I did not do it entirely for the Treasury, you know, Mr. Lubick. I mean, part of that was done for the benefit of the country, the taxpayers, the 230 million people in the country.

Mr. LUBICK. We agree, and we want to see that succeed and we think that going back to step-up would be a lock-in which would go contrary to that proposal.

Now, Senator Byrd, you have referred to the fact that death is not a loophole, and we have to agree with you that death is not a loophole.

Senator BYRD. Thank you, sir.

Mr. LUBICK. But neither can we say that death is a reason for forgiveness. The purpose——

Senator LONG. It's as good as any, I might say, though.

Senator BENTSEN. Most of us hope so.

Mr. LUBICK. A forgiveness of tax, Senator Bentsen, not a forgiveness of any other peccadillos.

The purpose of carryover basis, or some other provision, is simply to put the death situation on a par with the inter vivos situation, not to make death a worse situation than an inter vivos gift.

As a matter of fact, Senator Byrd, we have had carryover basis since 1921 in the case of transfers by gift and since 1942 in the case of transfers at death in the case of income in respect of a decedent and both of those provisions have worked very well.

Now, basically, what we are dealing with here is not a question of revenue. It is not a question of trying to raise more money.

To the extent that there is a burden, an undue burden on small business, on agriculture, on anyone, the problem is one of the estate tax, because the carryover basis does not, itself, result in a tax. If the combined burden at death is too high, because of estate tax and income tax potential, then the fair remedy is to make an appropriate reduction in the estate tax applicable to all taxpayers, those who have sold and those who have retained their assets, and to keep the equitable provisions with respect to the income tax of the carryover basis, or some other tax on those capital gains, so that we do not have income tax distortion.

Now, let me talk about one of the principal problems that has been raised in connection with carryover basis and that is the technical problem that proof of basis problems are so insurmountable that we cannot deal with this problem.

First, let me point out that when Congress enacted an income tax in 1913, it said that basis was to be either historical cost or March 1, 1913, value. Now, at that time, we did not even have a prior income tax so that the taxpayers who became subject to the income tax had not been put on notice that in the case of a sale during their lifetime they would have to know their basis and——

Senator BYRD. Could I interrupt just a moment at that point?

Mr. LUBICK. Surely.

Senator BYRD. I might point out that, in 1913, since you have brought it up, the tax was 1 percent but then when income exceeded $500,000, then there was an extra tax of 5 percent. So there was a maximum tax of 6 percent.

Mr. LUBICK. Those were real dollars too, though.

Senator BYRD. I think if you want to refer to 1913, I think that is fine. I want to put in the record at this point an income tax form of 1913, given the exact tax figures.

[The material referred to follows:]

Form 1040: Income tax.

The penalty for failure to have this return in the hands of the collector of Internal Revenue on or before March 1 is $20 to $1,000. (see instructions on page 4.)

United States Internal Revenue: Return of annual net income of individuals (As provided by Act of Congress, approved October 3, 1913.)

Return of net income received or accrued during the year ended December 31, 1913. (for the year 1913, from March 1, to December 31.)

Filed by (or for) ——— of ———.

In the City, Town, or Post Office of ——— State of ———.

1. Gross Income (see page 2, line 12).

2. General Deductions (see page 3, line 7).

Net Income.

Deductions and exemptions allowed in computing income subject to the normal tax of 1 percent.

4. Dividends and net earnings received or accrued, of corporations, etc., subject to like tax. (See page 2, line 11).

5. Amount of income on which the normal tax has been deducted and withheld at the source. (See page 2, line 9, column A).

6. Specific exemption of $3,000 or $4,000, as the case may be. (See Instructions 3 and 19).

Total deductions and exemptions. (Items 4, 5 and 6).

7. Taxable income on which the normal tax of 1 percent is to be calculated. (See Instruction 3.)

8. When the net income shown above on line 3 exceeds $20,000, the additional tax thereon must be calculated as per schedule below.
1 percent on amount over $20,000 and not exceeding $50,000.
2 percent on amount over $50,000 and not exceeding $75,000.
3 percent on amount over $75,000 and not exceeding $100,000.
4 percent on amount over $100,000 and not exceeding $250,000.
5 percent on amount over $250,000 and not exceeding $500,000.
6 percent on amount over $500,000.
Total additional or super tax.
Total normal tax (1 percent of amount entered on line 7).
Total tax liability.

Mr. LUBICK. Well, we will be glad to work with you to see how fast we can get back to 1913. Unfortunately, I do not think it will be too soon.

Let me also point out in this question of recordkeeping that the Canadians in 1971 put in a tax on gains at death and, in the last few days, we have been discussing with both officials of the Canadian Government and with friends of ours in private practice in Canada what problems they have had in their experience, and they have all indicated that in no case has this question of proof of basis been even raised in the public discussion as a problem. Their problem has been essentially the question of valuation as of December 31, 1971, because they went to a fresh start that required actual appraisals.

We avoided that particular difficulty in the legislation in 1976.

Essentially, the question of proof of basis is one which is different for different kinds of property. It is perfectly obvious that keeping records of tangible personal property—your piano, your furniture, your personal jewelry—is in a very different category from keeping records as to your investment assets. You do not normally expect to sell tangible personal property and therefore your motivation for keeping records is entirely different from your marketable securities or your depreciable real estate. And, indeed, with respect to your business property, you are apt to include information on your annual tax returns with respect to depreciation or other reasons that would indicate the necessity and the availability of records.

So that where our specific areas for recordkeeping are difficult, tangible personal property or residences, we have proposed specific rules to deal with those problems. But the bulk of the problem in this country involves investment assets and as to those areas, it seems rather odd that people can say that we can disable ourselves from taxation by making it impossible to keep records and by not keeping records, we can avoid taxation.

Indeed, in that sort of situation, it would lead to a lot of things not being subject to tax that clearly are. For example, unreported tips. We have done surveys that show that maybe 15 percent of unreported tips is included in income and, in that situation, no one is suggesting that this ought to escape taxation.

Senator BYRD. Could I ask you a question at that point?

Mr. LUBICK. Surely.

Senator BYRD. Your proposal would require, as I understand it, records dating back as far as 15 years, 20 years, 40 years, 50 years. There is no limit to the length of time for which an individual would be required to retain records.

Mr. LUBICK. That would not normally be the situation with respect to assets required before the effective date. Ultimately if, as in the

income tax today, one acquires stock—let's get over the fresh start, over the transition period—then it is quite true that we require proof of historical cost.

Senator BYRD. As I understand it, then, you propose to require records beginning with the period of time when this law becomes effective; is that it?

Mr. LUBICK. The fresh start adjustment and including the proposals which we have made, provides that, in the case of marketable securities, the basis——

Senator BYRD. Marketable securities present no problems for the simple reason you can just look that up in a newspaper of 50 years ago. A person who buys a stamp collection, buys some stamps 5 years ago, others 10 years ago, others 40 years ago—you do not propose to make him furnish these records; is that it?

Mr. LUBICK. Essentially that is correct, Senator, because we have proposed a fresh start rule which calls for a discount back——

Senator BYRD. The discount backward concept, however, makes assumptions about the rate of appreciation of an asset. It is a mechanical formula.

Mr. LUBICK. That is correct.

Senator BYRD. Yes. All right. Thank you.

Mr. LUBICK. It is a mechanical rule which, since the percentage——

Senator BYRD. Which may or may not be fair to an individual taxpayer.

Mr. LUBICK. In about 99.5 percent of the cases, it would be overgenerous to the individual taxpayer. There would be very few individual taxpayers where you would, over a course of 40 years, have a depreciation in value. But again, as you point out, marketable securities do not present any problem and it seems unfortunate to say you are going to throw out a system which is appropriate in the case of general investment assets simply because there may be one or two cases——

Senator BYRD. It proves my point that the people who are being hurt the most by this are the farmers, the small business people who are not investing in General Motors stock and A.T. & T.

Anyway, I will not interrupt you. Go right ahead.

Mr. LUBICK. I wish you would. As a matter of fact, I would like to deal with the points that you have made, because I think they are important ones and ones that should be understood.

The small business and the agricultural assets constitute about 7 percent of the assets that we are talking about, but in the case of small business and in the case of agriculture, there are current financial statements that are prepared year in and year out with respect to the preparation of income tax returns and in those situations those records form an adequate basis, an adequate ground, for establishing basis.

The point should not be lost that basis does not have to be established by a criminal law standard of beyond a reasonable doubt. Secondary evidence and reasonable estimates of basis in those few uncertain cases that may exist is admissible and in the case of small business which has to prepare annual income tax returns, in the case of agriculture which has to prepare annual income tax returns, there is a method for reconstructing basis.

I might refer you on page 16 where we quoted from one of my friends and colleagues who is an expert in the area, Mr. Covey of the American Bankers Association who stated in his article that "objections to carryover basis on the grounds that proof of basis problems were so severe as to merit a return to step up were premature, at least until a reasonable trial period is passed."

Let me talk again about the questions of complexity which have been raised. Again, I have to agree with you that no taxation is always simpler than taxation, but we do have a capital gains tax and the capital gains tax of necessity requires a computation of basis, otherwise, we would be taxing the entire amount of gross proceeds.

We have again proposed a list of the major problems of complexity and solutions to those problems. We see that the problems of the complexity of carryover basis seem to be nowhere as significant as the many complicated problems that we have itemized that exist in the estate tax law today. On page 17 there is a list of some of them; I will not trouble you with them.

But let me get into what you wanted to hear especially and that is what are the problems and what are the solutions which we would propose with respect to carryover basis.

First of all, again, is the question of complexity, especially as it involves small estates, and we have proposed, as I believe your bill did in the last Congress, that we eliminate nonfilers of Federal estate tax from the system altogether and that we increase the minimum basis from all taxpayers from $60,000 to $175,000 which is approximately the filing threshold for the Federal estate tax.

As we indicated once before, this eliminates 98 percent of decedents in the country from being involved with carryover basis.

Now, it has been suggested to us that that is not fair because you are taking someone out of the system simply because he has a small estate and you are saddling the large estates with all of the difficulties and the complexities of carryover basis, and I would like to address that problem.

First of all, we have proposed the elimination of estates under $175,000 not because this is a politically expedient thing to do but simply because that is not where the problem is. The bulk of the appreciation when you take out personal property and residences, the bulk of the assets that involve the problem are in estates over $175,000. But, Senator Bentsen—I know you raised this question with me—in order to treat the large estates equally with the small estates, we have also suggested that they have a minimum $175,000 basis so that, in effect, what we are doing is something like the income tax exemption. If you have got $1,000, the first $1,000 of income is not taxable for the small taxpayer or the large taxpayer, and so we have $175,000 of minimum basis that is available both to the small estates and to the large estates.

Senator BENTSEN. Mr. Chairman, since my name was used, I would like to say that I look on this as a political move to try to gain support. If there is inequity for one, there is inequity for the other.

If it is a complex thing for the small estate, it is also a complex thing for the very large estate and we ought to try to get some uniform application.

The question here is not a question of a loophole. It is a question of double taxation. You are taxed twice. I do not look on death as a vol-

untary conversion. It seems to me that most people do not really choose to die.

The estate tax is a high tax in this country. The estate tax goes up to 70 percent here.

Let me cite you what the estate tax is in other countries. In Austria, the law distinguishes between five classes of heirs. The lowest taxpaying class is composed of spouses and children and the tax rate for this class ranges from 2 percent to 15 percent.

In Belgium, the lowest taxpaying class is composed of spouses and children and the tax rate for this class ranges from 3 percent to 17 percent. Remember, again, 70 percent is the maximum in this country.

In Denmark, the rates range from 2 percent to 32 percent for children and spouses.

In France, the rates for spouses and children range from 5 percent to 20 percent.

In Germany the rates for spouses and children range from 3 percent to 35 percent.

Only in Britain do we see confiscatory estate tax rates and we are all familiar with the economic problems of that country. In Britain transfers to children can be taxed as high as 75 percent. But what you are talking about is going beyond that, Mr. Lubick, and you are talking about small business, farms and ranches which may have to be sold because they are often illiquid. That is my concern about your approach. I just frankly do not think it is fair, and I think one tax on death, particularly when we have a high tax, is quite sufficient.

Senator BYRD. Thank you, Senator Bentsen.

Mr. LUBICK. Senator, if I may reply briefly, carryover basis, as we have indicated, is not a tax on death. It is a continuation of the basis until the property is sold. But again, as we deal with these other countries. I think it is hard to take one aspect of their tax system. A number of them do have annual wealth taxes as well, which we do not have, and one has to look at the tax burden as a whole.

Senator BENTSEN. I am not asking for reduction of our estate tax; I am not asking for that. What I do disagree with is a double tax, a tax added on top of that. Even though you say it is not an estate tax, the capital gains tax, it certainly becomes a liability when a person dies.

Mr. LUBICK. And for that purpose, we have proposed an adjustment in the basis for the estate tax on the appreciation, but in the case of the man who sold immediately before death, he has paid his income tax and he is paying the estate tax on what is left. There is a question of equity among taxpayers who have the same amount of wealth and who are very wealthy, and we have one group of wealthy taxpayers who essentially are paying an income tax and an estate tax because they have sold and we have another group who have retained and are paying only an estate tax.

Now, it is much fairer if we have the same total burden but to spread it differently so that those who are paying tax, exclusively estate tax, will not pay less estate tax and some income tax and those who have been paying an income tax and an estate tax will continue to pay their income tax, but will pay less estate tax. It is the equilization of this burden which is the fundamental question of fairness between the two situations.

That, it seems to me, is the problem which has to be addressed. There is no more double taxation here than there is in any situation where one has realized income, paid his tax, and thereby has less in his estate subject to estate tax. He is still subject to the estate tax.

The basic question, I think, is illustrated by the situation where there is no estate tax and in that situation, if you have zero estate tax, would it be fair to say that the man who had never sold in his lifetime, in the event of his death, simply has the entire income tax liability on the fortune he has built up during his lifetime completely eliminated.

Senator BYRD. Thank you very much, Mr. Secretary. I will ask the committee counsel to be in touch with you and try to work out another hearing date some 60 to 90 days hence.

Everyone who is on the list of witnesses came here under good faith, and even though we are spinning our wheels since we have no legislation before us, I want to give each witness an opportunity either to testify today or to testify the first day that the new hearings are called.

Mr. LUBICK. Mr. Chairman, may I say just one thing? There are a number of other recommendations which we have made with respect to carryover basis and I do believe that the explanation contained in the formal statement is——

Senator BYRD. Yes; that will be published in the record in full.

Mr. LUBICK. So that everybody will have an opportunity to see them and to comment on them and we would welcome evaluations of those ideas and——

Senator BYRD. And anyone who wants to will, I am sure, avail themselves of the opportunity to comment upon your testimony. But they will also have an opportunity 30 days after you next testify to comment.

Mr. LUBICK. You are going to give me another crack?

Senator BYRD. I am going to give you another opportunity. I had hoped and expected that you would have a precise proposal today.

Senator Dole?

Senator DOLE. First, I would like to have included in the record prior to Mr. Lubick's statement a statement by the distinguished Senator from Mississippi, Senator Cochran.

Senator BYRD. Yes; that will be published in the record, without objection.

[The material follows:]

STATEMENT OF SENATOR THAD COCHRAN

I appreciate this opportunity to present my views on an issue of such great interest to so many people. There exists a wide variety of reasons why the 1976 provision in the tax law should be eliminated. First, the carryover basis rule in its present form is inadministrable. Second, it significantly increases the level and costs of taxation. And third, these increases produce a wholly undesirable impact on our social and economic life.

The public outcry which followed the legislation's introduction in the Tax Reform Act of 1976—and which has successfully forced its suspension and present reconsideration—has largely been directed against its confusing language and against the even greater confusion the principle would create in practice. The previous stepped-up basis rule had the significant virtue of simplicity. Establishing the fair market value of property acquired from a decedent at the date of transfer was easily determinable, dependent on no interceding unknowns. Furthermore, the rule's application did not confuse the division of property amongst

heirs. Nor did it create undue problems for executors. What we have in the present carryover basis provision, on the other hand, is a complex muddle that no amount of "clean-up" can sufficiently improve. The flood of reform proposals presented during the 95th Congress indicates its serious problems. During its consideration of the "Technical Corrections Act of 1977" this Committee compiled a record of some 450 pages of criticisms and suggestions from interested members of the public.

Our laws must be clear and straightforward both in word and application so as not to befuddle those for whom the laws are intended. Current law does not meet this test and should be repealed.

There has been much criticism about the unwieldy adjustments and exemptions included in the law. Included among those who have expressed concern about the administrative workability of the carryover basis are David Hardee and George Hauptfuhrer of the Committee on Carryover Basis in the Taxation Section of the American Bar Association, Arthur S. Hoffman of the American Institute of Certified Public Accountants, and John Butala, Jr., of the American Bankers Association. The thrust of their argument is that determination of original purchase date and value for personal property is in a large number of cases speculative. Many people do not hold records of the original purchase value of property they have inherited. Nor is it general practice to ascertain the tax basis of gifts received. But such records by the present law must be maintained and by many people for whom that law will ultimately not apply. As no one can be certain if they will eventually fit within the minimum basis requirements, especially in light of inflation, it is in their interest to act as though they shall.

Assuming that the basis of each asset is established—and every item's basis must be established at risk of penalty—the executor of the estate must then wend his way through an obstacle course of poorly defined exemptions and basis adjustments to determine the potential tax on each asset. I will leave it to others to detail the enormous problems of computation. I must, however, emphasize that this imposes a degree of fiduciary responsibility toward heirs which executors may be reluctant to shoulder. As Mr. John Butala, Jr., of the Taxation Committee, Trust Division of the American Bankers Association, informed this Committee in October, 1977:

"Perhaps the most fundamental objection to carryover basis is that it represents an undesirable intrusion by the Federal Government in the administration of estates. . . . The sale of assets to meet estate obligations is now significantly impacted by tax considerations, and in many cases executors will be required to make sale decisions involving substantial monetary consequences despite less than adequate basis information. . . .

". . . The total effect of the carryover basis law is that a fiduciary must now slash his way through an underbrush of tax complications to administer the estate, and even a routine estate now requires the assistance of a professional expert."

Executors have always had the formidable problem of determining which heirs are due which assets, but the situation is now exacerbated by the carryover provision in that it will make allocation of assets of equal fair market value dependent on their bases. The result will be a barrage of disputes among the beneficiaries and between beneficiaries and executors as to the proper distribution of assets.

The numerous administrative problems created by the carryover provision contribute in part to the second reason I have offered for the bill's repeal. Carryover basis will raise the level and costs of taxation at a time when we need less taxation, not more. The minority tax counsel to this committee estimates that between estate tax and income tax the tax rate in some cases could be as high as eighty percent. These might be the exceptions, but in any event the carryover basis will cost the taxpayer over $1 billion at the present minimum basis or $746 million at the newly proposed minimum basis.

The amount paid in taxes does not, however, give the full picture of the costs of the carryover basis. The legal fees incurred by disputes resulting from implementation of the carryover basis must be considered. Another by-product will be the additional expense incurred by executors in the difficult search for proof of basis, not to mention the man-hours necessarily spent in adjustment computations. Whether it be as a direct result of increased basis or as indirect legal costs, I do not believe that any rise in taxpayer costs is proper at this time.

The impact of this new tax provision should not be viewed in merely monetary terms, nor solely in its application to the individual taxpayer. Every law has a social impact which must be considered. One of the reasons given for seeking an

alternative to the earlier stepped-up basis provision was that its promises of future tax relief for one's heirs kept prospective decedents from selling their property. This effectively locked-in the property for an indeterminable number of years and inhibited the flow of capital. The introduction of carryover basis in no way solves that problems and may, in fact, perpetuate it. It encourages heirs to hang on to inherited assets which have greatly appreciated in value, discouraging any future sale.

A quite different result might occur for those whose liquid assets are not sufficient to offset rising levels of taxation. In such cases the carryover basis would work to exacerbate the problems involved in obtaining required funds. Two specific areas of the economy warrant inspection along these lines. Most critical to the welfare of this nation are the economic conditions under which our farmers operate. A tax environment conducive to the strengthening of family farm business is most desirable. But the application of carryover basis on agricultural holdings may have quite the reverse effect. The National Milk Producers Federation, the National Cotton Council of America, the National Association of Wheat Growers, and the Forest Industries Committee, among others, would, I am sure, join me in expressing the fear that the carryover basis would work to break-up the land. The only real asset of the majority of our farmers is in the land itself. Because of the higher income tax liability imposed by the carryover basis rule on inherited land, the need to satisfy estate tax or other debts would drive the farmer to sell even more land than had been the case previously.

The timber industry, a land intensive industry which relies on generations of growth to reach productivity, may suffer more than most the effects of carryover basis. With an already low return on investment, we can expect to see productivity shrink as the incentive grows to take land out of timber production. The price of our newspapers, books, and furniture may rise accordingly.

As introduced in the Tax Reform Act of 1976, the carryover basis rule is a sloppy, ill-defined and poorly thought-out concept. It has brought down a flood of criticism and proposed reforms. But the problems inherent in the rule make it unworkable, and, I believe, in many ways any tax law maintaining the carryover rule would have effects on our economic and social life we do not desire.

Senator DOLE. I would also like a copy of my statement included prior to the statement made by Treasury.

Senator BYRD. It will be published in full.

Senator DOLE. That is a summary of it.

[The prepared statement of Senator Dole follows:]

STATEMENT OF SENATOR BOB DOLE

Mr. Chairman, I appreciate your efforts in calling these hearings today to discuss the fate of the carryover basis provisions adopted as part of the Tax Reform Act of 1976. I know of no one else in the Congress who has demonstrated more interest and more concern than the distinguished Senator from Virginia (Senator Byrd).

Mr. Chairman, under the law prior to the Tax Reform Act of 1976, the basis of inherited property was generally "stepped up" or "down" to its value on the date of the decendent's death. Under the carryover basis rules, however, the beneficiaries of an estate generally take a basis in the property that is the same as the basis in the property as held by the decedent. The carryover basis rules are complicated, unfair and in many cases will cause economic hardship. As the sponsor of S. 112—a bill to repeal carryover basis—I believe it is incumbent upon Congress to eliminate the onerous and ill-conceived carryover basis rules.

COMPLICATED DISASTER

I believe that carryover basis is a complicated disaster. There is no question that the 1976 law is riddled with complexities that defy even the most sophisticated tax technician. Even if the inordinate complexities can be eliminated, which I doubt, there still remains many difficulties with carryover basis. First of all, it is often difficult to prove basis. The recordkeeping requirements and the question regarding fiduciary responsibility should not be overlooked. Carryover basis also increases the relative tax burden. The impact of carryover basis must be examined from the standpoint of both death taxes and income

taxes generated by the sale of assets to pay for estate taxes. The cumulative effect of Federal estate tax, State death taxes, the federal and state income taxes imposed upon an estate will often consume nearly all of the assets. The harsh tax result that flows from selling assets to raise money to pay death taxes should not be allowed to continue. I am afraid many small businesses and farmers will suffer.

Mr. Chairman, you will remember that last year you and I introduced two bills on carryover basis. S. 2227 was translated into the three-year deferral amendment that was adopted by the Finance Committee as an amendment to H.R. 6715, the Technical Corrections Act, and again as part of the Revenue Act of 1978. The Distinguished Senator and I also introduced S. 2228 which provided for many administrative changes in the carryover basis rules. However, after careful study of the matter and talking to groups across the country, I have concluded that carryover basis is bad tax policy.

Mr. Chairman, the enactment of carryover basis was a mistake. Congress should take the appropriate action to eliminate this error. I would urge the Senate Finance Committee to move expeditiously on my proposal for repeal.

Senator DOLE. Rather than take the time now, because of the number of witnesses. I would like to submit questions to Mr. Lubick. The answers can be provided for the record. I have some questions on the lock-in theory. It seems since the 1978 tax act an lock-in argument has dissipated somewhat.[1]

Senator BYRD. Certainly.

Mr. LUBICK. We would be very pleased to reply to all your questions, Senator Dole.

Senator BYRD. Thank you, Mr. Secretary.

[The prepared statement of Mr. Lubick follows:]

STATEMENT OF DONALD C. LUBICK, ASSISTANT SECRETARY OF TREASURY FOR TAX POLICY

Mr. Chairman and Members of the Subcommittee, I am pleased to appear again before this Subcommittee to discuss the important income tax question of the appropriate tax treatment of appreciated property passing at death.

THE TAX POLICY QUESTION

Before the Tax Reform Act of 1976 the basis of property acquired from a decedent was its estate tax fair market value. This rule is commonly called "step-up" in basis. The effect of step-up is to forgive forever the collection of any income tax on appreciation that has accrued in property held by an individual at death.

The enactment of carryover basis by section 2005 of the Tax Reform Act of 1976 has prompted volumes of comment that obscure the basic income tax issue carryover basis was designed to address. It is appropriate, therefore, to begin by identifying this issue.

To us the issue is not the workability of the 1976 carryover rules—we shall later in our statement elaborate changes that will solve the technical problems under the 1976 Act. The issue is instead whether income tax liability on gains accrued by a decedent at his death are to be entirely and irrevocably forgiven. The defenders of the pre-1976 step-up rule must make a case to justify going back to that result, other than simply that it existed before 1976. The Administration is committed to the principle that income tax on appreciaion accrued at death should no be forgiven.

FORGIVEN IS UNSOUND INCOME TAX POLICY

As a matter of income tax policy step-up is unsound for at least four reasons.

1. *Horizontal and vertical inequity.*—Step-up discriminates arbitrarily among taxpayers and creates significant horizontal and vertical inequities. This can be illustrated by a simple example.

Let us start by assuming that no estate tax is imposed on the transfer of property at death. Further, assume that on the same day two taxpayers, A and B, each bought shares of stock in the same corporation for $10,000. A and B decide to sell

[1] See appendix B to this hearing.

when the stock is worth $110,000. Each would pay a capital gains tax of 25 percent on any recognized capital gain. A goes into his broker's office and sells his shares. He walks out into the street and meets his friend B who is about to go into the broker's office to sell his shares. They engage in animated conversation about what each will do with his net after-tax proceeds of $85,000 and fail to observe a speeding vehicle which strikes and kills them both.

A sold is stock before he died.[1] He realized a capital gain of $100,000 upon which an income tax of $25,000 is due. His heir is left with $85,000 after the tax is paid.

Company B, who has died before he could sell his shares. The shares pass to his heir with a new basis of $110,000. B's heir to immediately sell the shares for that price and pocket the entire $110,000.

Accidental, untimely death has caused A's heir to receive $100,000 and B's heir to receive $110,000. The result gives an unjustafiable advantage to B's heir.

Some assert that the income tax problem so glaringly highlighted by the example does not really exist because the appreciation in the shares owned by B is subject to estate tax. If this assertion is true, the net amount received after payment of both income and estate tax should be the same for A's heir and B's heir.

To test the assertion, assume that the shares or their proceeds in the estates of A and B are both taxed at a 30 percent bracket. A's estate after payment of income tax has assets of $85,000. After the further payment of $25,500 in estate tax, A's heir receives $59,500. On the other hand, B's estate has assets of $110,000. When the shares of stock are sold to pay B's estate tax liability of $33,000, B's heir receives $77,000, $17,500 more than that of A. The combined income and estate tax burden on B's heir is reduced by about 35 percent from the burden on A's heir.

This example demonstrates two basic facts. First, the estate tax and the income tax are two separate tax systems. The estate tax applies to the transfer of property, the income tax to the receipt of income. The estate tax is not a surrogate for the income tax. It applies to wealth accumulated after payment of income tax as well as to wealth that was not subject to income tax.

Second, the example demonstrates the disparate income tax treatment which can occur solely due to the timing of capital gain recognition. Thus, step-up permits those who are able to accumulate wealth in the form of unrealized appreciation to pass on that wealth free of income tax. Those who have recognized capital gains, as well as salaried individuals, can pass on only that which is left after income tax has been paid. Only the wealthiest of American taxpayers are in a position to live comfortably solely on dividends, rents and interest derived from appreciating assets they are rarely forced to sell. No policy justifies granting this segment of society an income tax advantage over the vast majority who are not in this enviable and privileged position.

This is not an extreme or hypothetical situation. Any tax practitioner can recite from his own experience instance after instance of advice by him to his clients to retain assets that would otherwise be sold primarily to secure forgiveness of income tax at death.

Several recent court decisions demonstrate the magnitude of the problem. In *Estate of David Smith*,[2] the Court found the value of scrap metal owned by the decedent to be $2.7 million. Its basis was almost zero. Under step-up, virtually $2.7 in appreciation passed to the decedent's heirs free of income tax. In *Estate of Henry*,[3] the taxpayer made gifts of marketable corporate stocks totalling $6.7 million with a basis of $115,000. The untaxed appreciation was almost $6.6 million. In *Owen* v. *Commissioner*,[4] the taxpayer gave marketable American Express Company stock worth $5.2 million with a basis of $1,200. Virtually the entire $5.2 million passed free of income tax. In *Bradford* v. *Commissioner*,[5] property worth $2 million with a basis of $283,000 was the subject of the gift. Over $1.8 million of appreciation passed income tax free. In *Johnson* v. *Commissioner*,[6] the property given was worth $500,000; its basis was $10,800. Almost $490,000 of appreciation passed income tax free.

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[1] For purposes of illustration the technical question of when sale of stock is complete is ignored.

[2] 57 T.C. 650 (1972). Aff'd 510 F.2d 479 (2d Cir. 1975). cert. denied 423 U.S. 827.

[3] 69 T.C. 665 (1978).

[4] T.C.M. 1978-51.

[5] 70 T.C. 584 (1978).

[6] 495 F.2d 1079 (6th Cir. 1979).

This phenomenon is not restricted solely to those with inherited wealth. As noted in a recent article in Fortune magazine, "there are dozens—perhaps even hundreds—of individuals who have amassed fortunes of $50 million or more in privately held companies." [7] As the article shows, the initial investment in these enormously successful enterprises is nominal when compared to their current worth.

The impact of forgiveness of income tax at death is more significant as estate size increases. Table 1 demonstrates how estimated appreciation rises as a percentage of the gross estate as estates increase in size.

TABLE 1.—APPRECIATION AS A PERCENT OF GROSS ESTATE BY SIZE OF GROSS ESTATE (1979 LEVELS)

		Appreciation including personal residence			Appreciation excluding personal residence		
Size of gross estate (thousands)	Gross estate (millions)	Amount (millions)	As a percent of gross estate	Average per return	Amount (millions)	As a percent of gross estate	Average per return
Under $175	$25,183	$4,386	17.4	$18,000	$3,242	12.9	$13,300
$175 to $200	3,219	633	19.2	35,900	479	14.6	27,200
$200 to $300	9,037	1,800	19.9	48,200	1,375	15.2	36,800
$300 to $500	9,215	2,013	21.8	83,000	1,609	17.5	66,300
$500 to $1,000	9,774	2,280	23.3	158,500	1,888	19.3	131,300
$1,000 to $2,000	7,082	1,739	24.6	335,100	1,459	20.6	281,110
$2,000 to $3,000	3,179	821	25.8	622,400	722	22.7	547,400
$3,000 to $5,000	3,101	812	26.2	990,200	708	22.8	863,400
$5,000 to $10,000	3,057	833	27.2	1,876,100	752	24.6	1,693,700
$10,000 and over	3,365	1,153	34.3	7,161,500	1,114	33.1	6,919,300
Total	76,284	16,470	21.6	47,700	13,347	17.5	38,600

Source. Office of the Secretary of the Treasury, Office of Tax Analysis.

In fact, over 75 percent of appreciation is found in estates of over $175,000, which comprise less than 4 percent of decedents dying annually.

2. *Revenue loss.*—Step-up results in a significant revenue loss. Under step-up, an estimated $20 billion in accrued appreciation passes untaxed annually. The income tax on this $20 billion is not just foregone in the year of a decedent's death. It is permanently and irrevocably forgiven.

3. *Economic distortions.*—Step-up also creates serious adverse economic effects. The opportunity entirely to avoid income tax on appreciated assets by holding those assets until death distorts capital mobility by inducing individuals to retain assets solely to obtain this benefit. The inducement to hold assets to avoid the payment of income tax is referred to as "lock-in".

It is almost impossible to quantify the amount of wealth that is "locked-in". This is because "lock-in" is a negative phenomenon. It occurs when sales otherwise dictated by sound investment strategies do not occur. Of course, the decision not to sell may involve other considerations which cannot be separated from tax-induced "lock-in". Nonetheless, to the extent the income tax system can be said to cause "lock-in", step-up is a major source of that "lock-in". Those whose estate planning takes step-up into account, and plainly this includes many elderly taxpayers and most taxpayers with large accumulations of unrealized appreciation, will inevitably find their decision whether to hold or sell affected by this provision.

Congress in 1978 relied upon revenue from higher sales volume to justify increasing the capital gains exclusion to 60 percent. The "lock-in" effect of step-up will undermine the goal of the reduced capital gains rates enacted by the Revenue Act of 1978. The purpose of the reduced capital gains-rate was to unlock capital in the form of unrealized appreciation in assets that were not being sold because of the allegedly excessive tax burden imposed on the sales proceeds. This goal will not be met if taxpayers have the opportunity to avoid tax entirely by holding appreciated property until death.

"Lock-in" can best be reduced by treating death as a recognition event. If unrealized appreciation were taxed at the current long-term capital gains rates, a significant amount of the "lock-in" effect would be eliminated.

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[7] "In Search of the Elusive Big Rich", Fortune February 12, 1979, 12.

As to "lock-in", carryover basis is a second best approach. It somewhat reduces the "lock-in" effect for investors concerned with estate planning, since complete forgiveness is eliminated. However, if the property continues to appreciate in value, the capital gains tax would be greater when the heirs consider selling, and then their "lock-in" would be somewhat increased. Thus, "lock-in" would be decreased for some but increased for others. The net effect on aggregate "lock-in" cannot be determined fairly.

4. *Disparate basis treatment for lifetime gifts and accrued but unpaid income items.*—Carryover basis for property acquired by lifetime gift has been the law since 1921. Similar treatment has existed since 1942 even in the case of property passing at death that consists of compensation, pension benefits and unpaid installment obligations from the disposition of property. Yet, most property acquired by gift at death received a new basis. Lifetime and deathtime transfers should be treated similarly for income tax basis purposes.

THE SHORTCOMINGS OF FORGIVENESS ARE NOT NEWLY RECOGNIZED

The case against forgiveness on the grounds of inequity, revenue loss, adverse economic effects and structural inconsistency is overwhelming. It is not surprising that these deficiencies have long been recognized and that a number of responsible proposals to cure the problem were suggested prior to the 1976 Act.

In 1963, while proposing that the gain on the transfer of a decedent's assets at death be subject to income tax at that time, Secretary Dillon stated:

> The prospect of eventual tax-free transfer of accrued gains with a stepped-up basis equal to the new market value . . . distorts investment choices and frequently results in complete immobility of investments of older persons. . . . The reduction in capital gains rates alone would not effectively deal with the lock-in problem. Without this broader, more equal capital gains tax base, there would be no justification for lowering capital gains tax rates.[8]

While President Kennedy's 1963 proposal was not adopted, the House Ways and Means Committee did at one point tentatively adopt carryover basis as a solution.

The 1969 Treasury Department Tax Reform Studies and Proposals also included a proposal to subject to income taxation the appreciation in the value of assets transferred at death.[9] The proposal was addressed to the following deficiencies of step-up.

> [I]nequality in the income tax treatment of people who accumulate their estates out of currently taxable income as compared to those who accumulate estates by means of unrealized capital gains.
>
> At least $15 billion a year of capital gains fall[ing] completely outside the income tax system.
>
> [U]ndesirable economic effects because of the resulting "lock-in" effect.[10]

By 1976, Congress was prepared to address the issue. Forgiveness was repealed and carryover basis was subsituted, effective for estates of decedents dying after 1976. The reasons for change were:

Present law [step-up] results in an unwarranted discrimination against those persons who sell their property prior to death as compared with those whose property is not sold until after death. Where a person sells appreciated property before death, the resulting gain is subject to the income tax. However, if the sale of the property can be postponed until after the owner's death, all of the appreciation occurring before death will not be subject to the income tax.

This discrimination against sales occurring before death creates a substantial "lock-in" effect. Persons in their later years who might otherwise sell property are effectively prevented from doing so because they realize that the appreciation in that asset will be taxed as income if they sell before death, but will not be subject to income tax if they hold the asset until their death. The effect of this "lock-in" effect is often to distort allocation of capital between competing sources.[11]

A problem of substantial magnitude existed under stepup, the problem had long been recognized and it was resolved in an acceptable manner through the enactment of the carryover basis concept. Technical problems with the statutory provisions that have surfaced since enactment should not obscure this achievement.

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[8] Hearings on President's 1963 Tax Message Before the House Comm. on Ways and Means 88th Cong., 2d Sess., 49 (1963).

[9] U.S. Dept. of Treasury, Tax Reform Studies and Proposals, 91st Cong., 1st Sess., 28, 42, 107–111, 331–340 (1969).

[10] *Ibid.* at 331.

[11] House Committee on Ways and Means Report, Estate and Gift Tax Reform Act of 1976, H. Rep. No. 94–1380, 94th Cong., 2d sess., 36–37 (1976).

THE ARGUMENTS FOR STEP-UP FORGIVENESS

The 1976 repeal of step-up prompted a large volume of comment. It is important to examine carefully the substance of this comment to identify legitimate questions.

1. *Death is a "tax loophole".*—The assertion has been made that those who favor repeal of step-up view death as a "tax loophole." The issue is whether property which passes at death should be treated the same as property which passes *inter vivos.* It is not true that the repeal of step-up discriminates against people who sold property until death. Deferral of taxation aside, it simply places those individuals on an equal income tax footing with those who have not accumulated wealth in the form of unrealized appreciation and held it until death.

2. *Repeal of step-up will result in a new tax.*—Some assert that the repeal of step-up constitutes a new tax. This is untrue. There is no new tax imposed if step-up is repealed; rather certain property on which deferred income tax was forgiven now becomes subject to that tax. This is not a semantic point. As the Chairman of this Subcommittee stated in a recent address before the New York State Bar Association, "tax laws should apply equally to all taxpayers." When they do not, they should be changed. Forgiveness results in taxpayers who have sold property before death being treated differently than those who did not. The result is unequal application of the laws.

3. *The expectancies of those who relied on step-up must be protected.*—It is alleged that the repeal of step-up dashed the expectations of those who relied on that provision in making investment decisions. The answer to real, and not imagined, difficulties regarding expectations that should be protected lies in appropriate transition rules. The original carryover basis provision in H.R. 14844 contained no transition relief. To protect legitimate expectations, the transition rule, known as the "fresh start' adjustment, was added by the Conference Committee. If that provision does not achieve its intended purpose, it is appropriate to reexamine it and make necessary modifications. But it is totally inappropriate to retain step-up forgiveness because the transition rule may require adjustment.

4. *Repeal of step-up results in tax on inflation gains only.*—Some assert that step-up should be retained because much of the appreciation that would be subject to tax under an alternative system is attributable to inflation. The amount of appreciation involved in the gifts of property noted in the cases cited earlier demonstrate that this is not the case. There is no way that inflation can account for increases in value of that magnitude. But even if it were true, the simple example of A and B provides a total response. Each was equally affected by inflation and yet the heirs of each receive different amounts. While the effects of inflation are a matter to which the Administration is devoting considerable attention, it is neutral in this context.

5. *Death is an inappropriate time to impose income tax.*—Some of the comment over repeal of step-up has as its core the notion that it is inappropriate to treat the involuntary event of death as an income tax recognition event. This argument does not lead to the conclusion that forgiveness is correct. Rather, if accepted, it would lead one to adopt carryover basis. This is because under a carryover basis system no income tax is imposed until an appreciated asset is sold. Moreover, the argument ignores the fact that death is one of the few times an accounting of wealth is made for tax purposes.

6. *Repeal of step-up is unnecessary because unrealized appreciation is subject to estate tax.*—As I noted earlier, some assert that it is not necessary to subject unrealized appreciation to income tax because that unrealized appreciation is included in the decedent's estate and is subject to estate tax. This argument is rebutted by the simple example of A and B, one of whom sold his assets before death and the other who did not.

It has been suggested that, to the extent the argument against step-up forgiveness involves concern over the revenue loss attributable to the $20 billion of unrealized appreciation passing untaxed annually, the solution is simply to raise estate tax rates. However, there is nothing like the uniformity in the ratio of appreciable assets to estate size, between taxpayers having the same estate size, that would be required before consideration could be given to substituting an estate tax increase for repeal of step-up.

A simple increase in estate tax will not result in fairness for income tax purposes between estates of the same size.

If it is believed that carryover results in too great an overall tax burden, it would be fairer to lower estate tax rates for all estates than to forgive income

tax liability. If the Subcommittee desires, we would be happy to work with it to analyze this question. But the question of overall tax burden cannot be permitted to obscure the basic issue forgiveness raises: the equitable income tax treatment of those who have realized gain prior to death as opposed to those who have not.

7. *Carryover basis or subjecting unrealized appreciation to graduated income tax rates at death is regressive.*—The Committee may hear testimony that the 1976 carryover basis provision is regressive by estate size. A basis adjustment is made to account for the fact that estate tax has been paid on property that has been valued without taking into account the contingent income tax liability on unrealized appreciation. Because of this basis adjustment the increase in overall tax for a given amount of appreciation will decline as the size of the estate increases. This is said to be regressive.

It is, of course, true that for estates in the 70 percent bracket, forgiveness of income tax only lets the heirs keep 30 cents for each dollar of income tax that is avoided while in the 40 percent estate tax bracket the advantage of step-up forgiveness is 60 cents on the dollar. Carryover merely eliminates the advantage to the extent it exists. There is no more regressivity here than in the allowance of a deduction for administration expenses that is worth 70 cents on the dollar to a very large estate and nothing to a very small estate. Yet the deduction is necessary to measure the estate transferred. The adjustment simply assures that the estate tax applies to the correct transfer tax base, the gross estate less the amount of accrued income tax liability.

8. *Any system other than step-up cannot work because proof of basis problems are insurmountable.*—This subcommittee has previously received testimony and submissions to the effect that no system which relies upon the need to determine the basis of assets transferred at death can possibly work. The assertion is that either taxpayers do not keep adequate records of the acquisition cost of assets during their lives or if they do, those records somehow disappear at death.

This problem did not deter Congress when it first enacted the income tax. The basis of property held on March 1, 1913 was its value on that date or historical cost and the income tax system managed to work. The Canadians adopted a similar basis rule when they first treated gifts and deathtime transfers as recognition events. Their system has not posed significant basis determination questions. Both Canadian government authorities and private practitioners inform us that the issue of proof of basis has not even been a matter of public discussion. Moreover, carryover of basis has not caused significant difficulties for property transferred by gift or items of income in respect of a decedent passing at death. These carryover provisions have existed since 1921 and 1942 respectively. Nonetheless, we understand that the American Bankers Association, and perhaps others, will submit a number of actual cases in which, during the period carryover basis appeared to be in effect, executors had difficulty determining the basis of assets. We look forward to examining this report so that we can determine independently the scope of this problem and suggest appropriate solutions.

Notwithstanding the data which may be submitted, several fundamental points are relevant. First is the necessity of recordkeeping to provide for the case of a lifetime sale or other disposition of property. Second is the question of the types of assets for which it is reasonable to assume taxpayers retain cost records. Third is the standard to which taxpayers who acquired assets prior to the effective date of any new system should be held. Once these three issues have been examined it is possible to design a system which takes into account legitimate record keeping problems.

Under our income tax system (and for gift tax reporting purposes), an individual who acquires property should retain cost basis information. That information will be relevant if that property is sold or given away. Even under step-up forgiveness, records were unnecessary only if a taxpayer knew with absolute certainty that the particular asset would be held until death. Since most taxpayers pay for assets they acquire, and all taxpayers are interested in reducing tax on sale, it is in their interest to retain or obtain cost records. Otherwise secondary evidence will be needed to establish some basis or the entire sale price will be taxable.

We believe most taxpayers recognize this and do retain cost records for most assets. Whether those records are readily accessible or in a form which could be understood by others is a different question and one to be examined in the context of transition relief. However, it is simply not true that the vast majority

of taxpayers of this country fail to keep records as to the acquisition cost of the ast majority of assets they acquire, especially investment assets held by the wealthiest 2 percent of taxpayers.

The proposition that record keeping problems should control whether tax is imposed on an otherwise clearly taxable event would, if carried to its logical extreme, mean that only "easily measurable" income should be taxed. It also implies that the determination whether income is "easily measurable" rests entirely with the taxpayer. Thus, the taxpayer can, in his own discretion, control whether sufficient records exist to determine his income tax liability. If he fails to maintain records, income becomes hard to measure and hard to measure income is not subject to tax. Forgetfulness should not be blessed with forgiveness.

Records regarding the acquisition cost of closely held corporation stock may be difficult to find but should be capable of reconstruction. In the case of partnerships and subchapter S corporations past income tax returns will provide basis information. For those who are engaged in sole proprietorships, past income tax returns will show the basis of depreciable assets.

If acquisition cost records do not exist with regard to investment real estate, it is usually possible to recreate or estimate basis by a number of methods. For example, many deeds state the purchase price of real estate. Transfer tax stamps or local property tax assessments may also provide guidance. The basis of marketable securities can be estimated by reference to market quotations on or about the acquisition date.

We recognize, however, that record keeping problems do exist with regard to certain types of assets and that it is necessary to address these problems in designing appropriate relief. For example, many taxpayers may fail to retain records of the cost of items of tangible personal property such as furniture, clothing, collections of nominal value and the like. Many taxpayers also fail to keep accurate records with regard to improvements to personal residences.

Problems with records for property acquired prior to the effective date of the repeal of step-up must be distinguished from problems which may occur thereafter. Congress must assume that any justification for failure to keep records disappears once taxpayers are on notice that assets acquired after the effective date are subject to the new statute. Step-up cannot be retained just because there are fears that taxpayers will not keep records.

Therefore, the record keeping problem the Subcommitee should focus upon is that of basis information for assets acquired prior to the effective date of the repeal of stepup. Our experience under the income tax when originally enacted and the recent experience of the Canadians indicate that this should not be a serious problem. Moreover, the problems that do exist should be alleviated by the "fresh start" concept adopted in 1976.

Under this approach, the basis of property in the hands of an heir is the greater of historical cost or value on December 31, 1976. Two rules exist to determine value on December 31, 1976. If the property was a marketable security, the value is the market quotations. The December 31, 1976 value of all other property is determined by pro-rating appreciation from the date of acquisition to the date of death on a daily basis and adding to the acquisition cost that portion of the appreciation attributable to the holding period prior to December 31, 1976. However, under the 1976 rules, the fresh start adjustment is available only for purposes of determining gain. Thus, historical cost is also important because it is the only basis upon which a loss may be recognized.

Under this system of transition relief records play an important role. However, a few simple changes should resolve the record keeping problem for the vast majority of taxpayers. For example, consider the following. The present $10,000 personal and household effects exclusion would be increased to $50,000, property subject to the exclusion would be expanded to include tangible personal property which was a capital asset in the hands of the taxpayer, and excluded assets would be determined in ascending order of value as reported on the decedent's estate tax return. The basis of property acquired prior to the effective date would continue to be the greater of acquisition cost or the fresh start value but the fresh start value would be available for determining both gain and loss. Fresh start value for marketable securities would be the market quotation on the relevant valuation date. Certain classes of property the value of which will not increase after the valuation date (such as notes or selected types of preferred stock) would be treated like marketable securities for this purpose. All other property would have the fresh start value determined by use of a generous formula starting with estate tax value and assuming annual

appreciation of 6 percent, subject to a minimum in any case of 25 percent of estate tax value. That is, the fresh start value would be determined by dividing estate tax value by a number from a table which would contain the appropriate discount rate. The discount back formula would replace the present time apportionment method.

In this system, historical cost is relevant only if it exceeds fresh start value. It is not needed to determine fresh start value as is presently the case.

It is true that historical cost may exceed fresh start value and executors may still feel pressured to find historical cost. In the case of almost all property, however, it should be possible for the executor to make an educated judgment as to the likelihood of historical cost exceeding fresh start value. Where that is probable, we also believe satisfactory information to recreate basis will exist. However, if the Congress feels that finding historical cost, even after taking into account this generous fresh start relief, is still a burden it could simply say that the basis of assets acquired prior to the effective date will be equal to the fresh start value.

A solution such as that set forth above should eliminate proof of basis problems for the bulk of the examples which will be presented to the Subcommittee for assets acquired prior to the effective date. As for assets acquired after the effective date, taxpayers are put on notice of the need to retain basis records. Special relief is provided for household effects and the like.

In short, we believe the proof of basis issue is a red herring. We agree with the Special Tax Counsel to the Trust Division of the American Bankers Association, Richard B. Covey, who stated in a recent article that objections to carryover basis on the ground that proof of basis problems were so severe as to merit a return to step-up were "premature, at least until a reasonable trial period has passed." [12]

9. *Carryover basis delays the probate of estates, inordinately increases the cost of estate administration and presents irreconcilable fiduciary conflicts.*—The allegation is made that carryover basis, solely by introducing a new concept to be taken into account during estate administration, frustrates efforts of the probate bar to simplify the administration of estates. It is true that any departure from step-up introduces additional complexity. However, if the proposals we suggest are adopted this complexity will not exist for 98 percent of the estates coming into existence annually. The question is whether carryover basis unduly affects and delays administration of the estates of the remaining 2 percent.

If our proposals are adopted, much of the anticipated difficulty and cost of administration of carryover basis is eliminated. The aggregate cost of compliance will be insignificant compared to the revenue it generates and the increased income tax equity it produces.

It is also alleged that carryover basis improperly intrudes in estate administration by creating an entirely new set of considerations to be taken into account in distributing assets to various beneficiaries. While by no means certain under applicable state law, it is possible that a fiduciary may have to take income tax basis into account in making distributions.

If this is an assertion that fiduciaries are incapable of administering estates when they must take tax consequences into account, it is a curious one. Estate planning and administration is replete with tax considerations. The tax literature abounds with learned discussions of various minimization techniques. Entire books have been written on subjects such as the marital deduction. Law schools devote entire courses to estate planning and administration. Many wealthy taxpayers, who also happen to be those who would be affected by the repeal of step-up, often pay substantial legal fees to tailor estate plans to minimize taxation.

If this argument is premised on the fact that property with bases different from estate tax value cannot be dealt with by fiduciaries, it is also rather curious. The real world is complicated for those administering large estates. Fiduciaries must already make choices which have both tax consequences and affect the net amounts received by beneficiaries and they are not clamoring to have these elections eliminated. For example, fiduciaries must decide whether to file a joint or separate income tax return for the year of the decedent's death; whether to claim expenses as estate or income tax deductions; whether to elect the alternate valuation date; whether to elect special use valuation; whether to elect to pay estate tax in installments; whether to distribute property in cash or in kind; whether to receive retirement benefits in other than a lump sum; the choice of a fiscal

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[12] Covey and Hastings, "Cleaning up Carryover Basis," 31 The Tax Lawyer 615, 695 (1978).

year: whether to accumulate or distribute estate income; which assets to sell and how to reinvest the sales proceeds; when to settle claims and when to terminate administration. Carryover basis considerations do not materially add to these decisions. Indeed, in the more sophisticated estate plans, decisions with regard to the administration of formula marital deduction clauses make the alleged carryover basis problems pale in significance.

THE CHOICES

I have previously stated that the Administration is committed to the principle that income tax on appreciation in assets held at death should not be forgiven. The choices as to how to tax this appreciation are two: treat death as a recognition event for income tax purposes or provide that the decedent's basis carries over to his estate and heirs.

There are a number of principles that should be applied in making this choice. First, the system should be as simple as possible consistent with the principle that similarly situated taxpayers should be treated similarly. Second, the system should intrude as little as possible in the estate administration process. Third, where the system may produce hardships, such as liquidity problems, those issues should be identified and dealt with in a fair manner. Fourth, the treatment of lifetime and deathtime transfers should be the same.

Any system without step-up forgiveness is more complicated than a system with step-up. There is no question that forgiveness is simple. There is no need to determine basis and so long as an individual does not sell an asset, inaccurate or nonexistent records present no problems.

However, this argument proves too much. Nontaxation is always the simplest system and an argument as to simplicity can be made with regard to almost any taxing provision, including deductions or credits.

There is much to be said in favor of treating the transfer of property at death as an income tax recognition event. It achieves parity between taxpayers who sold property before death and those who did not, with those who held assets until death still retaining the advantage of tax deferral on unrealized appreciation. Such a system could be more simple than carryover basis because accounts would finally be settled at death. Alleged fiduciary problems encountered in taking into account potential income tax liability in connection with the distribution of property to various beneficiaries would be eliminated. The distortions of "lock-in" would be lessened. Finally, basis adjustments to account for estate tax attributable to unrealized appreciation would be eliminated.

The Treasury Department believes that treating a transfer at death as a recognition event is an entirely acceptable solution to the step-up problem. We have devoted considerable time over the last several months on the development of alternatives to implement such a system, including an examination of the two forms of "Additional Estate Tax" until recently favored by the American Bankers Association. If the Subcommittee indicates an interest in pursuing this course, we would be willing to supply these materials when we have completed our work on them.

I have also indicated that, in concept, carryover basis represents an acceptable solution to the forgiveness problem. However, we agree experience has shown that the 1976 Act statutory structure could be improved.

Recognizing this, Treasury has made a major effort to meet with interested professional groups and individuals to learn of their specific concerns and their suggestions for change. We have received valuable assistance from the American Institute of Certified Public Accountants, the Trust and Estates Law Section of the New York State Bar Association and individual members of the Special Carryover Basis Committee of the Tax Section of the American Bar Association, to name just a few. This hearing, we hope, will provide another opportunity for the public to suggest to the Subcommittee and Treasury their proposals for modifications.

At this time I should like to examine the complaints regarding the operation of the 1976 carryover basis provision that have been registered with the Subcommittee in prior hearings, and propose solutions to them. I shall divide my discussion of these problems into three areas, the basic statutory provision, the transition relief afforded by the fresh start adjustment and liquidity issues.

1. The Basic Statutory Provision

(a). The provision is overbroad because it applies to the estates of many decedents who are not required to file estate tax returns.—We recommend that

In general, carryover basis would apply only to those estates for which estate tax returns are required. The basis for assets held by estates not required to file Federal estate tax returns would be determined under step-up. Executors of nonfiling estates would not, therefore, be concerned with the basis of any property included in the estate except, as under present law, items of income in respect to the decedent. This change would eliminate approximately 98 percent of decedents dying annually from the operation of carryover basis.

It has been alleged that this change is purely a political expedient and that subjecting only 2 percent of decedent's estates to carryover basis violates the principle that the tax laws should apply equally to all taxpayers. Carryover basis will indeed apply to a small segment of decedents dying annually, but that small segment is the segment that owns more than 75 percent of all appreciated assets.

An increase in the minimum basis from $60,000 to $175,000 necessarily accompanies this proposal. Thus, the minimum basis assures that equality of tax benefit is given to large estates as well as small. Moreover, we believe the allocation of the minimum basis should be changed so that it does not depend upon a formula. Rather, the minimum basis would be allocated in the discretion of the executor first to capital assets and then, if any minimum basis remains, to assets which would produce ordinary income in whole or part when sold by the estate or heir.

The change in the allocation method will provide some measure of liquidity relief in those instances where the executor must sell assets to meet estate liabilities. It also eliminates the necessity to recompute the allocation of the entire minimum basis if there is an audit adjustment to the value of the property in the estate.

Minimum basis would be calculated prior to the death tax basis adjustment. This reverses the order of computation under the present provision. The minimum basis will therefore constitute a floor to which the death tax adjustment can be added rather than a cap as is presently the case.

(*b*) *The amount of the "personal and household effects" exclusion is too small and the term is ambiguous.*—The present exclusion would be increased to $50,000. To eliminate definitional ambiguity and relieve executors of the task of choosing excluded assets, the exclusion would be available to all items of tangible personal property that were section 1221 capital assets of the decedent. Assets subject to the exclusion would be selected in ascending order of value as shown on the decedent's estate tax return. In addition to eliminating questions of fiduciary choice, this expanded exclusion will solve the proof of basis problem for many of those who own collections.

(*c*) *The present death tax adjustments are unduly complicated, are computed by reference to an incorrect rate and require recomputation for all assets if the value of one asset is changed on audit.*—A simplified single death tax adjustment would replace the three separate but interdependent adjustments required under present law. A percentage number would be taken from the estate tax rate table and applied to each item of appreciated property subject to estate tax. The percentage to be applied would be the highest tax rate to which the estate is subject before any credits are applied, except that if an estate does not have at least $50,000 of property subject to tax in that bracket the next lower rate would apply.

To illustrate, a taxable estate of $400,000 will be in the 34 percent bracket. Each item of appreciated property equal to 34 percent of the appreciation in that property. The total federal estate tax payable on a $400,000 estate, after subtracting the $47,000 unified credit, is $74,800, or approximately 19 percent of the total estate. Yet, in this case, the adjustment would be 34 percent. Under the 1976 Act provision, the 19 percent average tax rate would have been used.

Where an estate is nontaxable because of the unified credit, an adjustment, based upon the estate tax rate schedule would nonetheless be allowed. The allowance of an adjustment in this case permits an ample adjustment for any state death taxes.

No adjustment would be made where the decedent's estate was not required to file a federal estate tax return. In that case step-up will apply.

The move to a single death tax adjustment, computed at the highest marginal estate tax rate, has been uniformly applauded as a major simplification by all with whom we have consulted. Indeed, Mr. Covey, has commented:

". . . The Treasury approach . . . is commendable and a major step towards simplifying the complex and defective section 1023 (c) and (e) adjustments. When combined with the proposed $175,000 minimum basis and with a compu-

tation of minimum basis before rather than after the adjustment for estate tax on appreciation, a fair overall result is achieved even though no direct adjustment is given for state death tax. In effect an adjustment is given for state and foreign death taxes in amounts equal to the section 2011 or 2014 (or treaty) credits because the marginal federal estate tax rate is a precredit rate.[13]

The proposal has been criticized, however, on the ground that it does not permit a basis adjustment for state death taxes that exceed the amount as a federal credit. It is true that state death taxes in excess of the federal credit do not result in an additional basis increase. However, one would question whether it is appropriate to give a federal tax adjustment for state taxes in excess of the credit amount. Rather, if a state's death taxes are too high, the problem should be resolved by the state. Moreover, the adjustment is computed at the highest applicable marginal federal estate tax rate, and therefore may result in an overcompensation because much of the estate has been subject to tax at rates less than the highest marginal rate. In addition, the adjustment is available without regard to the amount of depreciated property in the estate.

The most recent commentary of the American Bankers Association makes much of the failure to adjust for state death taxes. However, Mr. Covey makes the argument in opposition eloquently when he states, using New York as an example, that:

"The understatement of the basis increase for the New York estate tax on appreciation will most frequently occur when all of the appreciation is taxed in only one rate bracket for federal purposes. To illustrate, for a taxable estate in excess of $10 million with all appreciation taxed in the top rate bracket, the basis increase on the Treasury approach is $70 for each $100 of appreciation while under an exact method the increase would be $75 for each $100 of appreciation. If, however, the appreciation was taxed in two or more federal rate brackets, the federal basis increase under the Treasury approach would be overstated when compared with the result of an exact method. This point can be seen by taking estates of various sizes which are all appreciation. *In such a case, the Treasury approach would exceed the basis increase under an exact method until the taxable estate exceeds $60,000,000.* (Emphasis added)"[14]

Mr. Covey goes on to state:

"Major simplification would be achieved under the Treasury approach because the basis increase would in most cases not be "suspended." A change in the increase would be required only if as a result of the audit of the federal estate tax return the estate is moved up in a rate bracket."[15]

While this adjustment is generous in most cases, this generosity does not significantly affect horizontal equity, achieves a fair result and is consistent with the principle that complexity should be avoided where it is possible to achieve a comparable result in a simple manner.

(*d*) *It is unnecessarily time consuming to require the death tax adjustment to be computed separately for every asset included in the decedent's estate.*—Since the death tax adjustment is a single percentage, it is simple. Moreover, the executor would be permitted to elect to average the basis of similar items of property acquired at different times. For example, the basis of mutual fund dividend reinvestment shares or shares of stock of the same corporation acquired at different times could, at the executor's election, be averaged. The simplified single death tax adjustment would then be applied to the average basis rather than the acual basis of each share. This proposal would also simplify executors' decisions regarding the distribution of appreciated assets. All similar property would have the same basis and inherent gain would be the same.

(*e*) *Special rules are needed for personal residences.*—We propose two changes. First, if unused, the $100,000 personal residence gain exclusion would be available to the decedent's executor on an elective basis as a positive basis adjustment, without regard to the decedent's age but with the consent of a surviving spouse required. This would coordinate the 1978 Revenue Act changes with the carryover basis system. Second, an annual addition to basis (for example, $250), would be permitted for personal residences acquired after the effective date of the statute to account for improvements, unless a larger amount could be

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[13] Covey and Hastings, "Cleaning Up Carryover Basis", 31 The Tax Lawyer 615, 647 (1978).
[14] *Ibid.*, 647–648.
[15] *Ibid.*, 648.

substantiated in any year. This would mitigate the record keeping problem for minor home expenditures.

(*f*) *The present exporting requirements are unduly burdensome.*—If the foregoing proposals are adopted, basis information reporting would be required only from executors of the less than 2 percent of estates subject to carryover basis. Penalties would be assessed pursuant to a negligence standard only.

(*g*) *The basis of carryover basis property remains uncertain until that property is disposed of in a transaction in which basis becomes relevant.*—A procedure would be created pursuant to which executors could achieve a final determination of basis, binding upon both the executor and the Internal Revenue Service, at the time of audit of the decedent's estate tax return. A number of the groups with whom we have consulted have suggested that such a procedure is essential to resolve basis uncertainties and simplify the long-term administration of carryover basis.

2. *Transition Relief*

(*a*) *The fresh start rule applicable to nonmarketable property poses insurmountable proof of basis problems.*—This question was addressed earlier. To reiterate, the discount back rule of the Revenue Act of 1978 would be applied at a rate of 6 percent to determine the fresh start basis for all property held on December 31, 1976 other than marketable bonds and securities. The application of this formula could in no event result in a basis less than 25 percent of estate tax value. The present formula which apportions appreciation ratably on a day-to-day basis would be abandoned.

Historical cost would be important only if it exceeded the fresh start value. If this is deemed to impose undue burdens on executors, the discount back formula could be the sole method.

(*b*) *The fresh start adjustment unfairly discriminates against nonmarketable property, because its fresh start basis can never exceed estate tax value.*—It is true that the fresh start value of nonmarketable property cannot exceed estate tax value.

One solution is to provide a "national appraisal date" and permit the appraised value of property on that date to be its fresh start value. Congress specifically rejected this alternative in 1976 and we think it was wise to do so. Even if one believes in the veracity of appraisals, it is questionable whether all taxpayers should be put to the expense of obtaining such appraisals when it is not clear that the appraised property will be held until death. Moreover, in the real world, even contemporaneous appraisals are the subject of substantial dispute. It is, therefore, reasonable to anticipate administrative problems when the validity of an appraisal is examined many years in the future. These facts lead to the conclusion that the appraisal technique is not appropriate. The discount back formula is a reasonable alternative.

Certain types of nonmarketable property would be treated as if they were marketable securities for purposes of this fresh start rule. There are assets, the value of which will not change substantially from the fresh start date to the date of death. It is unfair to subject these assets to fresh start value determination under a discount back formula. Therefore, we propose that nonconvertible, nonparticipating preferred stock be given fresh start value equal to its redemption price on the fresh start date.

In addition, the Secretary would be granted regulatory authority to devise alternatives to the discount back formula for assets which will not substantially appreciate in value after the fresh start date, such as nonmarketable notes, and assets the value of which could be readily ascertained as of Decemeber 31, 1976 by a method other than appraisal. An example of the latter is property subject, on the fresh start date, to a binding buy-sell agreement that has the effect of fixing estate tax value. The fresh start value would be determined by reference to the formula set forth in the agreement.

(*c*) *The fresh start basis should be available for purposes of both gain and loss.*—Treasury agrees. This change would eliminate the need to retain records of separate bases for "fresh start" property.

(*d*) *The fresh start adjustment should be calculated by reference to estate tax value.*—Again, Treasury agrees. Executors would not be required to establish date of death value as a computation base where the estate tax alternate valuation date is elected.

3. *Liquidity Issues*

Carryover basis itself does not cause liquidity problems. No tax is due in a carryover basis system until carryover basis property is sold. No family farm

faces a tax liability from carryover basis until the farmland is sold. If liquidity problems exist, they arise because of the estate tax.

A large portion of the appreciated property held by estates is comprised of marketable securities and investment real estate. In the case of marketable securities there can be no liquidity problem. In the case of investment real estate, the estate tax will be imposed on the value of the property net of indebtedness. To the extent investment real estate is subject to estate tax, the net equity in the property should be sufficient to secure a loan sufficient to pay the estate tax.

Problems may exist where the investment property does not generate sufficient income to service a loan. We would be sympathetic to proposals to provide additional liquidity relief in these situations where there is demonstrated need.

Closely-held business interests and farms, which represent only 7 percent of the value of assets reported on estate tax returns, pose a somewhat different problem. In the case of farms, special use valuation significantly reduces includible value for estate tax purposes. Liberal estate tax deferral provisions provide an opportunity to spread the payment of estate tax over 10 or 15 years for qualifying farms and small businesses. Finally, section 303 provides an opportunity to have closely-held stock redeemed at reduced capital gains rates. The combination of these provisions provides a significant measure of relief. However, we are willing to explore additional liquidity relief solutions for farms and closely-held businesses that will reduce or defer the payment of income tax on assets sold to pay estate tax.

CONCLUSION

The basic issue before this Subcommittee is the fairness of an income tax system which forgives income tax on appreciated assets passing at death. Forgiveness is unsound income tax policy. Those who would return to step-up should justify that step. They cannot be allowed to use technical complexity as a rationale. Technical problems can be solved.

It is the Administration's firm position that unrealized appreciation in property held at death cannot be permitted to escape income taxation. Either carryover basis or treating death as an income tax recognition event is acceptable.

We look forward to hearing the testimony of those individuals who will appear before you and to reading the written submissions of the others. We hope you will permit us to respond for the record to the testimony you will hear today and next week. To that end I ask that you hold the hearing record open for an additional two weeks to enable us to prepare that response.

Senator BYRD. The next witness is Mr. John P. Simpson, Deputy Director, Economic Policy Analysis and Budget. Now, Mr. Simpson, who is taking the place of Mr. Kenneth Farrell, was supposed to share the time with Secretary Lubick. How long is your statement, Mr. Simpson?

Mr. SIMPSON. It is about six pages, Mr. Chairman. I can read it as fast as I need to.

Senator BYRD. You were to split an allotted time period with the Treasury Department.

Mr. SIMPSON. If you like, Mr. Chairman, I will simply ask that this be inserted in the record and I will answer questions.

Senator BYRD. Why do you not summarize your views. You may have 20 minutes, but you were supposed to have arranged with Mr. Lubick to allocate time between the two of you. If you could summarize, it would be helpful. I did not realize when the hearing was called today that the Treasury would not have specific legislation, or I would not have called the hearing today. So you do not now have anything on which to testify.

Are you testifying for or against something?

Mr. SIMPSON. I should say, Mr. Chairman, that we are not here today so much to testify for or against something as simply to point out the particular implications of different approaches to calculating capital gains on American agriculture.

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Senator BYRD. But we have no bill here on which you can testify, unless you want to testify on Senator Dole's bill to repeal carryover basis.

Mr. SIMPSON. No, sir.

I can present the statement I have, Mr. Chairman, or I can summarize our position, probably in 30 seconds, or I can come back later.

Senator BYRD. Why not take about 5 minutes and give your views or, if you prefer, go ahead and give the whole statement.

Mr. SIMPSON. Let me read it quickly.

STATEMENT OF JOHN P. SIMPSON, DEPUTY DIRECTOR OF ECONOMICS, POLICY ANALYSIS AND BUDGET, U.S. DEPARTMENT OF AGRICULTURE

Mr. SIMPSON. We do appreciate the opportunity to be here. Although the carryover basis for taxing gains is not solely the concern of agriculture interests, it is of special concern to the agricultural community and to the Department, and so we are pleased to be part of these hearings.

Our purpose here today is not, as I said, to testify on the details of the provisions that you are considering, but rather simply to provide some background on the impact of these tax provisions on the structure and health of the agricultural economy. So it is the long-term viability of the total family farm structure and all of the participants—large and small, those who have farmed for many years, and even for generations, as well as for those who are just entering farming—with which the Department of Agriculture is concerned.

Tax policies directed at the broader economy impact the farm economy as dramatically as any other government action, including our farm programs. These policies can act as an incentive or a deterrent to nonfarm investors contemplating investing in the agricultural plant. And, of course, they can influence farmers' investment or divestment decisions, and they can provide an unintended benefit, and therefore competitive advantages, to certain classes of farmers. I think the Tax Reform Act of 1976 illustrates amply how this occurs.

One of the objectives of the Tax Reform Act of 1976, as I understand it, was to reduce the trend toward greater concentration of business and farm ownership into fewer and fewer hands. Yet among the chief provisions of this act is a change in the method by which real property in an estate that is devoted to farming or other closely held business is valued for estate tax purposes. That change would allow farm property to be valued on the basis of its use as a farm, rather than on the basis of its fair market value.

Another provision allowed for a 15-year extension of estate tax payments for estates largely attributable to farm or other closely held business, replacing the 10-year extension which had been provided earlier.

The overall effect of the two special farm estate tax preferences is to reduce substantially the estate tax on qualifying farm estates. I think the most important of the two will probably be the use value assessment provision. Although the exact amount of estate tax reductions will depend on the size of the estate and its composition, our economists believe that the use value assessment can reduce farmland value by 40 to

70 percent for estate tax purposes. Of course, qualifying estates in urban fringe areas may be reduced even more.

The new installment method provided in the act is nearly as beneficial. If the value of the farm or other closly held business property constitutes at least 65 percent of the adjusted gross estate, then the period over which the tax liability may be paid is extended to 15 years and the interest penalty on the first $1 million of property is 4 percent rather than the market rate.

Of course, it is obvious that a subsidized interest rate over such a protracted period of time is quite advantageous to heirs of qualifying estates.

The combined effect of these two special farm estate tax preferences is likely to be sufficiently great that the Federal estate tax could largely disappear as a factor in the intergenerational transfer of farm estates of under $1 million in value.

Both of these changes tend to help bona fide farm families, particularly farms with limited liquidity, to cope with estate taxes and to retain possession of their farms. And because maintenance of family farms is a major objective of this administraion—and I believe, to a great extent, it is a bipartisan objective—we regard these changes of having been desirable strictly from the standpoint of promoting agricultural land retention.

But it is important to recognize that the ancillary effect of these changes is to foster accumulation or protection of assets in the hands of existing owners.

A third provision of the Tax Reform Act of 1976, and the one with which we are concerned today, was the revenue increasing provision which was designed to counterbalance the revenue concessions provided by use valuation and deferred estate tax payments.

Prior to the Tax Reform Act of 1976, the tax basis of farmland was "stepped up" to current value at the death of the owner. Consequently, in any subsequent sale by the heirs, capital gain was calculated from the time of the death of the previous owner and any gain in the value of the property resulting from appreciation, or reinvestment of corporate earnings, during the life of the previous owner was excluded from taxation.

The Tax Reform Act of 1976 substituted the carryover basis in place of the stepped up. Rather than a new value basis for capital gains purpose being established at death, the old basis is adjusted and retained until the assets are sold, so that although a farm could still be passed from generation to generation without capital gains being paid on it, when the farm is finally sold, capital gains must be paid on the entire accumulated increase in value.

Under both the stepped up and the carryover provisions, farmers and other owners of property which has appreciated in value have a strong incentive to refrain from sale of these greatly appreciated assets. The aversion to large capital gains taxes does discourage the realization of the appreciated asset value through sale.

This lock-in effect is of little concern to the family which is in farming and intends to stay in farming. It is of keen interest, however, to the investor for whom farmland is simply another attractive investment opportunity.

We have gone through a time in our history, and are going through a time, when farmland in the United States has more value as an in-

vestment asset than as a productive asset. Since 1970, average farmland value across the United States has more than doubled; in some areas of the Midwest, it has tripled.

The impact on the structure of agriculture of the attractiveness of farmland as an investment over other kinds of investments in the economy is not quantifiable. However, over the long run, land price inflation such as we have experienced in recent years tends to cause farmland to be bid away from smaller working farms to the more highly capitalized larger farms and nonfarm investors. The extent to which tax laws make farmland a way to shelter wealth for intergenerational transfer purposes, even if of benefit to some farmers, also increases the value of farmland as purely an investment asset and will therefore contribute to rising farmland prices and to the increasing concentration of farmland in the hands of larger, wealthier farmers and nonfarm investors.

The combination of higher land prices, increasing average farm size and low rate of turnover have established a barrier to potential farmers who have not inherited large farms. Today's entrants need substantial funds to establish a competitive operation. To the extent that persons inheriting farm property can escape taxation on the appreciation of farmland they have greatly improved their equity position, and use of this large equity provides established farmers a substantial competitive advantage in bidding for available farmland. Largely as a result of this, about three-fifths of the land changing hands has been an addition to existing farms. Over time, ownership of farmland, or any other form of wealth, will become concentrated in fewer and fewer hands if an opportunity is provided, literally once in each generation, to escape entirely from taxation on appreciation of assets.

Our concern is not to force farm sales but rather to eliminate a system which precludes farm sales and which leads to further concentration of farm ownership. Our goal is to move toward a system which treats agricultural taxpayers equitably with other taxpayers, but which allows continuation of the traditional family farm. Elimination of the stepped up basis as provided for in the Tax Reform Act of 1976, will potentially increase tax liabilities for certain well-established farmers who inherited their wealth. But the provision is equitable and it prevents the escape of substantial capital gains from taxation. We believe that a healthy farming sector does not need to be subsidized by tax gimmickry.

So, in summary, the Department of Agriculture opposes a return to the pre-1978 provisions which permitted some capital gains to escape taxation forever. While we favor the carryover basis over the old stepped-up basis, we do recognize that it also has unfavorable implications for agriculture. Future generations could be dissuaded from selling land in order to avoid taxes on capital gains accumulated during the lifetime of the previous generation.

Now there is, of course, as you know, a course which we may take to escape this situation. Both equity between income sources and liquidity of capital assets could be accomplished through taxation of capital gains at death. It would be very important to assure that the addition of another tax at death does not create an unreasonable tax burden.

A small capital gains exclusion at death could be allowed and there could be adjustments in the progressivity of the current estate tax

structure. We would certainly need to prevent the precipitous tax sale of land or other assets. To prevent that, payment of capital gains taxes and perhaps other estate taxes could be amortized over a period of years.

Taxation of capital gains at death would, however, avoid locking in of capital and it would tax capital gains which would otherwise escape taxation.

Senator BYRD. Thank you, Mr. Simpson. I have only one or two brief questions.

As I understand it, you are speaking for the Department of Agriculture now?

Mr. SIMPSON. Yes, sir.

Senator BYRD. You and the Department of Agriculture favor the carryover basis legislation as enacted in 1976?

Mr. SIMPSON. We do favor it, Mr. Chairman. We have reservations about the carryover basis, but given the choices confronting us——

Senator BYRD. But you feel that that is a workable, appropriate piece of legislation?

Mr. SIMPSON. We feel it can be made workable, sir.

Senator BYRD. Do you think it is workable now?

Mr. SIMPSON. I think the gentleman from Treasury would concede that there are some problems.

Senator BYRD. I was really asking your view and that of the Department of Agriculture. Do you feel it is workable as it is now, or not?

Mr. SIMPSON. I think in order to make it work—or, when it works, it could impose great difficulty on some farmers who have accumulated assets at different periods of time over a lifetime, who have not maintained scrupulous records of their costs of acquisition.

Senator BYRD. And there are many farmers in that category, I would assume.

Mr. SIMPSON. Particularly among older farmers, yes, the recordkeeping is not meticulous.

Senator BYRD. Those with smaller operations particularly have this problem.

Mr. SIMPSON. Yes, sir, generally.

Senator BYRD. Well, there are three, perhaps four, courses of action, as I see it, that this Congress could take. One is to repeal it entirely as Senator Dole recommends.

Another is again to defer carryover basis. Another is to modify it and another is to just leave carryover basis alone as it is.

Now, do you favor leaving it as it is, or not?

Mr. SIMPSON. Well, sir, we favor retaining it with modifications to make it workable.

Senator BYRD. So, in your judgment, it is not workable or fair the way it is today?

Mr. SIMPSON. Under its present form, it can only be made to work with great difficulty. It can be made to work, but as you have pointed out, there are great difficulties involved.

Senator BYRD. There are great difficulties, and as you pointed out, it could be very unfair and work great hardship on many small farmers who have not, over the years, known that they had to keep records. It could be very detrimental to them.

Mr. SIMPSON. Yes, sir.

Senator BYRD. Thank you, sir.

Senator Dole?

Senator DOLE. I have some brief questions.

I appreciate your statement particularly your reference to family farms. The concerns over agriculture are a bipartisan effort.

I am concerned about the impact of the Treasury suggested as what we might see as destruction or breaking up the family farm, many of those farms are being gobbled up by agribusiness and this is a policy contrary to what we want.

You do not see any problem there?

Mr. SIMPSON. Senator, as you know, we are perhaps marching to a different drummer than the rest of the administration in embracing the special tax provisions which were enacted in 1976, but we believe that an approach like that is the way to protect small family farms.

But allowing intergenerational transfers to escape capital gains taxation, for any form of wealth, does permit wealth to be concentrated in fewer and fewer hands. Now, that has particular implications when you talk about farming.

I think we are all very concerned about letting food production in this country tend toward being held by fewer and fewer people. If wealth can escape taxation altogether once in a generation, then there is a potential for that to happen. So we do support the carryover basis, if modified to make it more workable.

Senator DOLE. Of course, we do not know what the total impact would be. However, it seems it might be contrary to what you and I would like. This is an area that we have to be very careful about. Congress got stirred up last year over reports of purchases by foreign investors in America's farmland. We might be doing something here that would make it even easier for somebody to come in and to buy the farm, especially if the farmers are required to sell some of the assets to meet the new income tax that we are about to impose.

I am not trying to give the worst case scenario, but I think it is an area that we have to address.

Second, I think we are all concerned about whether or not carryover basis will have an adverse effect on the agricultural community. As you have indicated, carryover basis affects capital appreciation. It affects income tax liability rather than estate taxes. As far as I can tell, the Federal tax laws do not distinguish between appreciation due to inflation and appreciation that represents an increase in the real value of an asset.

Consequently, in the case of assets held over a long period of time, the tax is increased because the nominal value is increased by inflation.

Would you not agree that the tax on capital gains hits farmers and ranchers particularly hard because of the long holding period typical of farm assets?

Mr. SIMPSON. I made the point in my statement, Senator, that for the family in farming, and intending to stay in farming, capital gains taxes—I will not say they are immaterial, but they are not of great importance.

The imposition of capital gains taxes are primarily of concern to the professional investor to whom farmland is simply another investment opportunity. I cannot say that we want to discourage investment in farmland. That would necessitate the passage of explicitly discriminatory legislation. But I do believe that it is not in the interests of

American farmers to encourage that sort of investment, and to allow investments in farmland to escape taxation.

Senator DOLE. In the case of the farm, the crops and livestock usually have a zero basis because the farmer is permitted to expense the cost of crops and raising the livestock.

Does not this prospect for the zero basis cause particular hardship and could you explain this particular effect?

Mr. SIMPSON. Well, you are correct in that crops in inventory and livestock have a zero basis. Certain costs of producing crops and livestock are permitted, though, to be deducted from tax liability as operating expenses, and I think that is the appropriate way to do that.

Senator DOLE. How about the person who gets hit by this truck before he has sold his crop. Do you see any problem with that?

Mr. SIMPSON. Well, here again, legitimate operating expenses can be deducted, it is my understanding, from tax liability.

Senator DOLE. The carryover basis and the treatment of zero basis assets means that somebody has to pay a lot of tax. I think this is another area that we need to address. I hope we are not going to pass something that damages agriculture any more than it has been over the years.

Thank you.

Senator BYRD. The Senator from Montana, Mr. Baucus.

Senator BAUCUS. Thank you, Mr. Chairman. I have no questions at this time.

Senator BYRD. Thank you, Mr. Simpson.

Next will be a 10-minute panel consisting of Mr. Thomas Field, Taxation With Representation; and Mr. Robert S. McIntyre, Director, Tax Reform Research Group of Washington, D.C.

We are glad to have Mr. Field and Mr. McIntyre.

Welcome, gentlemen. You may proceed as you wish. The two of you will need to divide the time, of course.

STATEMENT OF THOMAS FIELD, TAXATION WITH REPRESENTATION

Mr. FIELD. Good morning, Mr. Chairman. My name is Tom Field. I very much appreciate the opportunity to speak briefly to you on a subject which poses fundamental questions, as the chairman remarked earlier this morning, about how we want to tax our citizens.

I do have a prepared statement. I do not want to read it. I would prefer to have it go into the record, if that is agreeable.

Senator BYRD. Yes. It will be published in full in the record, Mr. Field.

Mr. FIELD. Mr. Chairman, it seems to me that you were entirely correct in saying that we are faced here, in this hearing on carryover basis, with really very fundamental questions about our tax system. I would like to leave with the committee, and with those who are here in the audience, a question which seems to me to be crucially important. That is, how can we, members of this committee, tax lawyers, tax accountants and others, justify to the American public a zero rate of tax on gains from inherited assets when ordinary wages are taxed at rates up to 50 percent?

I ask this committee to think about that question. How can we justify a zero rate of tax on gains from inherited assets when ordinary

wages are taxed at rates up to 50 percent? That is our current situation. It is a situation which is patently and obviously unfair. It is a situation which fuels the burgeoning underground economy, because ordinary wage earners say very simply, "If they do not pay tax, why should I pay tax?"

If the rich heir who sells appreciated assets and goes away scott free from the tax collector, pays nothing, why should I who faces a Monday morning as a wage earner, pay anything? Why should I file an honest return?

So it seems to me that you are right, Mr. Chairman, that there are fundamental questions here, fundamental questions which Congress really does need to address and answer.

The chairman asked four questions in the course of his opening statement, and I would like to use the remainder of my time to provide quick, brief answers to those questions.

First of all, we were asked, what about the effect of the carryover basis rule on capital incentives?

Well, the best that one can say about the carryover basis rule is that it makes the lock-in problem worse, not better. The problem is, of course, that we rejected in 1976—and again are rejecting today—the one correct way to eliminate the lock-in problem, which is to tax capital gains at death. I am disappointed that the subcommittee has excluded that solution from the list of three possibilities which are currently under consideration.

Senator BYRD. Could I interrupt you at just that point?

Mr. FIELD. Yes, sir.

Senator BYRD. The committee has not excluded that option. I expressed the view that the Congress would not accept any proposal more radical than carryover basis, but if there is a proposal before the committee, the committee will hold hearings on it, and we will proceed accordingly.

Mr. FIELD. I would respectfully suggest, Mr. Chairman, that taxation of capital gains at death is the right answer. Of course, we also need ameliorating liquidity provisions to ease the impact of a capital gains at death rule, along the lines first proposed in 1964 by Treasury and then again in 1969 in tax reform studies and proposals. That is the one way to deal effectively with the lock-in problem as well as the fairness problem.

Second, in connection with incentives, I would also like to mention that the scholars who study public finance and taxation have, for generations, pointed out that taxation of any sort, either at death or after death, has the least effect on incentives of any form of taxation.

Contrast the situation of our existing income tax with respect to ordinary wages. We tax wages annually, and that does have some effect on the incentive to work. Granted, any tax will, to some degree, affect incentives, but the possibility that one's heir may, at some distant point in the future bear a tax, certainly affects incentives less than the possibility that I will have to pay wage withholding next week.

The chairman's second question was: "Are the small revenue gains involved in the carryover basis issue worth it?"

Well, as I remarked earlier, Mr. Chairman, the central question here is tax fairness, not tax revenue. But I would like to point out that even if the revenues from carryover basis are not great, those of us who

work for ordinary wages are going to have to come up with added taxes on ordinary wages to make up the revenue lost from repeal of carryover basis and to prevent the deficit from getting out of hand.

Third, the chairman asked "Is the cost of keeping records too much for taxpayers?" I think the only short and honest answer to this is that taxpayers ought to be keeping these records right now for income tax purposes. I do not know how others handle their affairs, but certainly when I buy a capital asset I attach the proof of basis to the proof of purchase. I do that because I have to sell capital assets occasionally to pay expenses, or for other emergencies that arise in the daily course of life.

Finally, the chairman asked about the question of complexity. Will carryover basis complexity lessen respect for the tax laws? Well, for 20 years, I have seen tax lawyers cope with rules such as the trust throw back rules, the consolidated return rules, the corporation reorganization rules of subchapter C, and the 482 adjustments. Tax lawyers are certainly able to cope with the carryover basis problem, especially if the limiting changes that have been proposed by Treasury are adopted. Furthermore, if the proposed Treasury changes are adopted, we are only dealing with the richest percent of all decedents, who can generally afford tax counsel.

Thank you.

Senator BYRD. Thank you, Mr. Field.

Mr. McIntyre?

STATEMENT OF ROBERT S. McINTYRE, DIRECTOR, TAX REFORM RESEARCH GROUP OF WASHINGTON, D.C.

Mr. MCINTYRE. Thank you, Mr. Chairman. I am Robert McIntyre, director of Public Citizen's Tax Reform Research Group. We appreciate the opportunity to appear before you today to present our views, and we ask that our full statement be included in the record.

Senator BYRD. Yes, it will be.

Mr. MCINTYRE. Mr. Chairman, as you know, in 1976 Congress took major steps to improve the fairness of the estate and gift tax system. It adopted provisions which made the estate tax, I think, for the people it still applies to, much fairer, especially by exacting the generation skipping trust provisions and by integrating the estate and gift taxes. At the same time the Congress cut the estate tax substantially, so that only 2 percent of the population is affected by it.

Finally, in conjunction with these estate tax cuts, the Congress approved the major reform of the income tax laws which is called carryover basis.

Now, Mr. Chairman, no one who has studied the tax code can be unaware of the gross inequities of the old stepped up basis system. Investors were favored over wage earners, hoarders over sellers and givers, and the very wealthy over the overwhelming majority. There were many extremely rich estates, Mr. Chairman, which avoided more in capital gains taxes through the step-up than they paid in estate taxes.

Tangible investment property which is passed on at death could be depreciated anew by the heirs, based on a value far in excess of its original cost, even if it had been fully depreciated by the decedent, especially in the case of real estate.

In addition, Mr. Chairman, the deleterious lock-in effect of the old step-up regime are well known.

Mr. Chairman, if I could, I would like to submit for the record a statement by Representative Wilbur Mills in 1976 explaining why he favored the carryover system, which he said he felt was the major reform left to do in the tax system. This is from the Congressional Record.

Senator BYRD. Yes. We would be delighted to have that for the record.

[The material referred to follows:]

[From the Congressional Record—House, Sept. 15, 1976]

REVISION OF GIFT AND ESTATE TAXES LONG OVERDUE

The SPEAKER pro tempore. Under a previous order of the House, the gentleman from Arkansas (Mr. Mills) is recognized for 10 minutes.

Mr. MILLS. Mr. Speaker, the long overdue revisions in the estate and gift tax laws were taken up in the recent conference on the Tax Reform Act of 1976 (H.R. 10612). Since the House did not include estate and gift taxes as a part of H.R. 10612, the revisions agreed to in conference must be taken back to the House in technical disagreement. The conference amendment is substantially the same as H.R. 14844, the bill recently reported by the Ways and Means Committee.

I had wanted, during the period of my chairmanship, to overhaul the estate and gift tax, but for one reason or another, this is a task I was not able to achieve. The amendment agreed to by the conferees is in most respects in accord with the revision of the estate and gift tax law I would have sought and I intend to vote for the amendment and urge you to do so too.

However, I believe one feature of this conference amendment is an especially important tax reform. I am referring to the carryover basis provision. The passage of this provision is probably the most important of the tax reforms that remain to be done. I tried to bring a provision of this type out of the Ways and Means Committee in 1963 but the Congress was not yet ready for this change. In fact I believe this provision was modeled on that earlier draft.

Let me tell you why I believe the carryover basis provision in this bill is so important to our Federal tax system.

Under present law, when a taxpayer sells stock which has appreciated in value, he must pay income tax on the gain. But if that taxpayer holds the stock until he dies, the income escapes tax forever. For example, assume that a taxpayer bought $5 million worth of stock, and the stock is now worth $15 million. If he sells the stock, he will have to pay a capital gains tax on the $10 million increase in value and, perhaps, a minimum tax. But if he holds the stock until death, neither he nor his heirs will ever have to pay income tax on this $10 million increase in value.

What this means is that the existing law discriminates heavily in favor of persons who pass on large amounts of appreciated property to others. It discriminates both against persons whose estates are accumulated out of salaries, wages and out of dividends or interest, all taxed at ordinary income tax rates each year as the income is earned.

At the present time, approximately $15 billion of unrealized appreciation passes through estates each year and escapes income tax because of this loophole. Of this $15 billion, over 60 percent goes through estates of over $500,000.

In addition to the inequity in treatment of taxpayers, the present law treatment has adverse economic consequences for the flow of capital, because of its "lock-in" effect. The step-up in basis under present law is a strong incentive for taxpayers to hold appreciated property until death, in order to take advantage of the tax loophole. As a result, large amounts of capital are "locked in," in the sense that taxpayers, especially the elderly, are reluctant to sell their assets and to pay an income tax on their gains. By providing a carryover basis, Congress would actually begin to free up billions of dollars for future investment, dollars that are now frozen because of the step-up in basis at death. As a result if this change is made, investment decisions can be based on economic considerations, not tax consequences.

I would like to answer briefly some of the arguments I have heard against the carryover basis. One is that it will hurt farmers and small business. This conference amendment, however, affords substantial tax relief for farmers and small business. I might add that this relief is premised on the argument which has been made to me, and to many other members, that estate tax policy should not force farmers and small businessmen to sell out in order to pay the estate tax. If the heirs of the farmer keep the farm in the family, carryover basis will not affect them. They may continue to defer paying tax on the capital gain until the farm is sold. I might also add that because of the liquidity provisions adopted, this should minimize any pressure which the estate tax might otherwise put on the heirs of the farmer to sell his farm.

Another argument that has been made is that a carryover basis results in the imposition of a double tax. This simply is not true, and those that make the argument certainly have not taken the time to read the conference amendment. The conference amendment allows the basis of an asset to be increased by the amount of the estate tax attributable to the appreciation in the asset. This means that the carryover basis provision is drafted in a way which prevents a double tax from being imposed.

This adjustment is very important because it prevents the combined effect of the estate tax, and any capital gains tax which may be paid by the heirs of the decedent if they sell the inherited property. This will keep the tax from rising to an unreasonable level. The basis adjustment means that if the heirs sell the property immediately after they receive it, the tax burden will be essentially the same as it would have been had the decedent sold the asset just before he died. There is, therefore, no double taxation.

I would also point out that a provision in the conference agreement under which each estate is given a minimum basis of $60,000, means that this carryover provision will only affect a relatively small number of estates, perhaps 6 to 7 percent of all estates, at the very most. In fact, it is my understanding that the large estates of over $1 million account for much of the untaxed appreciation—so clearly any additional revenue raised by the carryover basis will come mostly from the very large estates.

Finally, the idea of a carryover basis is not a new one as some have contended. In fact, it is the same rule that presently applies for lifetime gifts. In the case of gifts, the basis of appreciated property in the hands of the donor has been carried over to the donee since 1921.

I would like to see this one additional tax reform adopted while I am still a Member of Congress. If we are to have a fair tax system this reform must come sooner or later. It will be an important affirmative step that all of us who believe in tax reform can take at this time. I strongly urge you to vote for the conference amendment dealing with long overdue revision of the estate and gift tax laws.

Mr. McIntyre. Mr. Chairman, when the carryover basis reform was adopted, it was chosen over what I believe to be the more equitable "capital gains at death" approach in order to allow farms and small businesses to be continued in a family without tax interference. In addition, it was adopted with the quid pro quo of massive estate tax relief.

Now, when Senator Bentsen was here earlier, he said he was not arguing for cuts in estate taxes. He was arguing for the income tax relief of not having carryover basis.

Mr. Chairman, we had those cuts in estate taxes in 1976. It was a compromise proposal. That bill could not have passed the House of Representatives without carryover, and it is important to remember that we did cut estate taxes substantially as the price for carryover, the price for the improvement in fairness.

Mr. Chairman, this year the Congress must decide between three general approaches: First, it can continue the 1976 compromise by adopting the technical changes the Treasury Department outlined last year and, I hope, will outline this year.

Second, it can move forward and adopt capital gains at death, or a proposal like Senator Long made last year to have a nondeductible appreciation tax.

Third, it can go back to the pre-1976 system of step-up.

Mr. Chairman, the arguments against carryover basis have, up until now, revolved around its complexity. We have studied the proposals made by the Treasury Department last year, which we believe will be repeated this year, and we do not think the complexity arguments can continue to be made.

We think that the argument for repeal is stripped bare now. It is a case for inequity between taxpayers who are equally situated. It is a case for reducing taxes on the very wealthiest families in the country, and that is at the expense of the other taxpayers, Mr. Chairman, because we have a budget to meet.

We are convinced that the best solution to this problem is to tax capital gains at death, but we believe that the carryover compromise is an acceptable alternative. We are sure, Mr. Chairman, that if the Congress carefully studies the issues involved here, it will agree that a return to step-up is unfair and we hope that having recognized that inequity that the Congress will not choose to take that step.

Senator BYRD. Thank you, Mr. McIntyre.

Senator Baucus?

Senator BAUCUS. I have no questions.

Senator BYRD. I want to thank both of you for being here today. May I say to Mr. Field that what you said impresses me as being correct that carryover basis does make the lock-in problem worse. It seems to me that is one disadvantage of carryover basis. It makes it worse rather than improving it.

Mr. FIELD. Yes. I think it has got to be said, Mr. Chairman, that under prior law—which is to say current law—that we unlocked estates once a generation. That is to say the heir, after receiving inherited wealth, could then sell essentially free of tax, unless there had been some change in the value of assets since date of death.

Under present law, the heir is just as locked in as the decedent was. Given the realities of inflation, he becomes steadily more locked in as time goes on.

The capital gains at death proposal dealt with the lock-in problem effectively, by simply wrapping up the capital gains liability once a generation. The heir is just as unlocked under the capital gains at death proposal as he is under the rule of tax forgiveness for appreciation passing through an estate.

Senator BYRD. Thank you very much, sir. I agree that carryover basis makes the lock-in problem worse.

[The prepared statements of the preceding panel follow:]

STATEMENT OF TAXATION WITH REPRESENTATION

Mr. Chairman and members of the Subcommittee on Taxation and Debt Management: Thank you for this opportunity to testify on the carryover basis issue.

THE BASIC PROBLEM: TAX FAIRNESS

Our income tax system depends on self-assessment. Because it does, it is essential that the system treat similarly situated taxpayers fairly. Unless the tax system is fair—and is perceived by the public to be fair—the willingness of individuals and firms to file honest tax returns will evaporate, and the burgeoning growth of the underground economy will continue.

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The most fundamental problems of tax fairness involve income from capital. Congress has consistently failed to insure that those who earn income from capital are taxed in substantially the same way as those who earn income in the form of wages. There are many examples of this failure, but the most glaring is the complete forgiveness of the capital gains tax with respect to appreciated assets that pass through an estate.

Congress runs serious risks unless it resolves the carryover basis problem in a way that comports with recognized principles of tax fairness. The underground economy is large, and is growing rapidly. Unless Congress begins to restrict the most glaring of the tax loopholes for those fortunate enough to own capital, millions of less fortunate persons will feel fully justified in claiming "the poor man's loophole" as nonreporting and underreporting of income have commonly come to be known.

Accordingly, the most fundamental challenge posed by the carryover basis controversy is not the question of how to satisfy the timber producers, or to ease the computational problems of lawyers and accountants. Instead, the challenge is to insure that similarly situated taxpayers are treated in an evenhanded way. You've got to insure that a working couple who earns, say, $20,000 between them in the form of ordinary wages is treated the same way at tax time as the fortunate heir who realized a $20,000 gain when he sold inherited securities or timberland. You've got to insure that the woman who sells her own securities during the final years of her life to pay living expenses is treated for tax purposes in the same way as the more fortunate widow who sells securities that she inherited from her spouse. These individuals aren't being treated the same now: in one case, income tax is imposed, and in the other it's forgiven. That violates fundamental principles of tax equity.

You've also got to assure poor and middle class taxpayers that richer individuals are bearing their fair share of the tax burden. However, the forgiveness of income tax with respect to capital assets that are transferred at death confers its greatest benefits on wealthier individuals, and the greater one's wealth, the more likely it is that this tax forgiveness will be available. Poor and middle class individuals frequently have to sell capital assets—and pay income tax on their gains—to make a downpayment on a home, pay college expenses, cope with medical emergencies, or the like. Wealthier individuals don't have to do that as frequently, because their rents, interest, and dividends are generally more than sufficient to cover living expenses. Consequently, they are more likely to retain capital assets throughout their lifetime, and to gain the advantage of income tax forgiveness when those assets pass through their estates.

THE CORRECT ANSWER: CAPITAL GAINS TAXATION AT DEATH

The correct answer to these problems of fairness is full taxation of capital gains at death, as proposed by Treasury in 1964, and again in Tax Reform Studies and Proposals in 1969. To deal with liquidity problems which may arise in a very limited number of cases, generous installment payment provisions should be provided. And of course income tax paid with respect to capital appreciation should be excluded from the decedent's estate, so that it will not be subject to estate tax.

In its consideration of the estate and gift tax changes which became part of the Tax Reform Act of 1976, the House Ways and Means Committee considered and rejected the proposal to tax capital gains at death. Instead, it adopted carryover basis as a compromise position. It reasoned that carryover basis had worked in the case of inter vivos gifts, and that it might also work in the case of testamentary transfers.

The carryover basis compromise is clearly superior to the complete forgiveness of capital gains taxes on appreciated assets that pass through an estate because it resolves the most glaring of the equity problems described above. But carryover basis is far inferior to taxation of capital gains at death as a means of dealing with those problems, and other problems too.

Since this is the first time that the Senate Finance Committee has held hearings on the tax treatment of appreciated assets that pass through an estate, I urge you to give serious considerations to taxation of capital gains at death, along the lines proposed by Treasury in 1969 in Tax Reform Studies and Proposals. This approach has the following advantages:

(a) It resolves the equity problems outlined above, without creating new ones (such as possible inclusion in an estate of the funds used by heirs to pay income tax on pre-death appreciation.)

(*b*) It eliminates the lock-in problem, thus facilitating the natural tendency of the free market economy to move assets to those areas where the return is greatest.

(*c*) It taxes the correct person—the decedent rather than the heir—thus eliminating the complications that are inherent in basis allocations under the carryover basis concept.

CARRYOVER BASIS: A LESS SATISFACTORY BUT STILL CORRECT ANSWER

For all its faults, carryover basis is preferable to the complete forgiveness of income tax which has been the law in the past with respect to appreciated assets that go through an estate. There are some modifications that can and should be made in the existing rules, along the lines proposed a year ago by Treasury. Those modifications should go a long way toward simplifying an inherently complex statute.

But to repeal carryover basis because some lawyers cannot understand it, or because timberland owners want a free ride at the expense of the rest of us, is really outrageous. If this Congress accedes to the demands of the tiny but vocal minority that is now demanding repeal of carryover basis, it will jeopardize the faith of ordinary citizens in the integrity of the political system and the tax legislative process. The repeal of carryover basis would constitute a serious blow to basic tax fairness, and would fan the fires of tax resistance by demonstrating the improbability of tax reform. The public is already very cynical about the ability of Congress to create a tax system that is recognizably fair in its treatment of similarly situated individuals. Repeal of carryover basis would amply justify the existing cynicism, and would produce more.

I therefore end as I began, with the warning that public confidence is the fairness of the tax system is a fragile but vital national asset. Repeal of carryover basis would be a clear signal that Congress is unable or unwilling to tax similarly situated individuals in the same way, or the rich as heavily as the poor. I urge you not to gamble with the fate ot our self-assessment tax system in this way.

STATEMENT OF ROBERT S. MCINTYRE OF PUBLIC CITIZEN'S TAX REFORM RESEARCH GROUP

SUMMARY OF PRINCIPAL POINTS

1. The tax forgiveness granted to capital gains in assets held at death under the "stepped-up-basis" rule in effect prior to 1976 was one of the most outrageous loopholes in the entire income tax system.
2. The best resolution of this problem would be to tax capital gains at death.
3. The compromise "carryover basis" rule adopted in 1976—in conjunction with massive estate tax reductions—in a reasonable alternative to taxing appreciation at death, and the Treasury "clean-up" amendments make this approach workable.

Although it affects only a tiny percentage of the population, the tax treatment of unrealized capital gains in property passed on at death has long been controversial. Prior to the Tax Reform Act of 1976, the tax code provided that such gains were forever free from taxation. Heirs took their inherited stocks and bonds, real estate, and other assets with what was called a "stepped-up-basis." When they subsequently sold their bequests, only appreciation after their acquisition date was subject to tax—and even then only partially, due to the capital gains exclusion. Inherited tangible investment property—especially real estate—could be depreciated based on a value often far in excess of its original cost—even if it had previously been fully depreciated by the decedent.

Since all of us eventually die, these extraordinary tax benefits could in a sense be said to be available to everyone. In practice, however, only the very wealthiest families garnered any significant benefits. In 1972, for example, the average unrealized stock and real estate appreciation in the 90 percent of estates worth over $100,000 was only $444. The two-tenths of 1 percent of estates worth over $1 million, on the other hand, contained an average of $975,000 each in such appreciation.

In addition, the step-up rule violated principles of horizontal equity in viciously unfair ways. Those who amassed wealth—even in the most limited amounts—from labor were fully taxed as it was earned. Those who made their fortunes—no matter how big—by investing could not only postpone, but escape incomé taxes on their profits—forever. Moreover, if an individual sold his property prior to death, the gains were taxed. If he gave it away, his donees took a "carryover

basis"—and they eventually would be liable for the tax. But if the individual held on to his property until the end, the tax was forgiven.[1]

These incentives for holding onto property till death created serious economic distortions. People became "locked into" particular assets—if they could afford to so be. This meant that investment funds were often not put to their best use.

The fairest, simplest, and most economically efficient answer to the step-up problem was and is to treat death as a constructive realization, that is, to tax capital gains at death. (The same rule would apply to gifts.) Under such a regime, distinctions between wage earners and investors, lifetime donors and till-death hoarders, and sellers and stand-patters would be minimized. Because the tax issues would be resolved at the time of transfer, complications would be lessened. And because tax consequences do not hinge so crucially on timing, economic distortions would be greatly reduced. In 1963 when President Kennedy proposed to tax capital gains at death it was estimated that the beneficial economic (and revenue feedback) effects of such a step would dwarf any positive results from increasing the capital gains exclusion—as Congress did last year.

When a mild form of appreciation tax at death was proposed by Representative Ullman in 1976, however, it met organized resistance from groups which can accurately be described as apologists for the rich. Eventually, the Ways and Means Committee and ultimately the full Congress approved a compromise measure to extend to bequests the "carryover basis" rules already applicable to gifts. The reform was adopted in conjunction with enormous reductions in estate taxes.

Carryover does not have all the advantages of taxing gains at death. Because its effects are often delayed, it does not go so far to equalize the situations of wage earners and investors. And its effects on the "lock-in" problem are unclear. But carryover is far more equitable than the pre-1976 step-up rule. The potential for the nation's wealthiest families to avoid capital gains taxes for generations is significantly reduced. The ability to depreciate property over and over is eliminated. Individuals who give away their property are no longer penalized. Overall, carryover ranks as a major improvement in tax fairness.

Several of the technical details of the carryover rules—some of which were adopted at the behest of lobbyists for the well-heeled—have made the administration of carryover unsatisfactorily complex. Most serious is the overly precise method of adjusting basis for death taxes, which has been accurately described as a nightmare. The step-up to December 31, 1976 values has unnecessarily added calculations which are foreign to many practitioners.

As the Treasury Department has described, however, none of these problems go to the heart of carryover. In fact, at the end of last session the American Bar Association's Tax Section, the American Institute of Certified Public Accountants, and the New York Bar's Section on Taxation all pronounced themselves reluctantly satisfied with the Treasury's "clean-up" proposals, which not only solve most of the technical problems but exempt 98 percent of estates from any contact with carryover.

In spite of these endorsements, Congress last session chose to postpone carryover until the end of this year to allow time for further exploration of the issue. We opposed postponement then, recommending instead adoption of the Treasury amendments. We continue to believe that the clean-up is a satisfactory resolution of the problem. Since the opportunity for further consideration does exist, however, we think the Congress would be even better advised to enact a tax on capital gains at death instead.

Senator BYRD. Next is a panel headed by our distinguished colleague from Iowa, Senator Jepsen. I might say, Senator Jepsen, that you had been listed to be first on the list today, but I was told that you would prefer to join with the panel of your associates from Iowa rather than to take the place that you would have had, if you had desired to have it, of being first on the list today.

Senator Jepsen will be introducing Mr. Arley J. Wilson, chairman, Probate, Property and Trust Law Committee of the Iowa State Bar Association; Mr. Milton E. Meyer III who will be speaking on behalf

[1] And it should not be thought that the estate tax is in any way a substitute for the forgiven income taxes. The individual who sells property must still pay estate taxes on the proceeds. The person who gives property away pays gift taxes.

of the Colorado Bar Association; Mr. Theodore Pasquesi and Mr. George Brodie, Jr., chairman and vice chairman of the Illinois State Bar Association section on Federal taxation.

The committee is very glad to have each of you here this morning. We are especially glad to have Senator Jepsen. I believe it is the first time, Senator, that you have appeared before this committee and I hope that you will be before us frequently on any matters in which you have an interest. Welcome.

STATEMENT OF HON. ROGER W. JEPSEN, A U.S. SENATOR FROM THE STATE OF IOWA

Senator JEPSEN. Mr. Chairman, thank you very much for the opportunity to testify before your subcommittee today on a matter of great importance to the people of Iowa—in fact, I think, of importance to the people of this country. That is revision of the carryover basis provision of the Tax Reform Act of 1976.

I hope that my few minutes—and I would like to take a few minutes to make a very few, brief remarks—will be considered as not part of the 25 minutes for the people who are really the experts here.

Senator BYRD. Yes. That will be satisfactory.

Senator JEPSEN. You hear them talk about two things that are certain, death and taxes, you know, and it is kind of a misnomer. Death is uncontrollable and it is certain and we cannot control the time and the circumstances, but taxes are controllable both as to time and circumstances, and that is what we are talking about this morning.

Later this morning, you will be hearing from expert witnesses far more competent than I do to discuss technical aspects of the law, including Mr. Arley Wilson of the Iowa Bar Association, and therefore, I am going to confine my remarks to more general aspects of the problem as I see them.

The Tax Reform Act of 1976 marked the high point in the drive for tax reform. While there are certainly innumerable aspects of the tax law which deserve reform and revision, the drive for tax reform which culminated in the Tax Reform Act of 1976 was really just a euphemism for soaking the rich. The goal of the reformers was quite simply to increase the tax burden on the rich so that taxes could be reduced for the poor. Since it was not feasible to increase statutory tax rates on the rich, it was decided to attack loopholes and thereby raise the effective rate of taxation on high income.

The fuel for this tax reform effort was the erroneous notion that many, or even most, people with high incomes pay very little, if any, taxes. The logical corollary to this is that the poor are paying more than their share, and we have heard that alluded to by prior witnesses here this morning.

The true situation is quite different. According to the latest IRS figures, those in the upper 50 percent of gross income classes with incomes of $9,561 or more in 1976 paid 93.3 percent of all individual income taxes. Those in the top 25 percent of gross income paid 73.2 percent of income taxes and those in the highest 10 percent of gross income, paid 49.9 percent of all individual income taxes.

By contrast, those in the lower half of gross income classes paid 6.7 percent of total income taxes in 1976.

Now, I am not suggesting, of course, that taxes be increased for those with lower incomes. I am merely suggesting that the emphasis on tax reform is misplaced, and this is how we got ourselves into this carryover basis mess.

My understanding is that the rationale for changing the previous stepped up basis for taxation of assets at death was that it constituted a tax loophole for those who died before disposing of their assets. In other words, you had to die first before being able to take advantage of this so-called loophole.

I have a lot of problems with this kind of rationale, Mr. Chairman. In the first place, I do not like the term "tax loophole" or the newer term, "tax expenditure." These terms imply that the Government has some preordained right to your income, and if you are allowed to keep some of it by a provision of the tax law, then there is something wrong with the law.

Another problem I have is the implication that tax breaks, such as they are, are primarily available only to the rich. Actually, most tax breaks accrue to those with moderate incomes. Examples of these are the deduction of mortgage interest on owner-occupied homes, the deductibility of property taxes on owner-occupied homes, the exclusion of employer contributions for medical insurance, medical care, and pension contributions.

Now, those tax breaks, which do appear to primarily benefit those with upper incomes, on the other hand, are much fewer in number than one would suspect; they tend to have considerably less fiscal impact; and are often associated with things the Government clearly wants to promote, such as charitable giving.

In the latest Federal budget, the tax expenditures for capital gains at death is listed as $9 billion for fiscal year 1979 and $10 billion for 1980. By implication, the Treasury is saying that if carryover basis were fully implemented then taxes on the American people would increase by $9 billion to $10 billion. Although I question the basis on which these estimates are derived, nevertheless, implementation of carryover basis rules would amount to a significant tax increase.

I think this is entirely inappropriate at a time when individual income taxes are rising at the rate of $10 billion to $12 billion per year solely due to inflation. Social security taxes have taken a giant leap and the American people are revolting against the high level of taxes and spending.

This is the most important point I would like to raise today regarding this carryover basis problem. It is nothing more than an effort to raise taxes and redistribute income in the name of tax reform. This, and similar so-called reforms, are now associated in the public's mind with tax increases. Thus, it is not surprising that Secretary of the Treasury Blumenthal has said, "There is a big constituency in the country for tax reduction but not for tax reform, except as reform is used as a code word for reduction."

I agree.

Just to show the committee how far this reform thing can go if it is allowed to continue, let me draw your attention to special analysis G of the President's 1980 budget. This section discusses tax expenditures in detail, including an explanation of particular items that are not yet

subject to tax. In reading over this discussion, there is a very strong implication that such items ought to be taxed. Let me quote one part:

> Imputed income from owner-occupied housing and other sources. A theoretically pure income concept would include imputations for income received in kind from the occupancy of a home owned by the taxpayer and for in-kind income from the ownership of other durable assets.

In other words, as I read it, if you live in your own house you are somehow escaping taxation to the extent that you ought to be paying rent to yourself and be taxed on the income. How utterly absurd a concept.

Under such logic, the amount of taxes a person could theoretically be forced to pay escalates to infinity. Presumably, every time you mowed your lawn, or painted your house, or did any work for yourself at all, the IRS could compute the value of such labor as though you hired yourself to do it and taxed such imputed income for tax purposes.

Lest anyone think that an absurdity such as this is not a real possibility, given the mentality of those in the administration or its allies at the Brookings Institution, let me remind you that last year, the Commissioner of Internal Revenue, Jerome Kurtz, launched a campaign to tax fringe benefits. The Congress was ultimately forced to restrain the IRS from such action by law.

The logic of Kurtz's proposal is really no different from what I have just postulated. He wanted to say that if a person was given a parking space at work, his gross income for tax purposes should be increased by an amount equivalent to what it would have cost that person to pay for parking. He even admitted that this approach to employee compensation could be extended to include such things as discount meals in company cafeterias, homegrown food by farmers, medical and life insurance, and many other things that would have drastically increased the tax burden on working people.

I have gone rather far afield from a specific discussion of carryover basis, but I wanted to make it clear that carryover basis is only one aspect of a larger problem, which is the intrusion of the Federal Government into more and more areas of our personal life. The worst intrusion of all is when our personal property is confiscated from us.

In my area of the country—Iowa—the people are extremely concerned that family farms and businesses will be lost forever due to already heavy estate taxes. Things like carryover basis can only make the situation worse. They are also upset about the incredible complexity and paperwork involved in complying with such laws. The people I represent want to pay their fair share of taxes but feel they are being forced to pay more than their fair share. Indeed, they feel that Federal taxes today constitute virtual confiscation.

In closing, after which I will defer to my friend, Arley Wilson, who will discuss more technical aspects of the law, I would just say that anyone who does not believe there is a tax revolt in this country is simply living in a delusion. The people do not want carryover basis reformed so it will work, they want it abolished. They do not want tax reform, they want tax reduction. Unless we as legislators deal with this reality, then we will justly deserve the wrath of the people.

Thank you very much, Mr. Chairman, for affording me this time to be on this side of the hearing for a change.

Senator BYRD. Thank you, Senator Jepsen. You made an excellent statement. You brought out some important new facts.

Before introducing your associates and constituents, let me make this statement since you mentioned the word reform. In every speech I make to my constituents, I suggest that they be very, very skeptical of any piece of legislation with the word reform in it. We had so-called welfare reform proposed by President Nixon and subsequently proposed by President Carter, which means doubling the number of people on welfare. I do not exactly call that reform.

Then we had last year labor reform which gives vast additional power to the already powerful labor leaders of this Nation. I do not exactly call that reform.

Then we have a multitude of tax reforms which has meant an increase in taxes on most of the people. So I take a very skeptical view of the word "reform" in any piece of legislation and I urge my Virginia citizens to do the same.

You may proceed as you wish, sir.

Senator JEPSON. Thank you, sir.

It is my honor to introduce now Arley Wilson who is one of Iowa's leading probate lawyers. He has been in more than 35 years of practice.

In that time, he has been involved in the probate of more than 2,000 estates. I have a great deal of respect for him, and I thank him for taking of his time and coming halfway across the country to testify today.

Senator BYRD. We are very glad to have you, Mr. Wilson. Proceed as you wish, and I assume that the four of you will divide up the time as you think appropriate among yourselves. I gave the Treasury additional time, so I am not going to charge Senator Jepsen's time to you.

STATEMENT OF ARLEY J. WILSON, CHAIRMAN, PROBATE, PROPERTY AND TRUST LAW COMMITTEE OF THE IOWA STATE BAR ASSOCIATION

Mr. WILSON. May I express the appreciation of the Iowa Bar Association for the privilege of presenting the practical problems of the application of carryover basis?

The practicing lawyer in my neck of the woods is no longer speaking from an academic or philosophical or hypothetical point of view. He has had 22 months of actual experience with carryover basis before the blessed moratorium became reality.

During that 22-month period, we have found that carryover basis is not only unworkable in its present framework, but it is totally uncorrectable in its present concept and will remain uncorrectable until the proponents recognize that the problems really—what they really are and what they will end up with in 1987.

The representations of proponents of carryover basis are not only hypothetical but worse, they are scarcely believeable. What they have not told you, or the practical application of which they may have misunderstood, is of even greater impact—and that is what I propose to deal with today.

For instance, carryover basis has been referred to as a tax on capital gains at death. This is only the tip of the iceberg. It has become

apparent in application that carryover basis in rural communities is a tax on ordinary income as much on capital gains, with even greater impact, such as raised livestock with a zero basis, raised crops with a zero basis and, mostly, mortgage.

I have seen no example by any proponent which has even recognized the existence of such type of income. The examples of the proponents are all addressed to stocks and bonds which receive a fresh start as of a fixed date and a fixed value. This is not so with application of carryover basis to real estate and personal property used on a farm and in the small business. The longer the taxpayer owns the property, the less the basis, until eventually it becomes minimal.

Probably one of the less desirable representations is that euphemistically called the tax on appreciation when we all know much of the tax is on inflation. It does not have a thing to do with the 160 that has remained in the family for three generations.

No attention has, at any time, been given as to how to handle negative basis. What is this critter that nobody will talk about?

Suppose I bought a property in 1977 for $100,000. By 1987, the property has depreciated $50,000 worth. The so-called depreciated value in 1987 is $250,000, but I have borrowed $200,000 on this $250,000 value.

If I die and give the property to my child, my child will have a property basis of $50,000. The mortgage due will be $200,000. The tax will be $56,000.

The mortgage plus the tax will eat up the whole business. The actual economic loss will be $6,000 to my child. This realization then becomes intolerable. How even academically, then, can one make the assertion that this will free up capital?

While negative basis is not contemplated today so much as it will be in 1987 with current rates of inflation it will then be an everyday event. One cannot help but ask oneself, in estate planning of tomorrow, will it include a plan involving such a property where it will be recommended to borrow as much money as you possibly can and then leave the property to some person you do not even like?

In 22 months, the Service has not provided one rule, one regulation or one guideline dealing with this problem and they have refused consistently to recognize it. It has been said that this is a once-in-a-lifetime settlement of accounts. Nothing can be further from the truth.

The proposed settlement does not occur in a lifetime, but after death; as the result, the decedent is deprived of the lifetime benefit he would have had if living, such as loss of exemptions, loss of zero bracket income, loss of investment credit carryover, loss of net operating loss carryover, loss of income averaging, loss of selectivity of the time, the place, and the property he wants to use to pay the tax, and loss, above all, of the joint return schedule.

Carryover basis does not recognize the reality of the multiplicity of tax occurring by virtue of the accident of death. We have Federal estate tax, we have Federal income tax, we have State death taxes, we have State income taxes, and taking the Federal example of $590,-000 passing from a father to a son, this can so be conceived if it is addressed in terms of farm property to provide for a collective tax of 124 percent. This is the death knell to the family farm and the family small business. Nobody can afford to pay over 124 percent.

It has been urged that the estate tax and the income tax are two separate taxes and the results of the application of both taxes should be considered separately. This is as foolish as trying to deny the parenthood of only one Siamese twin while claiming the fatherhood of the second. Academically, it may sound great, but the taxpayer is more pragmatic. He msut pay all of the taxes, regardless of the niceties of what kind, or whatever its source of origin.

Carryover basis, it is impossible to practically and legally give effect and equal treatment to the heirs and residuary beneficiaries, even though the relationship among the heirs is harmonious enough to permit the executor to make a non pro rata distribution. Revenue Rule 69486 may recast that non pro rata distribution. The executor faces an impossible dilemma is attempting to distribute property equitable with carryover basis, bearing no predictable relationship to the current market value.

If there is anything of substance to distribute after paying the taxes, the family farm and the family small business must, for safety reasons alone, be distributed pro rata and, to say the least, this produces an awkward, if not totally unworkable situation.

Throughout this talk, we have related our discussion to the small and medium-sized estate affecting the family farm and the family operated business. We have not had much experience with those multimillion dollar estates in our office that were talked about this morning. We are country lawyers and we, as country lawyers, are impressed by the fact that the House of Delegates and the midyear meeting of the American Bar Association adopted unanimously a resolution approving the repeal of carryover basis.

We are further impressed with the fact that there was not one voice raised in defense of carryover basis. Nothing can be more clear than the fact that carryover basis law, as written in 1976, cannot be implemented, nor can it be practically modified. It is, in fact, a leaky boat, and every time you fix one leak, two more appear.

It leaves us with two more alternatives, one of which is the enactment of the limitation on the dollar amount that my youth and my child can inherit. If social engineering is to be the order of the day and there is to be a dollar limit on the right to inherit, let's have the courage to say. Let's not indulge in what Winston Churchill called "terminological inexactitude." The other alternative is to completely repeal carryover basis in its entire concept because it is not only unworkable, it is unfixable, and if you practically try to apply it, it just will not cut the mustard.

Senator BYRD. Thank you, Mr. Wilson. You stopped right on the dot, I might say.

The next witness, Senator Jepsen?

Senator JEPSEN. Yes; Mr. Milton E. Meyer on behalf of the Colorado Bar Association.

Senator BYRD. Please proceed, Mr. Meyer.

STATEMENT OF MILTON E. MEYER, JR., ON BEHALF OF THE COLORADO BAR ASSOCIATION

Mr. MEYER. The Colorado Bar Association went on record in early 1977 advocating the repeal of carryover basis on the grounds of ad-

ministrative complexity. As an interim step preferable to the existing alternatives of section 2005 of the Tax Reform Act or various fix-up proposals, it supported the present moratorium.

Anything that involves a continuation of carryover basis in some form or an alternative tax on appreciation at death suffers, of course, from the continued necessity that historical basis must be ascertained. This constitutes a change in rules prevalent for over 63 years, rules that have given stability and predictability to our tax laws, and which have been relied on throughout that period by estate owners not intending to dispose of particular assets during their lifetimes.

This is significant in Colorado, where family ownership of farms, ranches, mineral interests and water rights is so prevalent and important. These assets involve land inherited at various dates, depreciable improvements added typically in an evolutionary sort of way, frequently involving the labor of the owner or members of his family, perhaps a reuse of materials on hand.

This kind of asset also includes depletable mineral resources. Basis records and adjustments thereto are frequently nonexistent, or confused at best. As in other parts of the country, Colorado has its share of nonfarm and nonranch businesses where the owners never anticipated a taxable transfer during their lifetimes and where their basis records are not adequate.

Furthermore, Colorado is a State whose professionals have pioneered the use of the revocable trust as a will substitute and have persuaded their legislature to be among the first in the country to adopt the uniform probate code, all toward the end that the expenses, delays, traumas and frustrations associated with death and the administration of decedents' estates could be held to an irreducible minimum.

For these reasons, Colorado's lawyers and other estate professionals early identified the costly and difficult to impossible administrative determinations required by carryover basis as being a gigantic step backward in attaining these professional and human objectives.

Consistent with these concerns, the Colorado Bar Association urges that the moratorium be resolved. They have three proposals and they are submitted in this particular order:

The first, Mr. Chairman, is a total repeal of carryover basis and return to pre-1976 law. This has the unanimous consent and urging of the councils of the taxation section, the probate and trust section and the executive council of the Colorado Bar.

As a second alternative, we would return to prior law but add a modest increase in estate tax rates to serve as a trade-off for a loss of revenue associated with untaxed appreciation at death.

Mr. Chairman, this proposal makes no sense unless Congress feels that the loss of revenue at death resulting from not taxing appreciation is truly significant. We have heard Mr. Lubick this morning say it really is not significant, that revenue is not the issue. At the same time, he speaks of $20 billion of unrealized gain a year, if I understood him correctly, and I simply challenge that figure. That cannot be.

In all of fiscal 1978, slightly more than $5 billion was collected in estate and gift taxes. You assume that this represents estates of over $130,000 or thereabouts under present phase-in of the unified credit. Taking an average rate of, perhaps, 35 percent, that brings all estate

assets that are subject to tax up to about $16 billion. So how can you have $20 billion of untaxed appreciation out of assets that cannot conceivably have exceeded $16 billion?

I think Congress should look into those figures very carefully.

Senator BYRD. Mr. Lubick stated today that there is very little revenue involved in carryover basis—and that is not the purpose of the law.

Mr. MEYER. I know he did, and yet he did make the other statement as well.

So indulging the assumption—and it is only that—that Congress does have that concern for lost revenue, we would be amenable to a toll charge to be exacted from estate owners for the privilege of stepping up the basis of estate assets to estate tax value at death. Such a toll charge would probably be modest in rate, particularly in light of the effect of inflation on estate values and could be a flat surcharge against all the assets of the estate over a certain threshold value, or against particular schedules on the form 706.

If this proposal is viewed to have merit, we would be pleased to submit more detailed suggestions for implementation.

We understand Congress may have responded in 1942 to suggestions then arising for carryover basis by adding to the estate tax rates instead. This is an arbitrary approach, certainly, but no more arbitrary than the fresh start provisions that we have heard about in connection with carryover basis and, on analysis, probably no more arbitrary than anything else in the Internal Revenue Code all of which, by definition, has to be arbitrary.

Again, we do not feel that this is a burning need, but if Congress feels there is lost revenue, we offer this as some kind of a trade-off so that we can at least get back to the certainty and stability of having a stepped-up basis at death.

Our final recommendation is one that, I must say, is without any enthusiasm, and that is that there be a fix-up of carryover basis along the lines that the Treasury is apparently willing to concede, plus anything more they may be induced to concede, with one more provision they have not yet agreed to, and that is a total grandfathering under prior law of all assets owned by an estate owner as of a date not earlier than December 31, 1976.

We really think there is no constituency whatsoever in the country for any change away from step-up in basis. I, for one, am not particularly impressed with Mr. Lubick's oft-repeated example about the two investors who are killed simultaneously under particularly unusual circumstances. Life is chancy at best. I think that all of us are prepared to sell assets and pay a capital gains tax when it suits our fancy, and are delighted to have the balance of our estate derive a stepped up basis at death.

I just cannot feel too sorry for the person who, knowing the tax consequences, is prepared to sell something during his lifetime, absent, of course, a distress sale where tax considerations are secondary.

In this day and age of proposition 13 and concern with government regulation and harassment, I just feel that carryover basis or any alternative form of taxation of gain at death is simply out of touch with the mood of the country and, I think, the mood of the Congress that passed the 1978 Revenue Act.

Thank you, sir.

Senator BYRD. Thank you, Mr. Meyer.

Senator JEPSEN. Mr. Chairman, before introducing Mr. George Brode who will be testifying—Mr. Brode is the vice chairman of the council of the Illinois State Bar Association section on Federal taxation—I would like to acknowledge the presence of Congressman Grassley of the Third District in Iowa who has been actively carrying on this message and this battle in the House, and he is attending this session to even better advise and inform himself.

Senator BYRD. Congressman Grassley, come up to the witness stand. We are very glad to have you here. Congressman Grassley and I worked on another very important matter last year when the Senate and the House passed legislation to mandate a balanced budget for the Federal Government beginning in October of 1980. Congressman Grassley is the one who made the motion in the House of Representatives that brought about the adoption of this provision.

We are glad to have you, sir.

Senator JEPSEN. George Brode.

STATEMENT OF GEORGE BRODE, JR., VICE CHAIRMAN, COUNCIL OF THE ILLINOIS STATE BAR ASSOCIATION SECTION ON FEDERAL TAXATION

Mr. BRODE. My name is George Brode, Jr. I am a tax attorney and vice chairman of the Federal taxation section of the Illinois State Bar Association.

I am here with Mr. Ted Pasquesi, who is chairman of the Federal tax section. I will speak to technical issues; Mr. Pasquesi will address general problem areas.

It is the position of the Illinois State Bar Association that Congress should repeal carryover basis and retain the present code section 1014 step-up in basis rule.

If Congress deems additional revenue necessary, it might couple that proposal with an increase in tax rates for larger estates, possibly at $750,000 and beyond.

We believe that the three alternative solutions proposed by Treasury; namely, a patched up carryover basis; second, a capital gains at death provision; or third, an AET tax provision, are all unworkable in that each requires detailed tracing of records to determine the decedent's cost basis in the property and the date of acquisition in order to calculate the tax on a subsequent sale of the property.

On the other hand, one key aspect of the Code section 1014 step-up in basis rule is that there is no recordkeeping requirement because executors, administrators and heirs may readily determine basis in the property as being equal or equivalent to that property's fair market value as of date of death or the alternate valuation date.

Furthermore, it is the position of the Illinois State Bar Association that Congress should reject any proposal which incorporates the extreme complexity of carryover basis and should opt instead for a proposal which first is administratively feasible, both for taxpayers and the IRS; second, does not require extensive calculations which, in and of themselves are extremely time consuming and costly; third, it should omit the need for exhaustive record tracing requirements; and

finally, and perhaps most importantly, create a rule which is simple to understand, not only for the bar at large, but for the public at large.

The remainder of my comments relate to technical difficulties that the practitioner and the public at large are experiencing in attempting to make the carryover basis calculations. I developed, over a 6-month period, with an expenditure of nearly 350 hours, a 218-step computer program to calculate carryover basis. That computer calculation, including the printout of 20 answers, can be run in approximately 25 seconds.

For the tax attorney or the accountant who has to try to make the calculation of carryover basis using a hand calculator, I estimate it will take somewhere in the neighborhood of between 1 hour and 1½ hours.

Development of the computer program assisted us in uncovering the following four key problem areas in determining an assets' carryover basis.

First, the complexity of the five calculations under Code sections 1023(h) concerning the fresh start adjustment; the 1023(b) reduction for $10,000 of personal property; 1023(c), the stepup for Federal estate taxes paid; 1023(d), the $60,000 minimum basis provision; and 1023(e), the stepup for State inheritance taxes makes it nearly impossible for the average attorney, accountant, executor or administrator to calculate an assets adjusted carryover basis.

Two, the fact that the (b) and the (e) adjustments—the (b) adjustment is the $10,000 reduction for personal property and the (e) is the stepup for State inheritance taxes, are true variables, means that you can either put them into the formula or not put them into the formula, based upon how the executor so determines.

You really have four subvariables: two in, two out; one in, the other out, and vice versa. In addition, when you couple that with the fact that appreciated property may be allocated between the spouse and the children in at least three ways, for example, maximum to the spouse, split equally between the spouse and the children, or maximum to the children and a minimal amount to the spouse, really means that there are potentially twelve different possible solutions to each carryover basis asset.

For example, when I am talking about funding the estate distributions, assume you have an estate of $1 million, with one $700,000 appreciated asset and assume that the balance of the estate is cash. Query: how do you allocate the property between the wife and children?

Do you give $500,000 to the wife, $200,000 to the children; $350,000 to the wife, $350,000 to the children; or $500,000 to the children and $200,000 to the wife? The long and the short of it is that there are at least 12 different solutions for each carryover basis asset in the estate. To do this by hand, in an estate in which you only had 10 carryover basis assets, may require an expenditure in time somewhere in the neighborhood of 120 to 180 hours and that would apply in the smallest estate as well as in the largest.

Finally, the present calculation of carryover basis for nonmarketable property requires input of 11 known factors. First, fair market value of the appreciated property.

Second, cost basis. Third, the maritaldeduction portion; the nonmarital deduction portion; the personal property election (in or out);

the adjusted gross estate; the taxable estate; the net estate taxes; the State tax credit; the period the property was held before December 31, 1976; and finally, the total period in all.

Thank you.

Senator BYRD. From what you say, it seems to me that carryover basis would add greatly to the administrative and legal costs of administering an estate. These costs are passed on to the individual citizen, individual beneficiary.

Mr. BRODE. What it means, Senator, is that attorneys' fees and accountants' fees would go up dramatically. But we are here arguing that you kill this off, because to expend somewhere in the neighborhood of 120 to 180 hours at normal billing time would bury many estates in legal fees which they could never afford.

In other words, we are really saying that the expenditure of time, not only by attorneys, not only by accountants, but by the IRS as well, is an expenditure of time that this country really doesn't need in terms of the revenue that it produces, and certainly in terms of the equality.

Senator BYRD. We have one additional witness, and then I will yield to Senator Dole.

Senator JEPSEN. Yes. Mr. Theodore Pasquesi, chairman of the Council of the Illinois Bar Association Section on Federal Taxation.

STATEMENT OF THEODORE PASQUESI, CHAIRMAN, COUNCIL OF THE ILLINOIS STATE BAR ASSOCIATION SECTION ON FEDERAL TAXATION

Mr. PASQUESI. Thank you.

Our Illinois State Bar Association has over 20,000 members and this association has, for some time, urged the repeal of carryover basis. Carryover basis is an excessive burden, especially for middle-class Americans. Why?

Because first, it requires a total analysis and reconstruction of the cost basis history of the decedents' assets and it then requires these complicated computations, which Mr. Brode referred to, to transfer this basis.

These two deceptively simple terms—"basis reconstruction" and "basis transfer"—are forcing the American public to spend much too much money on lawyers and accountants for carryover basis information and advice. This, in turn, makes any resulting additional tax one of the most inefficient we have ever encountered.

Going from bad to worse, the inefficiencies are even greater with the smaller estates. No matter where the exemption is set, $60,000, $175,000 or any other level, the greatest taxpayer burden per new revenue dollar will fall on the smallest estates affected.

Why? Because the closer the value of the estate is to the exemption, the less is the potential difference between carryover basis and stepped up basis and therefore, the less will be any additional tax. And yet, the basis reconstruction and basis transfer burdens apply across the board.

The inefficiency curve of carryover basis is staggering for those estates just above the exemption. And in which bracket will most of the estates affected fall?

There should be no question about it; just above the exemption level.

Why, then, is carryover basis even considered? One reason is easy to identify: the revenue it may generate.

Now, we were told this morning that revenue was not a factor, but that was not what I was told when I testified before House Ways and Means last year.

Regardless of whether or not revenue is a factor, to the extent that Congress considereds additional revenue necessary, we urge that it be obtained without any system which requires a determination of decedents' basis.

The extent of revenue needs is the business of Congress, but assessing the cost to heirs and determining the decendent' basis is our business. We have been on that firing line for over 2 years.

The second argument in favor of carryover basis is some notion of equity. The argument goes that taxpayers who sell before death pay a tax on appreciation while the heirs of those who hold until death do not.

Let's zero in on that word "appreciation." Appreciation is an increase in value and value is the worth of an asset relative to something else. Appreciation of an asset cannot be measured without measuring the relative value of goods and services available on exchange. Under our system, there can be no true measurement of appreciation without considering the changes in the value of our medium of exchange, the dollar.

That brings us to inflation, or at least, it should. Interestingly, this morning's first witness, Mr. Lubick, with Harry L. Gutman, authored an article in the January 1979, issue of Trust and Estates magazine entitled, "Treasury's New Views on Carryover Basis."

In that article, I counted 24 references to the word "appreciation," but the word "inflation" was conspicuous by its absence. Again this morning, Mr. Lubick failed to use the word "inflation," although Senator Dole did.

Senator BYRD. If you would permit me to interrupt, he did in an indirect sense when he mentioned 1913 income tax, and I brought out that, even including what was called the supertax, the maximum tax rate was 6 percent. He said, "Yes," but they were in different dollars, which I assume he indirectly noted the great increase in inflation.

Mr. PASQUESI. I agree, Senator, and I think indirectly he also referred to inflation when he made reference to this so-called $20 billion of annual appreciation.

To ignore the impact of inflation when measuring appreciation is to ignore the inequity which inflation injects into our so-called capital gains tax. This refusal of some to face up to the impact of inflation suggests that the so-called equity argument for carryover basis is really an attempt to extend a rapidly growing inequity in our system of taxation. But Congress, fortunately, has not been so biased. It has taken action against the inequities of inflation, and it can do more by a total repeal of carryover basis.

Thank you.

Senator BYRD. Thank you, sir.

Senator Dole?

Senator DOLE. I apologize for being absent. I was out testifying on the constitutional amendment on the balanced budget.

Did you want to say something, Charlie?

Representative GRASSLEY. Senator Byrd, Senator Dole, members of the panel and Senator Jepsen, the only point I would like to make and the one that is basically behind my involvement in the repeal of

the carryover basis is that it is such a sense of frustration for farm families— and I know it applies to others than just farm families, but that is what I want to emphasize—to work hard all their life and most of what they accumulate is a direct result of their labor being put into their capital and reinvestment of it, and then to have it taxed away to a point upon death that that cannot be continued in the family. If we want to do one thing in this country to keep the family farm going, one of the things that can contribunte to that would be the repeal of te carryover basis, and without it, it is going to be a leading factor in the demise of the family farm.

Senator BYRD. Thank you, sir.

Senator DOLE. I have a number of questions, but because of time constraints, I would like to ask if anybody on the panel, that if the proposal as discussed by the Treasury Department were enacted, would you anticipate significant litigation regarding the carryover basis rules?

I assume the answer to that is "Yes," and in what areas.

Mr. WILSON. May I?

Senator DOLE. Yes.

Mr. WILSON. I am Arley Wilson.

I think you are going to find it in two areas that you are going to have a lot of conflict in litigation. One, we have always had the litigation on value, but when we get into the area of identification, you can have a paucity of information or you can have a plethora of information. How are you going to tell which black cow, which feed pump, which three-bottom plow?

When you start in, the fellow is there, if he is living on the farm, and he can tell that. But the Internal Revenue Service is not going to be so kindly. They are going to say, you prove it. They always have; they always will.

The other is the negative basis. Negative basis just cannot be answered because most everybody in my community has a negative basis which will not surface until they die. They have inherited or bought land at $150 to $200 an acre and they have an $180,000 to $200,000 mortgage on it, right now, to keep them alive in their operating income, because you could not borrow money cheaper on the land than you can borrow it on the crop that you are raising.

It is just a well-known fact that it is 8¾ money today from the Federal Land Bank and it is 10½ percent money if you just borrow operating money.

I think we are going to have a lot of litigation in those two areas.

Mr. PASQUESI. Senator, may I add that in addition to your concern about litigation, there is undoubtedly also a concern about extended audit difficulties which may not result in recorded litigation, but is a tremendous burden to the American public and in our experience, much of this audit difficulty stems from valuation questions.

Senator DOLE. I would just say generally, we are told that carryover basis is not a question of revenue, it is a justice and equality effort by the Treasury Department. I guess the revenue estimates are what, about $93 million?

Here, we round that off to zero.

But if that is the case, then I think you have made some suggestions to pick up revenue that might have more merit. Maybe we ought to index the basis of assets to take care of inflation. Then there would not

be anything left of carryover basis. That might be another way to skin the cat.

The Department of Treasury is opposed to indexing. They want us to pay taxes on inflation. Every administration does, not just this one. Indexing basis might be a substitute.

However, I think the best approach would be to repeal carryover. I know there is a lot of support for repeal. Maybe they would accept some of the suggestions made by members of this panel, and others, if they are concerned about revenue.

Thank you.

Senator BYRD. Thank you, Senator Dole.

Three States are represented on this panel, Iowa, and Colorado and Illinois and each of those three States, as I visualize it, have very substantial farming, so all of you are well familiar with the farming problems. See if I am reasonably correct about this.

It seems to me that carryover basis would tend to force the sale of farms and if that is the case, it seems to me that is playing into the hands of the large farm operators, the so-called conglomerates which are buying up farmland. Many farm sources are buying up farmland, and the more the Government, by tax laws, forces small farms to sell, the less small farmers there are likely to be and the more likely it will be that the land will get into the hands of fewer and fewer people. This is not a very desirable outlook for our country.

Do you see it somewhat that way?

Mr. BRODE. Senator, yes. I think what will happen is that you will have a telescoping effect. In other words, you will get hit with the estate tax on death, which may cause you to have to liquidate the farm to pay the estate tax, assuming that you are not making one of the code section 6166 elections to secure either a 10-year postponement, a 15-year postponement, or the farm election under section 2032(a).

But then if you are forced to sell, what happens is you then run right up against a second tax, the income tax, which—I mean, it is almost a totally defeating situation. You are having a large portion of your estate taken away with the estate tax and because you are forced to sell to pay the revenue to Uncle Sam you are hit again with a second tax, an income tax, probably at capital gains rates.

Senator BYRD. And that is at inflated value. If this inflation continues, and I see no indication that it is likely to be reduced any time soon, that is going to add a greater burden on the taxpayer.

Mr. BRODE. The longer beyond December 31, 1976 that he lives, the greater is the capital gains burden to him.

Senator BYRD. Say that again, please.

Mr. BRODE. The longer that he lives beyond December 31, 1976, the greater the burden may become.

Senator BYRD. 1979, would it not be?

Mr. BRODE. I believe that the technical amendment change takes you back, at least for purposes of nonmarketable property to December 31, 1976. I may be incorrect on that, but I believe that is the way it was done.

But the date is still December 31, 1976, and not December 31, 1979.

Mr. PASQUESI. I believe that is correct, Senator, and the impact of that under present law would be that someone dying in January 1980 will have had no benefit from the Revenue Act of 1978. That person's

estate will be exactly as it would have been under 1023 as enacted in the Tax Reform Act of 1976, so there really was not deferral; there was only a waiver of carryover basis for the 3 years in question, if the decedents died in that period of time.

Mr. BRODE. Their position is as if this postponement has never taken place. The Treasury will not lose one cent of revenue by having had the postponement if the law becomes law once again on January 1, 1980.

Senator BYRD. Well, then, to use Mr. Lubick's example, it would be financially desirable for somebody to get hit by a truck pretty soon after 1976.

Mr. BRODE. That is exactly what we are advising clients to do. Of course, they are having a little difficulty complying with that recommendation. If you are going to elect to die, die before January 1, 1980.

I have seen various articles that have suggested that. The December 1978 issue of "Taxes" magazine has two of them.

Senator BYRD. Senator Dole?

Senator DOLE. I would not want to endorse that.

Mr. BRODE. The clients are not, either.

Senator BYRD. Thank you, gentlemen, very much. Your testimony has been very helpful.

[The prepared statements of the preceding panel follow:]

STATEMENT OF ARLEY J. WILSON, MARSHALLTOWN, IOWA, ON BEHALF OF THE IOWA STATE BAR ASSOCIATION

COMMENTS ON CARRYOVER BASIS

First, may I express the appreciation of the Iowa Bar Association for the privilege of presenting the practical problems of the application of COB, from both the taxpayer's point of view and that of his attorney.

The practicing lawyer is no longer speaking from an academic, philosophical, or hypothetical point of view. He has had 22 months of actual experience with COB before the blessing of moratorium became a reality.

During that 22-month period we have found that COB is not only unworkable in its present framework but is totally uncorrectable in its present concept and will remain uncorrectable until the proponents recognize where the problems really are and will admit the reality of the end result which will be reached 10 years from now.

The representations of the proponents of COB are not only hypothetical but worse they are scarcely believable. What they haven't told you or the practical application of which they may have misunderstood, is of even greater impact.

For instance—

1. COB has been referred to as a tax on capital gains at death. That is only a part of the story. It has become apparent in application that COB is in the rural community a tax on ordinary income as much as on capital gains, with even greater tax effect, such as (A) raised crop, 0 basis; (B) raised livestock, 0 basis, mostly mortgaged.

I have seen no example by any proponent which has even recognized the existence of such type of income. The prime examples of the proponents are all addressed to stocks and bonds which receive a fresh start as of a fixed date, and a fixed value. This is not so with the application of COB to real estate and depreciable personal property used on the farm and small business. The longer the taxpayer owns the property, the less the basis, until eventually it becomes minimal.

2. Probably one of the less desirable representations is that euphumistically the tax is called a tax on appreciation when in reality it is a tax on inflation. Why not recognize the kind of tax this really is?

3. No attention has at any time been given as to how to handle negative basis. What is this critter no one want to talk about?

Suppose I bought property in 1977 for $100,000. By 1987 the property is depreciated to $50,000. The so-called appreciated value in 1987 is $250,000 but I have borrowed on it $200,000 non-recourse. I die, giving the property to my

child. The result—my child has property basis $50,000, mortgage due $200,000, value $250,000. If the child or my estate sells the property for $250,000 and pays maximum marginal tax on capital gains at 28 percent, the tax will be $56,000, the mortgage $200,000. The actual economic loss of $6,000 will occur. This realization event becomes intolerable when the public realizes what has happened. How, even academically, can one make the assertion that this will free up capital at death?

While negative basis is not commonplace today, by 1987 with current rates of inflation, it will be an everyday event. One cannot help but ask one's self if estate planning of tomorrow will include a plan involving such a property where it will be recommended to borrow as much as possible and then leave the property to some person you don't like. [See addendum No. 1.]

4. It has been said that this is a "once in a lifetime" settlement of accounts. Nothing could overlook the practical application more. The proposed settlement does not occur in the lifetime but after death, as a result the decedent is deprived of the lifetime benefits he would have if living such as—

(*a*) Loss of exemptions;

(*b*) Loss of zero bracket amount;

(*c*) Loss of investment credit carryover;

(*d*) Loss of net operating loss carryover;

(*e*) Loss of income averaging benefits;

(*f*) Loss of selectivity in both time to recognize gain and the property to be used to pay;

(*g*) Loss of joint return rate schedule. [See addendum No. 2.]

5. COB does not recognize the reality of the multiplicity of taxation occurring by virtue of the accident of death which are:

(*a*) Federal estate tax;

(*b*) Federal income tax for the decedent and for the estate;

(*c*) State death taxes;

(*d*) State income taxes for the decedent and for the estate.

Which in total of an estate of $590,000 passing from father to son lead to a collective tax of up to 124 percent. This is the death knell to the right to inherit the family farm or family small business.

It has been urged that estate tax and income tax are two separate taxes and the results of the application of both taxes should be considered separately. This is as foolish as trying to deny the parenthood of only one Siamese twin while claiming the other as your child.

Academically it may sound great, but the taxpayer is more pragmatic. He must pay all the tax regardless of the niceties of what kind it is or its source of origin. [See addendum No. 3.]

6. With COB it is almost impossible to practically and legally give equal treatment to the heirs or residuary beneficiaries. Even though the relationship among the heirs is harmonious enough to permit the executor to make a non-prorata distribution, Rev. Rul. 69–486, 1969—2 C.B. 159 may recast the non-prorata distribution. The executor faces an impossible dilemma in an attempt to distribute property equitably with COB bearing no predictable relationship to current market value. If there is anything of substance to distribute, the family farm or family business must for safety reasons be distributed prorata and to say the least, this produces an awkward if not unworkable situation.

A simple example of the difficulty is that if John, father of two sons, had purchased an 80 acres when he returned from World War II for $150 an acre or $12,000 basis, and in 1974 he was able to purchase an adjoining 80 acres for $1,500 an acre or $120,000 and he died in 1978 and the value of each 80 acres was $3,000 an acre or $240,000 each, if he left one son the first 80 and the second son the remaining 80, he could not treat the sons equally because the basis of the first 80 purchased would be substantially less than the basis of the second 80 purchased and this exact value could not be well determined until the date of death of the testator. [See addendum No. 4.]

7. It has been pretty well conceded by all persons of reason who have attempted practical application of COB that it is totally unworkable. Too little available information requires speculation. When adequate information is available, identification of the property is equally speculative—which black cow?—which four-bottom plow?—which feed bunk?—the list could almost be unending.

One of the many unanswered problems not yet considered by the proponents is how do you apply COB in a Sec. 351 tax-free incorporation times of a small business or farm? As a practical matter the assets have been acquired at different times with different costs and varying levels of depreciation. It is impractical to

have a different basis for each share of stock issued. Would this require multiple classes of stock—one representing the home 160—one for the acquired 80—one class for machinery—one class for breeding livestock? The administration and organization of such a vehicle would be preposterous.

Throughout this talk we have related our discussion to the small and medium-sized estate affecting the family farm and the family-operated business. We have not had too much experience with the multimillion dollar estate in our office. We as country lawyers are impressed with the fact that the House of Delegates at the mid-year meeting of the American Bar Association adopted unanimously a resolution approving the repeal of COB. We are further impressed by the fact that there was not one dissenting vote in the House of Delegates nor one voice raised in the defense of COB. Nothing can be more clear than the fact that the COB law as written in 1976 cannot be implemented nor can it be fairly administered by the Service without great expense. It is equally clear after 22 months of hard work in trying to apply this law that it cannot be modified or patched up by any device yet suggested.

It is in fact a leaky boat with bad planking and every time one hole is patched and one leak is stopped, two more leaks appear. I have not yet met one practicing attorney in Iowa who believes that this law can be implemented or effectively repaired. That leaves us with two alternatives, one of which is to enact a limitation on the dollar amount you inherit in any event. If social engineering is to be the order of the day and there is to be a dollar limit on the right to inherit, let us have the courage to say so rather than ruin a perfectly workable tax system which predated the 1976 act and not indulge ourselves in what Winston Churchill once labeled as terminological inexactitude. The other alternative is to completely repeal COB in its entire concept.

ADDENDUM NO. 1—THE NEGATIVE BASIS PROBLEM

The COB rule may produce harsh and inequitable tax consequences whenever the inherited or devised property is subject to a mortgage liability substantially greater than its COB. In that case the beneficiary may discover (to his or her surprise and subsequent horror) that the tax liability resulting from the sale, gift or foreclosure of the property far exceeds the cash proceeds realized by the beneficiary.

For example, suppose that in 1977 D purchased real property for $100,000 cash. In 1987, when the property had appreciated in value to $250,000 and D had deducted $50,000 of depreciation with respect to the property. D borrows $200,000 on a non-recourse note secured by the property.[1] D spends the loan proceeds on unrelated personal activities and dies soon thereafter, bequeathing the property (still worth $250,000) to his child.[2] Ignoring the adjustments for federal and state death taxes, C would acquire a COB of $50,000 in the property, the same as in the hands of D immediately before his death. If C then sells the property (still valued at $250,000) subject to the $200,000 mortgage, C would realize net cash proceeds of $50,000 (ignoring selling expenses). But since under the rule of *Crane* v. *United States*,[3] the mortgage encumbering the property must be included in computing C's amount realized on the disposition, C's realized gain is $200,000 computed as follows:

Amount realized:	
Cash	$50,000
Mortgage	200,000
Adjusted basis	250,000
Carryover basis	50,000
Realized gain	200,000

If the gain is subject to tax at the maximum marginal rate of tax on capital gains (currently 28%), the tax liability arising from the sale will be $56,000, or $6,000 more than the net cash proceed realized by C on the sale. The tax liability would exceed the net cash proceeds realized from the sale by an even greater

[1] The encumbering of property in an amount exceeding its adjusted basis is not considered a realization event, even though the owner does not assume personal liability for the indebtedness. *Woodsam Assocs., Inc.* v. *Commissioner*, 198 F.2d 357, 359 (2d Cir. 1952).

[2] The transfer of property at the donor's death is not considered a realization event, even though the property is subject to an encumbrance in excess of the decedent's basis. See New York County Lawyers' Association. 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, 156–57 (1977).

[3] 331 U.S. 1 (1947).

margin if all or part of the gain was subject to depreciation recapture or was subject to tax at ordinary income rates for other reasons.

This result is objectionable for several reasons. First, it is unfair to tax C on the $200,000 of gain because there is no indication that C received any economic benefit from the mortgage proceeds. Those proceeds may have been expended by D prior to his death or bequeathed to some other beneficiary. Moreover C received no tax benefit from the depreciation deduction taken by D before his death. Yet, under the COB rule, those deductions decrease C's COB and increase his gain on a subsequent disposition of the property. Not only is it inequitable to tax C on a gain of $200,000 when he inherited (or was bequeathed) an equity of only $50,000 ($250,000 gross value less $200,000 mortgage), this result will also reduce capital mobility and, hence, economic efficiency, by discouraging C from disposing of the property because of the exorbitant tax cost involved.

C would be not better off if he decided to give the property away instead of selling it. Under the decided cases, the gift of property subject to a mortgage in excess of its basis is treated as a partial sale of the property for an amount realized equal to the amount of the mortgage liability.[4] Thus, if C gave the mortgaged property (still valued at $250,000) to his child GC, C would realize a gain of $150,000, determined as follows:

Amount realized mortgage liability	$200,000
Adjusted basis carryover basis	50,000
Realized gain	$150,000

This result is most objectionable because (1) C received no cash proceeds on the transfer to GC; (2) C received no economic benefit from the mortgage proceeds which were obtained by D; (3) C received no tax benefit from the depreciation deductions that reduced D's, and hence C's, adjusted basis for the property.

These anomalies do not arise under the basis rule of section 1014(a). Under that provision, C would obtain a basis in the property equal to its estate tax value ($250,000). C would not realize any phantom income on the subsequent sale or gift of the property. If he sold the property for $250,000, he would realize no gain or loss on the transfer:

Amount realized:	
Cash	$50,000
Mortgage liability	200,000
Total	$250,000
Adjusted basis (Sec. 1014(a))	250,000
Realized gain	0

If he gave the property (subject to the mortgage) to his child GC, he would likewise realize no gain or loss:

Amount realized:	
Mortgage liability	$200,000
Adjusted basis	250,000
Realized loss[1]	0

[1] Even though the adjusted basis of the property transferred exceeds the amount realized, no loss is realized on a partial gift transaction. Treas. Reg. § 1.1001-1(e).

ADDENDUM NO. 2

1. Death at a time when the expenses of the crop have been incurred and paid but before the crop has been reduced to income for income tax purposes resulting in:

(a) Loss of decedent's exemptions.
(b) Loss of decedent's zero bracket amount.
(c) Loss of investment credit carryovers.
(d) Loss of income averaging benefits.
(e) Loss of joint return rate schedule, or at worst (but still better than estates) single return rate schedule.

[4] See, e.g., *Johnson* v. *Commissioner*, 495 F.2d 1079 (6th Cir. 1974); *Malone* v. *United States*, 326 F.Supp. 106 (N.D. Miss. 1971), *aff'd per curiam*, 455 F.2d 502 (5th Cir. 1972); Rev. Rul. 70-626 1970-2 C.B. 158; Ward, Taxation of Gratuitous Transfers of Encumbered Property: Partial Sales and Section 677(a), 63 Iowa L. Rev. 823 (1978).

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(*f*) Loss of choice of time to recognize income or deductions.

(*g*) Loss of choice to be selective as to the items and nature of income and deductions to be recognized.

(*h*) Loss of net operating loss carryover.

(*i*) Until law is amended to provide otherwise, loss of capital loss carry-overs.

As we have previously noted, all of these disadvantages hit a farmer particularly badly because most of the income he will realize under the COB rules will be ordinary income rather than long-term capital gain.

ADDENDUM NO. 3—TAX FACTS, APPENDIX A

ASSETS: $590,000 (all assets acquired after December 31, 1976).

	Fair market value at death	Basis
Principal residence	$180,000	$167,000
Life insurance	75,000	
Marketable security X	50,000	20,000
Marketable security Y	70,000	40,000
Closely held security Z	200,000	160,000
Tangible personal property	15,000	Unknown
Total	590,000	387,500

Debts and expenses: $20,000.
Date of death: January 1, 1981.
State estate tax: $12,800.
State inheritance tax on recipient of Z: $10,000.

COMPUTATION OF ESTATE TAX

Gross estate	$590,000
Less: Debts and Expenses[1]	20,000
Taxable estate	570,000
Gross tax ($155,800 plus 37 percent of $70,000)	181,700
Less: Unified credit	47,000
State death tax credit ($10,000 plus 4 prcent of $70,000)	12,800
	59,800
Estate Tax	121,900

[1] Assumes no marital or charitable deduction.

Taking the foregoing example presented in the article by Donàld C. Lubick, Assistant Secretary for Tax Policy, and changing this value to a small tenant farmer in the Mid-West and addressing it to the kind of property such farmer would possess, we come up with a table correspondingly simple, as hereinafter set out. You will note that no figures have been changed, only a distinction has been made as to the kind of property anticipated by the Treasury Department and that which is actually owned by the farmer.

Treasury has refused to admit that all accumulated wealth is not a matter of capital gains. This is a matter of their example when presented to the public and congress but in practical application will not be true. Let us change the nature of the property and make it more compatible with the farmer as follows:

	Fair market value at death	Basis
Farm machinery	$180,000	$167,000
Raised black cow herd	75,000	0
Raised market hogs	50,000	0
Raised fat cattle	70,000	0
Grain	200,000	0
Small tools	15,000	
Total	590,000	167,000

The following results will be obtained

Gross Estate	$590,000
Costs of Administration	20,000
	$570,000
Gross Tax (Tax Bracket)	181,700
37% of $70,000	
Less Unified Credit	47,000
Death Tax Credit (10,000 + 4% of 70,000)	12,800
Total Credits	59,800
Amount	121,900
Iowa inheritance on $448,100, (180,000−7825+8 percent)	29,273
Iowa income tax on feeding livestock and grain sold for $320,000 ($75,000−7420+13 percent)	49,020
Federal income tax on $320,000 Fed livestock and grain, ($200,000−125,490+70 percent)	209,490
Total tax	409,683
Requires a mortgage of $109,683 ($89,683 to pay tax and $20,000 to pay costs of administration) on property remaining valued at $270,000.	
Net value of estate remaining	160,317
Subject to Carryover Basis in ? amount.	

Collective tax burden on top dollars:	Percent
Inherited Federal estate	37
Less credit for Iowa inheritance	(4)
Plus actual Iowa inheritance	8
Plus Iowa income tax	13
Plus Federal income tax	70
Collective taxes	124

Treasury states that Federal Estate Tax is not surrogate to other taxes (I am not sure what this means) but practically estate taxes are the basis for the collection of income tax federal, income tax state, death tax federal and death tax state in whatever form they may be and while this is not probably of too much import to the Treasury, to that person who is required to pay the taxes from the property received it becomes pressingly important. The foregoing property is based upon the transition of property from a father to a son. If the property was transferred to a niece, nephew or fosterchild, brother-in-law, sister-in-law or step-grandchild, the cumulative tax would be 131 percent and not 124 percent as above.

ADDENDUM NO. 4—UNEQUAL TREATMENT OF HEIRS UNDER CARRYING BASIS

The potential for unequal treatment of the distributees of an estate is increased in several ways by the COB rules. It is impossible to perceive all the distribution problems that may be encountered by the executor of a typical Iowa estate with farm or business assets.

A threshold difficulty exists in that there is virtually no state-level law to guide an executor in making distributions of assets that may have equal market values but disparate economic values due to differences in basis. Even where a will grants the discretion to make non-pro rata distributions in kind, the executor may be unable to exercise the discretion because of the duty to treat all distributees impartially. Even where the relationship among the distributees is harmonious enough to permit the executor to make non-pro rata distributions, Rev. Rul. 69-486, 1969-2 C.B. 159 may recast the non-pro rata distribution. My understanding of this Ruling is that where it is uncertain whether the fiduciary may make non-pro rata distributions, the distributees will be deemed to have received a pro rata distribution and to have thereafter made exchanges of their respective undivided interests in order to end up with non-pro rata interests in the assets distributed with such exchanges being treated as taxable transactions for income tax purposes. To sum up on this aspect, I am of the opinion that an executor may not make non-pro rata distributions in the absence of

specific authority in the Will. If the Will purports to authorize non-pro rata distributions but is silent as to the authority to disregard differences in basis, the duty of impartiality among the distributees may overrule such a discretion and require pro rata distributions.

If the Will purports to authorize the executor to make non-pro rata distributions without making any adjustments among the distributees to correct perceived inequities, the line of cases spawned by *In re Warms' Estate*, 140 N.Y.S. 2d 169 (Sur.Ct. N.Y. Co. 1955) may mandate that an equitable adjustment be made among the distributees to reflect the differences in basis of the assets distributed. *Warms'* held that where an executor elected to claim administration expenses as an income tax deduction, the income beneficiaries must reimburse the principal account to the extent of the additional estate tax incurred as a result of the election. The result of this case has been codified in New York and Maryland and has been followed judicially in California, Florida and Pennsylvania. There is uncertainty, however, as to whether such adjustments will be required where the act of the executor does not constitute the making of an election under the tax law. The line between tax law elections and something else has not been drawn. In several cases the court wound up making a choice between equity among the parties and simplicity in administration.

The executor faces a dilemma of impartiality in attempting to select the "personal or household effects" to be excluded up to $10,000 in value wherever the testator has made specific bequests of some of such assets. This provision was enacted to provide a limited area of relief from the "unknown basis" problem where it is most likely to arise. However, it would appear to be unwise to make the election until all efforts have been exhausted to ascertain the decedent's basis because in some instances that basis will be in excess of the estate tax value. The limitation of basis to fair market value under Sec. 1023(a)(2) is for purposes of loss and does not apply for the purpose of gain where the asset is later sold for more than its estate tax value. Where the basis is known and is higher than the estate tax value, the election should not be made with respect to that asset.

The distribution of an interest in special use valuation property (farm land under Sec. 2032A) to the non-marital share of an estate could be unfortunate where the qualified heir sells the property to a person outside the family within 15 years after death of the owner. Such a sale will trigger an additional estate tax based on what the tax would have been wtihout the special use valuation election. The hypothetical estate tax computation in such an instance would allow a higher marital deduction only where the marital share was actually funded to a level sufficient to permit a larger deduction. This would be unlikely where no interest in the special use property was distributed to the spouse.

The testator who attempts to provide for specific distributions of low basis property to low income tax bracket beneficiaries and high basis property to high-bracket beneficiaries runs the risk that the income tax status of the beneficiaries may be reversed or changed by the time distributions are made.

Inequality may exist where distributees receive property of equal value and equal basis in the situation where the gain on the sale of one property may be subject to ordinary income treatment because of depreciation recapture while the gain on the sale of the other property qualifies for capital gain treatment.

It is a common experience for a farm testator to want to give farm assets to one child and non-farm assets to another child, but at the same time to give each child about the same amount of property in value. The impact of different bases will compound this difficult problem.

Colorado Bar Association Statement of Position Regarding Resolution of Current Moratorium on Carryover Basis Provisions of the Tax Reform Act of 1976

The Colorado Bar Association went on record in early 1977 advocating the repeal of Carryover Basis on the grounds of administrative complexity. As an interim step preferable to the existing alternatives of Section 2005 of the Tax Reform Act or various "fix-up" proposals, it supported the present moratorium.

Various proposals have been made to resolve the time-bomb created by the moratorium. In broad terms they are:

1. Return to the pre-TRA '76 law involving "step-up" in basis.

2. Some improved form of carryover basis.

3. Some form of taxation of gain at death generally breaking down into (a) treating death as a realization event or (b) an "additional estate tax" on the appreciation.

Proposals 2 and 3 suffer from the continued necessity that historical basis must be ascertained. This constitutes a change in rules prevalent for sixty-three years—rules that have given stability and predictability to our tax laws and which have been relied on throughout this period by estate owners not intending to dispose of particular assets during lifetime.

This is a significant consideration in Colorado where family ownership of farms, ranches, mineral interests and water rights is so prevelant and important. These assets involve depreciable improvements (added typically in an evolutionary way, frequently incorporating the labor of the owner and his family and the re-use of materials on hand) and depletable mineral resources. Basis records and adjustments thereto are frequently non-existent or confused at best. As in other parts of the country, Colorado has its share of family owned non .arm and ranch businesses where the owners have not anticipated a taxable transfer during lifetime and, therefore, have inadequate basis records.

Colorado is a state whose professionals have pioneered the use of the revocable trust as a will substitute and have persuaded their legislature to be among the first in the nation to adopt the Uniform Probate Code—all to the end that the expenses, delays, traumas and frustrations associated with death and the administration of decedants' estates to be held to an irreducible minimum. For these reasons, Colorado's lawyers and other estate professionals early identified the costly and difficult-to-impossible administration determinations required by carryover basis as being a gigantic step backward in attaining these professional and human objectives. Consistent with these concerns, the Colorado Bar Association, speaking through its Taxation Section and its Probate and Trust Law Section, urges consideration of the following proposed resolutions to the existing moratorium in the order stated.

1. *Return to the Pre-TRA '76 Law Involving "Step-Up" in Basis*

It is submitted that a return to prior law is a viable and acceptable solution to the dilemma Congress and the Nation finds itself in as a result of the action (or, more precisely, non-action) of Congress in allowing carryover basis to be added to the 1976 Act, as Senator Harry F. Byrd, Jr. recently said, "at the 59th minute of the eleventh hour, after the . . . Act had passed both the Senate and the House." He points out the now well-known fact that carryover basis was brought up in the conference between the House and the Senate without House action and without hearings by this Committee of the Senate or any consideration by this Committee or by the Senate.

Clearly, then, carryover basis can scarcely be considered a deliberative act of the Congress although the result was to overthrow a principal of tax law that had prevailed since 1913.

It is our view that there is no meaningful constituency in the country for a change from prior law. The disparate tax treatment of the now famous pair of identically situated investors who are killed simultaneously, one having just left his broker's office where he sold his appreciated securities and the other just approaching his broker's office to sell his similarly appreciated securities, is a problem which fascinates scholars and Treasury officials but does not, it is submitted, really bother real-life estate owners. They tend to be happy to sell appreciated assets when it suits their fancy and to retain other assets until death, deriving a stepped-up basis. Absent a forced sale (when tax considerations are secondary) every sale of an appreciated asset is a volitional act with tax consequences known. No one need be too concerned for the investor in the cited example who chooses to take a profit subject to taxation (except for the punitive effect created by inflation) rather than hold on until death. He may have wished that capital gains rates were less, but he obviously made a judgment to sell anyway.

The correlative concern about "lock-in" of capital ought to tend to disappear when capital gains rates begin to retreat (as they happily did in the 1978 Act) from a high of 49.125%. Carryover basis merely exacerbates such lock-in—under prior law it lasted no longer than the estate owner's death; under carryover basis, it could go on, in theory, for generations!

Death is a difficult time at best, rarely chosen as a deliberate tax avoidance device (if it were such a device, we could anticipate a rash of suicides by estate

owners in December of this year, depending on what Congress does with the moratorium!). Why add to the already substantial burdens of the families of deceased estate owners and fiduciaries that already exist in meeting substantial estate and inheritance tax levies that, in themselves and apart from the fact of the death of the estate owner, may jeopardize the continuity of family businesses and farm and ranch holdings? Is it sensible to subject them to the expenses and frustrations of the carryover basis requirements, the possibility of penalties for insufficient compliance, and the potentiality of lawsuits by heirs and distributees unhappy with their assigned carryover basis and built-in tax liabilities? Is this kind of "solution" to the academician's "problem" of untaxed appreciation at death consonant with the mood of the country today as evidenced by Proposition 13, an obviously growing popular antipathy toward government regulation and harrassment, and the very flavor of the Congress which just enacted the Revenue Act of 1978?

In view of the above, the Colorado Bar Association urges as its first preference a return to prior law regarding the step-up of basis at death.

2. *Return to the Pre-TRA '76 Law Involving "Step-Up" In Basis Together With a Modest Increase In Estate Tax Rates To Serve As a Trade-Off For a Loss of Revenue Associated With Untaxed Appreciation at Death*

This proposal makes sense only if Treasury and other proponents of carryover or taxation of appreciation at death are actually motivated by concern for resulting loss of revenue under prior law. Spokesmen for the Treasury Department have sometimes given the impression that revenue is really not the issue when it addresses the subject of untaxed appreciation at death. Just what the issue may be, if not revenue, is not very well articulated but one is forced to conclude it has to do with considerations that may be outside the traditional and proper role of the Treasury. While such non-revenue objectives are properly within the purview of the Congress, they should be identified "up front" and not hidden under the guise of alleviating revenue losses. Consideration of such fundamental changes in the direction of this country ought to be undertaken only against a background of public debate.

Departing from matters of policy and indulging the assumption that the concern of Treasury and other advocates of change in prior law relating to "step-up" has to do with loss of revenue, the Colorado Bar Association suggests that a "toll-charge" be exacted from estate owners for the privilege of stepping-up the basis of estate assets to estate tax values at death, thereby providing (1) basis certainty for heirs and distributees, (2) elimination of the necessity to produce historic basis records and make further administrative adjustments to such bases, and (3) restoration of settled techniques and expectations in providing required liquidity for estates (Sections 303 and 306 redemptions, relief provisions for the payment of death taxes, conventional buy-sell agreements, etc.).

Such a "toll-charge" should probably be modest in rate, particularly in the light of the possible effect of inflation on estate values, and could be a flat surcharge against all assets of the estate over a certain threshold value or against particular schedules on the Form 706, probably excluding charitable bequests and possibly excluding family homes, insurance and other cash items, and other non-investment property. If the proposal is viewed to have merit, we would be pleased to submit detailed suggestions for implementation.

We understand Congress may have responded in 1942 to suggestions then arising regarding carryover basis by adding to estate tax rates instead.

While arbitrary, this approach to dealing with a loss in revenues flowing from non-taxability of appreciation at death has simplicity to commend it. It is no more arbitrary than numerous other provisions of the Tax Code . . . such as percentage depletion; non-proration of dependency exemptions and gift splitting or joint income tax filing privileges, despite status changes within the taxable year; use of sales tax tables and standard deductions; requirements to use actuarial assumptions at odds with actual facts; differentials between tax tables for married tax payers and singles; disregard of the effects of inflation in defining taxable capital transactions; the rates of progressivity in income and transfer tax rate schedules; and all references to time periods or effective dates that determine whether a transaction falls within or without a particular tax result. In the final analysis, everything in the Tax Code, in its ever-changing form, is arbitrary, being totally disassociated from any "natural" law. There would seem to be room for one more arbitrary addition in the interest of simplicity.

3. *A "Fixed-Up" Carryover Basis that Includes the Various Changes Agreed to January 27, 1978 at Scottsdale Arizona, Between Treasury Representatives and the American Bar Association Taxation Section Carryover Basis Committee Plus a Total "Grandfathering" of All December 31, 1976 (Or December 31, 1979) Assets*

Efforts have been made to "fix-up" some of the worst features of carryover basis. At the meeting of January 27, 1978, at Scottsdale, Arizona, attended by Harry L. Gutman, Deputy Tax Legislative Counsel of the Treasury, and members of the American Bar Association Taxation Section Carryover Basis Committee, a number of these fix-up attempts were articulated and agreed to in principal. The attached summary of "Carryover Basis Simplification Proposals" prepared by the Treasury Department is reflective of such agreements but not necessarily identical therewith.

The residual flaw in these agreements is the Treasury reluctance to eliminate the retroactive need to determine the decedant's basis in property where the cost and date of acquisition are unknown. Since this need, which springs entirely from carryover basis (or any realization of gain at death approach) could not have been anticipated by estate owners who had no intention of making taxable dispositions of key assets in their lifetimes, fairness dictates that the need be prospective only. This would be accomplished by "grandfathering" all assets owned by the decedents on a key date (December 31, 1976 or December 31, 1979, for example) and making the prior "step-up" provisions applicable to such assets in their estates. At least everybody then starts equally with actual or constructive knowledge of the rules and is in a position to protect himself. While Congress certainly has the power to make tax laws changes retroactive in effect, there is no requirement that this be done and, certainly, equitable reasons exist in this case not to do so.

Consequently, it is the recommendation of the Colorado Bar Association that, if the Congress is persuaded that some form of carryover basis is appropriate at the expiration of the current moratorium, the form reflect the most liberal and favorable features (from the point of view of taxpayers and estates) heretofore or hereafter agreed to by the Treasury *plus* the applicability of stepped-up basis to all assets owned by decedents on a key date not earlier than December 31, 1976.

The Colorado Bar Association, while not favoring any form of realization of gain at death (including AET), would nevertheless urge that any such system adopted by Congress have a similar "grandfathering" provision in the interest of fairness and minimization of administrative costs and burdens.

Thank you.

Carryover Basis Simplification Proposals

This memorandum summaries a number of proposals the Treasury Department believes will simplify the operation of the present carryover basis provisions. The material in this memorandum is in part a distillation of the suggestions and comments received by the Treasury over the past 18 months from the professional tax community and other interested persons. Many of these proposals are incorporated in Section 2461, introduced by Senator Hathaway during the 95th Congress.

The proposals contained herein are not exhaustive and suggestions for modification will certainly be entertained. Treasury is continuing to study the resolution of other issues raised by the carryover provisions.

The memorandum is divided into three parts. The first sets forth proposals for long range simplification; the second, proposals for additional transition relief; and, the third, proposals for conforming changes.

I. Long Range Simplification

A. Exclude from the operation of carryover basis all estates which are not required to file estate tax returns. Basis for assets held by estates not required to file federal estate tax returns would be determined under prior law. Executors of these estates will not, therefore, be concerned with the basis of any property included in the estate except for items of income in respect of a decedent.

B. Increase minimum basis from $60,000 to $175,000. The minimum basis would be allocated in the discretion of the executor first to capital assets and, if any minimum basis remains, to assets which would produce ordinary income in whole or part when sold by the estate or an heir.

C. The minimum basis would be calculated prior to the calculation of the basis adjustment attributable to death taxes. It will therefore be a floor to which the death tax adjustment can be added rather than a cap as is presently the case.

D. A simplified single tax adjustment would replace the three separate but interdependent adjustments required under present law. A simple percentage number would be taken from the estate tax rate table and applied to each item of property subject to tax to give the addition for both federal and state death taxes. The percentage to be applied would be the highest tax rate to which the estate is subject before any credits are applied except that if an estate does not have at least $50,000 worth of property in that bracket, the next highest rate would apply.

To illustrate, a taxable estate of $400,000 will be in the 34 percent bracket. Each item of appreciated property which goes to fund a taxable bequest would have a basis increase of 34 percent of the appreciation in that property. The total federal estate tax payable on a $400,000 estate, after subtracting the $47,000 unified credit is $74,800, or approximately 19 percent of the total estate. Yet, in this case, the adjustment would be 34 percent even though the effective rate on the estate is only 19 percent. Under the 1976 Act the 19 percent rate would be the rate of adjustment made to basis.

Where an estate is non-taxable because of the unified credit, an adjustment, based upon the schedule rate applicable under Section 2001(c), would nonetheless be allowed, thus permitting an ample adjustment for any state taxes.

No adjustment would be made where the decedent's estate was not required to file a federal estate tax return because, in that case, prior law will apply.

E. Redefine the personal and household effects exclusion and increase the exclusion from $10,000 to $25,000. The $25,000 exclusion would cover all tangible personal property which was non-business property in the hands of the decedent. The exclusion would not be elective. Property subject to the exclusion would be determined in ascending order of fair market value on the relevant estate tax valuation date, starting with the least valuable property included in the decedent's gross estate. Pieces of property, none of which has a fair market value in excess of $100 and all of which are related in function or use, may, at the executor's election, be treated as a single piece of property, e.g., dishes, clothing, stamps, coins, etc.

F. Permit an elective average basis for similar property acquired at different times, e.g., mutual fund dividend reinvestment shares or securities in the same corporation.

G. Provide, in addition to the $175,000 minimum basis, a $250 per year addition to the basis of a personal residence for any year in which capital improvements in excess of that amount cannot be substantiated. This alleviates recordkeeping burdens with respect to minor home improvements.

H. Basis information reporting would be required only from the executors of estates subject to carryover basis and penalties would be assessed pursuant to a negligence standard.

I. A procedure would exist for executors and/or beneficiaries to achieve a final determination of basis, binding upon the executor and the I.R.S., at the time of audit of the decedent's estate tax return.

II. PROPOSALS FOR TRANSITION RELIEF

A. The discount rule of the Revenue Act of 1978 could be applied at a rate of 6 percent to determine an elective minimum "fresh start" basis for all property held on December 31, 1976 other than marketable bonds and securities. However, application of the formula could in no event result in a basis less than 25 percent of estate tax value. Alternatively, the discount rule could be adopted as the sole method of determining fresh start basis for non-marketable property. This would eliminate the need for complex rules to account for the appreciation attributable to improvements to the property.

B. The "fresh start" basis would apply for loss as well as gain purposes. This would eleminate the need to retain records of two separate bases for "fresh start" property.

C. The fresh start adjustment would be calculated on the basis of estate tax rather than date of death value.

D. Non-convertible, non-participating preferred stock would be treated as having a fresh start value equal to its redemption price.

E. The Secretary would be granted regulatory authority to devise alternatives to the present time proration fresh start formula for assets which will not substantially appreciate in value after December 31, 1976, such as non-marketable notes, and assets, the value of which could be readily ascertained as of December 31, 1976 by a method other than appraisal, e.g., property subject on that date to a binding buy-sell agreement that has the effect of fixing estate tax value.

III. CONFORMING CHANGES

A. The unused capital loss of a decedent would carryover to the decedent's estate and to the distributees of the decendent's estate.

B. Section 1221(3) (relating to works of art, etc.), would be modified so that carry-over basis property would not automatically be disqualified from capital gain status in the hands of the heir.

C. Section 453 would be amended to permit an estate to sell assets on the installment method and distribute the installment obligation to beneficiaries of the estate without accelerating the deferred gain.

D. Section 101(a)(2) would be amended to permit the transfer of an insurance policy by a corporation to a co-shareholder of the insured. Thus, corporations will be able to transfer existing insurance policies to shareholders without running afoul of the "transfer for value" rules.

E. The recapture provisions would be amended to provide that where property subject to recapture is used to fund a pecuniary bequest the amount of gain recognized as ordinary income cannot exceed the amount recognized under Section 1040.

Senator BYRD. The next witness is Mr. Arthur J. Dixon, the chairman of the Federal tax division of the American Institute of Certified Public Accountants.

Mr. Dixon?

STATEMENT OF ARTHUR J. DIXON, CHAIRMAN, FEDERAL TAX DIVISION OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. DIXON. Thank you, Mr. Chairman.

My statement will be quite short, and there is attached to the statement some suggestions we have, and I would request that the statement and the suggestions be included in the record, sir.

Senator BYRD. It will be placed in the record.

Mr. DIXON. Thank you very much.

My name is Arthur J. Dixon and I am pleased to testify before you today in my capacity as chairman of the Federal Tax Division of the American Institute of Certified Public Accountants.

As practicing CPA's we are, of course, very much concerned with making the tax laws as simple and as equitable as possible.

The AICPA neither supports nor opposes carryover of basis as a matter of principle. We do, however, oppose the carryover provisions presently contained in the Internal Revenue Code to become effective January 1, 1980. If Congress determines that carryover is to be the solution to the problem of unrealized appreciation at death, we believe that carryover must and can be made workable.

At hearings on the Tax Reform Act of 1976 and the Technical Corrections Act which followed, we opposed carryover. We deeply believed that the carryover legislation then being discussed was extremely complex and unworkable to the point of being inequitable. We have been very gratified to note that in response to suggestions from our organization and from many others, that the Department of the Treasury has made responsible, corrective proposals. We be-

lieve that the Treasury proposals, with certain further corrections which we recommend, and possibly with other modifications, would make carryover workable, though continuing to be quite complex. I must emphasize again, however, that under our voting rules, we do not have a sufficient consensus to support or oppose the principles of either carryover or step-up.

On March 1, 1978, we sent all members of the Committee on Finance our clean-up recommendations, and I call those to your attention, and they are attached to our statement. We would obviously be very pleased to discuss any of those, or others, with the committee.

Senator BYRD. If I could ask one question, does your proposal have a grandfather clause?

Mr. DIXON. Our proposal does not have a grandfather clause, Senator, but we do think that it is appropriate for a grandfather clause to be considered. We have no position either in favor or opposed to a grandfather clause, but we think it is an additional modification that is worthy of consideration, sir.

Senator BYRD. Thank you.

Mr. DIXON. We have also submitted our recommendations to the administration at its request.

Mr. Chairman, the choice between carryover of a decedent's basis and stepped-up basis at death presents a very difficult problem of where to draw the line based on considerations of equity and government revenue between the relative complexity of carryover basis and the relative simplicity of stepped-up basis. We recognize that there are strong and sincere convictions on both sides of the issue, as there are, indeed, within our own membership. The AICPA has been unable to come to a consensus as to where this line should be drawn.

We believe that Congress, as the elected representatives of the people, should appropriately make that difficult determination.

We do, however, oppose the alternatives to carryover and stepped-up basis which would make death an income recognition event. These alternatives, such as capital gains at death—

Senator BYRD. May I interrupt there? There has been no such proposal about which I know.

Mr. DIXON. Well, there has been no proposal, I think, that has been as yet come upon the legislative scene, but certainly in testimony before the House Ways and Means Committee——

Senator BYRD. But there has been no legislative proposal to do that.

Mr. DIXON. No, there has been no legislative——

Senator BYRD. And there has been no recommendation from Treasury to do this.

Mr. DIXON. All I am saying here is that if there is such a proposal, we would oppose it.

As I say, we do oppose, if such a recommendation is made—and it has certainly been discussed——

Senator BYRD. I will almost guarantee you it will not be passed, if it is made.

Mr. DIXON. I am delighted to hear that because we think it would be inappropriate.

Senator BYRD. But I do think it is being used by Treasury to try to scare individuals into supporting carryover basis.

I can almost guarantee you it is not going to be passed.

Mr. DIXON. I am delighted to hear that, but we wanted to put on the record that if such a recommendation is made, that is one we do have very much of a consensus of opposing.

We think that there are other possibilities that should be considered, and without, at this point, either favoring them or opposing them, they include the possibility of making some overall estate tax rate adjustments and grandfathering of the carryover provisions. Other possibilities should be considered before this entire question is disposed of.

We do strongly believe that Congress should provide a transition rule for the deferral of carryover basis enacted by the Revenue Act of 1978. For those who relied on the existing law between December 31, 1976 and November 6, 1978, it seems entirely inequitable to make a retroactive change without providing some transition rule.

We recommend that an election be provided for those who relied on the carryover basis provisions between the date of their enactment and the date of their deferral, to use either carryover or stepped up basis.

Senator BYRD. If you would permit me to interrupt you at this point, we tried to get that accomplished in the Committee of Conference last October, but the Treasury Department representatives at the Conference told the conferees that an election under current law could not be administered.

So I do not know. That being the case, the conferees decided not to push the matter. But the votes were there to do exactly what you wanted until Treasury testified, which astonished me, that even if we did that, they could not administer it.

Mr. DIXON. Well, frankly, we would disagree very strongly with Treasury in that view, and we believe that the equity considerations far outweigh the other tax policy considerations on this issue.

We supported the current deferral of the effective date of carryover. We believe that it provides, and it ought to provide, an excellent opportunity for Congress to determine whether carryover or some alternative should be the answer to the problem of unrealized appreciation at death, and if Congress decides to do so, to clean up carryover basis.

We believe that our cleanup suggestions are constructive and would, of course, be pleased to assist in evaluating them and other possible solutions to this very important issue and we very much appreciate the opportunity to testify before you, Mr. Chairman, and before this subcommittee.

Senator BYRD. Thank you very much, Mr. Dixon. Let me ask you just one question. Do you feel that carryover basis as it now stands in the law is workable?

Mr. DIXON. No, sir. Definitely not.

Senator BYRD. Well, then this is why I say that Treasury said that even if the conferees had made provision to utilize carryover basis as it now exists in present law for those who have died in the meantime that they could not administer it, even though the law might permit it.

Mr. DIXON. Well, that is a little bit of a catch-22 because all that we are saying is that in the case of a particular decedent who died during that period and whose executors decided that they would, in their particular case, have to live with it, and went forward on that basis and had consequences as a result of that, now, to deprive them of at

least the option of doing what they determined they could do seems to us to be very unfair.

Senator BYRD. I do not disagree with that at all, and the conferees were prepared to do exactly what you said until Treasury said that if you do that, we cannot administer it. This is another way of saying the law which Treasury played such a big part in putting on the books is not only unworkable from the point of view of the attorneys and those who have to administer estates and the taxpayer, but it also cannot be administered by the Treasury itself.

Thank you very much.

Senator Dole?

Senator DOLE. I have no questions.

Senator BYRD. Thank you, sir.

[The prepared statement of Mr. Dixon follows:]

STATEMENT OF ARTHUR J. DIXON, CHAIRMAN, FEDERAL TAX DIVISION OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

My name is Arthur J. Dixon, and I am pleased to testify before you today in my capacity as Chairman of the Federal Tax Division of the American Institute of Certified Public Accountants (AICPA).

The AICPA has over 140,000 members, many of whom advise clients on tax matters, prepare tax returns, and work generally with the tax provisions which you help to write. We are vitally concerned with making the tax law as simple and equitable as possible.

The AICPA neither supports nor opposes carryover of basis as a matter of principle. We do, however, oppose the carryover provisions presently contained in the Internal Revenue Code to become effective January 1, 1980. If Congress determines that carryover is to be the solution to the problem of unrealized appreciation at death, we believe that carryover must and can be made workable.

At hearings on the Tax Reform Act of 1976 and the Technical Correction Act which followed, the AICPA opposed carryover. We deeply believed that the carryover legislation then being discussed was extremely complex and unworkable to the point of being inequitable. We have been very gratified to note that in response to our specific suggestions, the Department of the Treasury has made responsible, corrective proposals. We believe that the Treasury proposals, with certain further corrections, which we recommend, would make carryover workable, though continuing to be quite complex. I must emphasize again, however, that under our voting rules, we do not have a sufficient consensus to support or oppose either carryover or stepup.

On March 1, 1978, we sent all members of the Committee on Finance our cleanup recommendations. I would call the attention of the Subcommittee to these recommendations and ask that they be included in the record of this hearing at the completion of my testimony. Our "Comments on Various Proposals to Modify Carryover Basis" were made with reference to corrective legislation which was introduced during the last Congress. Although these comments address most of the commonly mentioned cleanup proposals, we would be pleased to comment on the specific provisions of any similar legislation introduced during this Congress. We have also submitted our recommendations to the Administration at its request.

The choice between carryover of a decedent's basis and stepped-up basis at death presents the difficult problem of where to draw the line, based on considerations of equity and government revenue, between the relative complexity of carryover basis and the relative simplicity of stepped-up basis. We recognize that there are strong and sincere convictions on both sides of the issue, as there are, indeed, within our own membership. The AICPA has been unable to come to a consensus as to where this line should be drawn. We believe that Congress, as the elected representatives of the people, should, appropriately, make this determination.

The AICPA does oppose the alternatives to carryover and stepped-up basis which would make death an income recognition event. These alternatives, such

as capital gains at death and the "additional estate tax," would be a significant departure from the established principle that taxes on appreciation should be imposed only when gains are realized and when cash for the payment of taxes is generated. In addition, many of the basis determination problems of carryover would also be present with such proposals.

Other than those alternatives to carryover which would make death an income recognition event, the AICPA supports the exploration of alternatives to, or additional modification of, carryover basis. Without commenting favorably or unfavorably on them, such alternatives or modification might include estate tax rate adjustments, grandfathering of carryover provisions, or a prospective valuation date for certain types of assets. We believe that it may be useful to take a fresh look at such alternatives or modification in an attempt to find a simpler and fair solution to the problem of unrealized appreciation at death.

The AICPA strongly believes that Congress should provide a transition rule for the deferral of carryover of basis enacted by the Revenue Act of 1978. For those who relied on the existing law between December 31, 1976 and November 6, 1978, it seems entirely inequitable to make a retroactive change without providing some transition rule. We recommend that an election be provided for those who relied on the carryover of basis provisions between the date of their enactment and the date of their deferral to use either carryover or stepped-up basis. We believe that the equity considerations far outweigh the other tax policy considerations on this issue.

The AICPA supported the current deferral of the effective date of carryover. We believe that it provides an excellent opportunity for Congress to determine whether carryover or some alternative should be the answer to the problem of unrealized appreciation at death and, if Congress decides to do so, to clean up carryover of basis. We believe that our cleanup suggestions are constructive and would be pleased to assist in evaluating other possible solutions to this very important issue.

Federal Tax Division of the American Institute of Certified Public Accountants

(Comments on various proposals to modify carryover of basis)

INTRODUCTION

In letters dated March 1, 1978, addressed to Senator Russell B. Long, Chairman, Senate Committee on Finance, and to Representative Al Ullman, Chairman, House Committee on Ways and Means, we stated that the Executive Committee of the Tax Division had determined that the AICPA should withdraw its opposition to carryover of basis.

The letters expressed the belief that the provisions of S. 2461, introduced by Senator Hathaway on January 31, 1978, if amended by certain other proposals which have been made by the Department of the Treasury, and others which the AICPA would proffer, would change our previously expressed conclusion that the current law is unworkable. Accordingly, we recommended that the effective date of carryover be deferred—as has been passed upon by the Senate Finance Committee—and that S. 2461, as appropriately amended, be enacted to become effective at the end of the deferral period. We also urged that further hearings be held in the near future so that the merits of further proposals to amend carryover could be weighed.

The AICPA has been pleased to see that sincere criticisms of the carryover basis rules have been met by responsible and constructive proposals, of expanding scope and perception, by the Department of the Treasury (in the form of a memorandum dated January 9, 1978, and addressed to the Joint Committee on Taxation) and those embodied in bills introduced by Senator William D. Hathaway (S. 2461), and Representative William A. Steiger (H.R. 10617). There are some differences among the proposals to change and improve the carryover basis rules, and there are matters as yet untouched by the proposals. In the comments which follow, the AICPA expresses its support for various proposals, its preferences where differences exist, and offers suggestions for further improvement in the rules.

In addition to the Hathaway and Steiger bills cited above, reference will be made to the bill introduced by Senators Harry F. Byrd, Jr. and Robert Dole (S. 2228).

PART 1—PROPOSALS FOR MODIFICATION OF CARRYOVER BASIS WHICH ARE SUPPORTED BY THE AICPA

1. Exclusion from carryover

Under the Tax Reform Act of 1976, the carryover basis rules apply to estates containing $60,000 of carryover basis property. Consequently, although the executor may not be obliged to file a Federal estate tax return, he may nonetheless be obligated to perform the search of the decedent's records—for purchase dates and prices of assets—make the extensive computations, and maintain records and issue information called for under the carryover rules. The process is time-consuming, expensive, and unproductive of sufficient revenues to make the rigors of compliance justifiable in the case of estates of modest size.

The AICPA strongly urges adoption of the immediate outright exception from carryover provided for estates consisting of $175,000 or less of carryover basis property granted by both the Hathaway (S. 2461) and Steiger (H.R. 10617) bills. The $175,000 figure corresponds to the exemption equivalent of the estate and gift tax unified credit when it is fully phased-in by 1981. This approach, as opposed to a phase-in of the exception would be particularly appropriate and would result in little revenue loss if the effective date of carryover is deferred until 1979, as contemplated by the Senate Finance Committee and as we have recommended.

2. Exemption from carryover for personal and household effects

Under current law, an executor can elect to exclude $10,000 in personal and household effects from carryover. This provision purports to solve the problems which would beset executors who must ascertain the bases for multitudes of assets which were in the possession of most decedents.

The AICPA supports the position in the forewords to the Hathaway and Steiger bills, that the exemption is inadequate to accomplish its purpose and should be increased to $25,000. It would be appropriate for the terms "personal and household effects" to be broadly defined so that the intended relief would apply to widely-held non-business tangible assets.

3. Minimum basis adjustment

Consistent with our recommendation for the exclusion of estates with less than $175,000 of carryover basis property from the carryover rules, the AICPA believes that the minimum basis adjustment should be increased from the figure of $60,000 under the Tax Reform Act of 1976 to $175,000 without phase-in, as proposed by the Hathaway and Steiger bills.

4. Adjusted basis of personal residence

Determination of the decedent's basis for his personal residence is a particular problem for the Executor under current law. An accurate determination requires identification of every payment for improvements over what might be decades of residency. The Treasury proposals and the Hathaway and Steiger bills each offer resolutions of the problem, but vary in their details. The approach is an assumption of a dollar amount of improvements for each year the property was held. The Treasury's figure is $750 with a limitation of $30,000.

The AICPA recommends adoption of the Treasury's position. The figure must stand the test of time, and thus should take cognizance of future inflation. We believe that, in the long term, $750 will be reasonably proximate to the improvements made by the typical homeowner subject to carryover of basis.

5. Fresh start adjustment

(*a*) *Determining both gains and loss.*—The fresh start adjustment increases the bases of the decedent's assets to their values at December 31, 1976 only when gains are being recognized. The adjustment is not applicable for the purpose of determining a loss. Consequently, under present law, two sets of basis figures, each changing by reason of the death tax adjustment, etc. must be maintained.

The Hathaway and Steiger bills provide that fresh start would apply in computing both gain and loss. The AICPA recommends adoption of this solution to a particularly burdensome aspect of the current law.

(*b*) *Extension of the marketable security rule to other property.*—Securities which are listed on a stock exchange, in an over-the-counter market, and the like, are given valuations based upon their quoted prices. All other assets are valued in accordance with a formula which embodies the assumption that

appreciation takes place evenly over the entire holding period. The assumption is patently false when the asset has an established price, or readily determinable value.

The AICPA supports the adoption of the provisions of the Hathaway and Steiger bills which would extend the method of valuing marketable securities at December 31, 1976 to non-convertible, fixed dividend preferred stock, and to other property subject to buy-sell, redemption or other agreements which establish relatively fixed values. (See "11-4", below re Section 306 stock).

(c) *Estate tax value to calculate fresh start adjustment.*—The fresh start adjustment is calculated with reference to the excess of the date of death values over the decedent's adjusted basis for the property. The Treasury Department's Proposals contain the following recommendation. "The fresh start adjustment would be calculated on the basis of estate tax value rather than date of death value".

The AICPA agrees with the Treasury's recommendation. Where the estate tax return contains the election for alternate values for estate tax purposes, those values are finally determined as a result of the ensuing tax examination; the date of death values for nonmarketable securities may receive little attention. We believe that the formula method could have reference to estate tax values, and the holding period factor could be modified accordingly.

(d) *Discount alternative to formula method for determining the value of property other than marketable securities.*—The formula method for valuing assets other than listed securities at December 31, 1976 employs the date of acquisition and cost of every item of property other than marketable securities. Determination of these facts from a decedent's records will often be time-consuming and expensive, if not wholly impossible. The Technical Corrections Bill (H.R. 6715) passed by the House of Representatives and reported out by the Senate Committee on Finance on April 19, 1978, recognized the difficulties of proving basis and holding period in the case of tangible personal property such as items of art, antiques, and collections of stamps and coins. The solution provided in H.R. 6715 is to permit the valuation of such property at December 31, 1976 to be established by discounting the date of death valuation at the annual rate of 8 percent.

The Hathaway and Steiger Bills provide the executor with an election to adopt the discount method of establishing a minimum basis for non-business tangible personal property (i.e. such property which was a capital asset in the hands of the decedent), and for certain personal, principal residences; furthermore, they reduce the discount rate to 6 percent. The bills differ to some extent: The Steiger version would not reduce the minimum basis below 50 percent of the date of death valuation; the Hathaway bill sets the floor at 25 percent.

The AICPA supports the Hathaway and Steiger concept of extending the opportunities to use the discount method of valuation; their adoption of a 6 percent discount rate; and establishment of minimums below which bases determined by the discount rate would not fall. We believe that a 6 percent assumed rate of appreciation of assets over a prolonged period is more reflective of economic realities than the 8 percent rate appearing in H.R. 6715. We also believe that the floor under the valuation determined by the discount method is appropriate recognition of the fact that market prices generally do not rise indefinitely without abatement. Accordingly, we support the 25 percent floor as a minimum basis provided by the Steiger bill.

We note that the Treasury proposals afforded greater scope to the elective discount rate than the bills. According to the Proposals, "The elective discount rule of the Technical Corrections Act would be applied to determine a minimum 'fresh start' basis for all property held on December 31, 1976 other than marketable bonds and securities". We believe that carryover basis raises so many valuation issues that it has the potential of clogging court calendars far into the future. We believe that executors will need a fair and reasonable alternative to specific proof of decedent's basis for all varieties of assets so that they can protest the estate's interest without engaging in litigation. Accordingly, we urge that serious consideration be given to broadening the coverage of the elective discount rule in line with the Treasury's recommendation.

(e) *Basis information furnished by executors.*—Carryover presents a challenge to those who must compute and then alter the computations of the bases of assets. Because of the need in most cases to resort to imperfect records to establish the fresh start adjustment under the formula method; because of the likely impermanency of the initial determination of death taxes allocable to the appre-

ciation of each asset (discussed in "6", below) ; in general, because of the potentially innumerable variations which would alter basis assigned to an estate's assets, an executor's responsibility—to reeport to both the Internal Revenue Service and beneficiaries under threat of severe and automatic penalties for inadvertant errors of ommission—is a heavy responsibility indeed.

The AICPA supports the provision in the Hathaway and Steiger bills which require submission of information on basis only if the estate contains more than $175,000 of carryover basis property, and then only to the beneficiary receiving such property. Furthermore, the penalty would be imposed only if the failure to furnish information is due to negligent or intentional disregard of rules and regulations. We believe that the present law constitutes an ill-advised barrier to service as executors by individuals. Those who are aware of the severity of the penalties for purely inadvertant, even trivial transgressions, especially in small estates where the assessment would outweigh commissions, are justified in declining appointment as executors. The tax law should not operate to deny the testator his choice of a representative.

6. Death tax adjustment

The Federal and state death and succession taxes attributable to the unrealized appreciation of each asset are added to basis. The adjustment is made asset-by-asset; and the tax rates employed in the computation are the average rates to which the estate is subject. The prescribed method requires recomputation of the bases of all assets whenever a tax examination or amended estate tax return revises the value of any single asset or the amount of any deduction. The Treasury proposals and the several bills take cognizance of the unusual burden imposed by this method of determining the death tax adjustment. In order to simplify the original computations and reduce the probability of an examination causing a multiplicity of re-computations, they propose that the adjustments be determined by reference to the highest Federal estate tax rates reached by the estate before being reduced by credits.

The AICPA recognizes the critical need to simplify thee computations required under the present method of computing the death tax adjustment. In our testimony on carryover basis we protested against a formulation which in the normal course of an estate's administration obligates fiduciaries and beneficiaries to file, and the Internal Revenue Service to process innumerable amended income tax returns. The method proposed by the bills is a vast improvement over present law, and we support the proposed modification. It does not—as does present law—take account of state taxes which exceed the amount of the Federal credit granted for such taxes; and in some states the excess can be substantial. However, since the adjustment is based upon the highest rate of Federal estate tax to which the estate is subject, the impact of the resort to a single table of rates will be tempered.

Additional comments on the death tax adjustment appear below (at "11-1").

7. Decedent's capital loss carryovers

The advocates of carryover embraced the concept of equality of tax treatment. A mainstay of their side of the long debate has been a comparison of the tax treatment accorded a taxpayer who sells appreciated property before his death, in contrast to one who holds such assets throughout his lifetime. However, at this juncture, inequality of tax treatment is a by-product of carryover since present law prescribes that a decedent's unused losses expire as conclusively as he does. This fact leads to a correlative illustration of inconstant tax treatment: the estate and heirs of a decedent who had capital loss carryover, and who sold his appreciated assets before he died are greatly favored over the estate and heirs of a decedent who neglected to take advantage of his carryovers.

Every proposal referred to in this commentary—that of Treasury, and the various bills—recognizes that this anomaly should not exist. The Treasury phrased its proposal as follows: "The unused capital loss of a decedent will carryover to the decedent' estate and to the distributees of the decedent's estate". The Hathaway and Steiger bills authorized the allowance of a carryover, "for the estate's first taxable year".

The Institute recommends adoption of a carryover of a decedent's unused capital losses, where the carryover of basis rules apply, to the estate and to its distributees.

8. Depreciation recapture on funding of pecuniary bequests

If appreciated property is transferred in satisfaction of a pecuniary bequest the estate must recognize gain to the extent of the appreciation occurring be-

tween the valuation date for estate tax purposes and the date of distribution. The Treasury proposed, the Hathaway and Steiger bills provide, and the AICPA supports a conforming provision: if the prosperity has had basis adjustments subject to recapture the ordinary income recognized will be limited to the post-death appreciation.

9. Installment obligations distributed by executor

If property is sold by an estate and the installment method of reporting gain is adopted, the transfer by the estate of the installment obligation to a legatee will cause the gain to be recognized. Carryover has made the problem especially acute, although it existed under prior law, since the gains on sales of carryover basis property may be substantial. Treasury proposed not to treat the transfer of an installment obligation to beneficiaries of the estate which sold the property as a disposition accelerating the gain. The Hathaway and Steiger bills adopt this position.

The AICPA believes that the current rule unduly impinges upon the executor's fulfillment of his duties. The installment method of reporting gain reflects the financial realities attending deferred payments. Yet, an executor should terminate his period of administration promptly. If distributions in termination accelerate the gain the tax law has created a quandary and snare for no perceptible reason. Accordingly, the Institute supports the provision which removes transfers of installment obligations to beneficiaries from dispositions accelerating gains.

10. Limitation on section 303 redemptions

In testimony before the House Ways and Means Committee on October 6, 1977, we addressed the problem of the estate of the owner of a closely-held family business. We pointed out that carryover piles income taxes upon estate taxes when the obligation to pay the later necessitates the sale of assets and that the problem was especially acute in the case of such a business. It was in this context that we expressed concern that Section 303 fails to shelter from dividend income treatment the proceeds of a redemption to pay the income taxes, and, that the overall tax burden resulting from a shareholder's death can force the sale of family businesses.

The AICPA is pleased that the bills introduced by Senators Byrd and Dole, and by Representative Steiger would extend the limits upon a redemption qualifying under Section 303 to cover the amount of income taxes generated by the redemption. We enthusiastically endorse these proposals.

11. Conforming the qualification tests under the relief provisions

In order for an estate to avail itself of the installment payment privilege under Sections 6166 or 6166A, the decedent must have held an "interest in a closely-held business". The definition of such an interest is different for purposes of each section. Under Section 6166, the partners or stockholders may number as many as 15. Under Section 6166A, the figure is limited to 10. The AICPA urged that Section 6166A's definitional standard be conformed to that of Section 6166 in its Recommendations for Technical Amendments to the Estate and Gift Tax Provisions of the Tax Reform Act of 1976, submitted to the Ways and Means Committee on February 18, 1977. We are pleased that the Byrd-Dole, Hathaway and Steiger bills embrace the proposition, and we re-affirm our support of its adoption.

12. Capital gain treatment of inherited creative works

Adoption of carryover of basis had the effect of denying capital gain treatment to the estate and heirs of artists, composers and writers upon sale of the inherited creative work. The combination and sequence of estate taxes followed by income taxes at ordinary rates on sales of inherently low basis assets causes the tax burden to reach confiscatory levels.

All of the proposals discussed herein—except for the Hathaway bill—would extend capital gain treatment to inherited created works. The AICPA enthusiastically supports the adoption of such a provision.

PART II—ADDITIONAL PROPOSALS BY THE AICPA FOR MODIFICATION OF CARRYOVER BASIS

1. Decedent's loss and deduction carryovers

We have endorsed the carryforward of a decedent's capital losses to his estate and distributees. As noted above (at "1–7") this relief provision appears in the Treasury proposals and the various bills. However, other items of loss

and deduction which are allowed to be carried over during the decedent's lifetime expire upon his death. This expiration results in an unfair distinction between taxpayers, as we mentioned in the earlier section cited above.

The AICPA proposes that, during the period of deferral of the carryover of basis rules, the subject of loss and deduction carryovers be studied. The study should determine which items are suitable for allowance from decedent to his estate and its distributees in order to equitably counterbalance the impact of carryover of basis on income producing activities continued to be conducted after the taxpayer's death.

2. Removal of the taint on section 306 stock

Prior to the Tax Reform Act of 1976, the "taint" (in general, the application of ordinary income treatment in the event of sale of certain preferred stock) was removed upon the death of the stockholder. This rule was present in the Code since the adoption of Section 306 in 1954. The carryover of basis rule had the technical consequence of leaving Section 306 stock with its taint after the death of its owner. As a result, the combination of estate taxes and ordinary income taxes on dividend income could reach confiscatory levels.

The Technical Corrections Bill (H.R. 10617), to a limited extent, addresses the effects of carryover on Section 306 stock. It extends the fresh start adjustment to such stock; and permits redemptions to pay death taxes and funeral and administration expenses to qualify for capital gain treatment under Section 303. However, the AICPA in its testimony before the House Ways and Means Committee on September 8, 1977, and in earlier written comments, declared that the amendment applying the fresh start adjustment would fail in its avowed purpose. We pointed out the fresh start adjustment is computed under the special valuation method which presupposes that appreciation occurs at an even rate, day-by-day, over the entire holding period. As a result, when applied to assets having a fixed value such as Section 306 stock, the adjustment to basis would decrease for each day the owner lives past 1976. We believe that this particular problem should be resolved by the extension of the marketable security valuation rule to non-convertible, fixed dividend preferred stock, as provided in the Hathaway and Steiger bills. We expressed our support of this provision above (at "1-5-b").

Nevertheless, the taint remains after the death of the owner of Section 306 stock; and, unless redeemed under Section 303, post-1976 issues will be exposed to an unwarranted level of taxation. No proposal discussed herein offers a remedy for this problem.

The AICPA testified in favor of removal of the taint. We believe that in most instances the closely-held corporation is recapitalized and preferred stock is issued so that retired employees will have a source of income, and younger employees will be encouraged—by sharing to a larger extent in the equity of the business—to remain with a small company rather than seek positions in large public companies. The death of the preferred shareholder adequately rebuts the supposition of Section 306 that the issuance of such stock may well be the first step in a plan to bail-out the earnings of the corporation.

In light of these comments, the AICPA re-submits its appeal for reinstatement of the long-standing rule removing the taint from Section 306 stock upon the death of the shareholder. We believe that the Technical Corrections Bill and the Hathaway and Steiger proposals ameliorate but do not cure the problem facing closely-held corporations. Unless the taint is removed, Section 306 will constitute a barrier to recapitalizations designed to perpetuate the existence of many family-owned corporations.

Senator BYRD. The next witness is Mr. Vester T. Hughes of Hughes & Hill, Dallas, Tex.

Mr. Hughes, I am glad to see you again. You and I had a talk last fall, as I recall, and I enjoyed chatting with you and I am glad to see you today.

Mr. HUGHES. Mr. Chairman, it is a pleasure to be here. If I may, I would like my prepared statement to be put in the record and I will speak more informally.

Senator BYRD. Yes; it will be published in full, and you may proceed informally.

STATEMENT OF VESTER T. HUGHES, JR., ATTORNEY, HUGHES & HILL, DALLAS, TEX.

Mr. HUGHES. I have practiced law in Dallas, Tex., for 23 years, specializing in Federal income, estate, and gift taxation.

Carryover basis is a subject of considerable interest, both historically and in terms of its immediate application. The purpose of the enactment of carryover basis for gifts in 1921 was the protection of the income tax. Affording a stepped-up basis to property received by gift could provide a relatively easy opportunity for an individual to avoid income tax by giving away appreciated property. For example, a father holding appreciated stock could give the stock to his child. If the child thereby received a stepped-up basis, the child could immediately sell the stock at no gain, and the family would have avoided the capital gains tax by the simple means of a voluntary transfer. The Supreme Court, in upholding the validity of carryover basis for gifts, said that such protection of the income tax seemed fair, in the context of a voluntary transfer. For transfers at death, however, a fair market value basis was considered proper by most thinkers of the period.

The first time that there was any real impetus toward imposing a tax on involuntary transfers by reason of death was in 1942, when Randolph Paul proposed the imposition of a capital gains tax at death. What is the justification for requiring income to be recognized at death? There is, in fact, no realization of income at death. In order to require recognition of income at death, death itself must be made a taxable event for income tax purposes, and all taxpayers must be put on the accrual basis by reason of death. Only by those two far-reaching departures from tax law as we know it can an accrual of unrealized gains be required on the decedent's last return.

I am pleased to hear your view, Mr. Chairman, that the imposition of an income tax at death, as suggested by Mr. Paul, is not a real possibility. It is vital to acknowledge, however, that carryover basis is really just a variation on the same theme. The only difference between (i) imposition of capital gains tax at death, and (ii) carryover basis at death, is timing. The first alternative is a tax on the difference between basis and fair market value of property upon the owner's death; the second alternative merely postpones such tax until the eventual disposition of the property. Capital gains tax at death and carryover basis at death are the same phenomenon; the difference is merely the date of occurrence of the taxable event.

A point which sometimes concerns proponents of carryover basis at death is the difference in tax treatment between the man killed on his way to the brokerage office and the man killed on his way from the brokerage office. The same difference in treatment applied in October and November of 1978 when the capital gains tax deduction was changed. The man who sold on October 31st was taxed differently from the man who sold on November 1st. If the criterion of fairness required that all taxpayers at all times be subject to the same tax treatment, the tax law could never be changed. It is axiomatic that fairness requires only that two taxpayers who are in the same circumstances be treated the same. Surely, a transferor by death and a transferor by sale or gift are in different enough circumstances to justify a distinction in tax treatment.

The "inequality" of treatment resulting from stepped-up basis at death is simply a consequence of acknowledging the substantial difference between voluntary lifetime transfers, whether by sale or by gift. and involuntary deathtime transfers, and according them correspondingly different treatment. Such a difference is a valid distinction which has long been recognized in American law.

Some will argue that carryover basis at death will not add to the burdens of compliance with the tax laws, since the necessary records must be kept anyway for annual income tax purposes. Such an argument is not altogether correct. Basis of property is not usually computed annually, since basis is normally significant for tax purposes only when property is transferred. The transferor in a voluntary lifetime transfer commonly either knows what his basis is, or knows how to determine it. In an involuntary deathtime transfer, the decedent frequently carries such information with him to the grave, leaving his widow, his children, or others who are not even acquainted with the decedent, to try to divine the information from records that often have not been kept at all, or that have been kept inadequately because they are so rarely needed.

The administration of the carryover basis rules requires retrieval of complicated, obscure information regarding the original cost of an asset, basis of previous holders, adjustments to basis, and date of acquisition. Such an investigation can be time-consuming and will often yield little more than a guess. For example, ascertaining the year of purchase of a stock would seem to be a fairly simple task. Unfortunately, such is frequently not the case. What if there have been periodic stock dividends? What if there was a program of reinvestment of cash dividends? This is only one illustration of the very, very difficult practical problems of application of the carryover basis rules.

An interesting study was recently done in Dallas to determine the ages of decedents with estates of at least $250,000 who died between 1974 and 1977. The average age was 74.2 years. The implications of this fact with respect to the imposition of carryover basis at death are depressing. Upon retirement at 65 or 70, a person gives up the office. moves to a smaller home, and can look forward to spending the remaining few years of his life constructing and maintaining complicated, detailed accounting records of his every transaction. Such a burden seems unduly oppressive.

Carryover basis at death results in the imposition of a double tax on inflation. This is because (i) an estate tax is imposed on inflationary appreciation at death, and (ii) carryover basis results in the imposition of an income tax on the same inflationary gain on disposition of the property involved. Attached to my testimony is an example prepared by a Dallas real estate person which provides a striking illustration of the effects of this double tax on a $500,000 net equity investment in a piece of real estate. In round figures, $60,000 would be left of $500,000 after the imposition of both the capital gains tax imposed as a result of carryover basis and the estate tax.

The imposition of carryover basis will result in fewer small businesses being able to cope with such heavy additional taxes, and will thereby exacerbate such trends as the increasing concentration of ownership of property by tax-exempt and foreign entities, and the

direct involvement of institutional investors in business. Such a consequence would have a terribly unfortunate effect on the faith of the individual American in Government, his legislative representatives, and the free enterprise system.

The hearings of the Joint Economic Committee in 1977 on the subject of capital formation reveal the potentially adverse—if not disastrous—effects of carryover basis on capital formation for small business. The hearings demonstrated that the high capital gains tax rates during the period 1970 to 1978 had a highly detrimental effect on capital formation. Carryover basis, which requires replacement of the income tax resulting from disposition of property received by death before capital growth is possible, would serve only to intensify that effect.

In sum, I think that the time, energy and effort that would be necessary to retain basis records, find basis information, and translate it to tax returns, will be much better spent in productive pursuits. More taxable income will be generated, and engagement by the population in useful activities will not be restricted.

Senator BYRD. Thank you, Mr. Hughes.

Let me ask you just one question, and I ask it for information, because I cannot quite visualize what the situation would be.

We do know that in the 1920's property in Florida went up very, very rapidly to very high prices and then came the Depression and the values dropped, in some cases, almost to zero. Now, we know now that real estate prices are very high. Let's assume we have carryover basis, and let's assume 10 years from now someone who had bought property at a very high price today dies and the price of that property has dropped 50 percent or 75 percent or whatever it might be. What is his situation, or his beneficiary's situation, at that point under the proposal that now exists?

Mr. HUGHES. Under current law which is now subject to the moratorium, a transferee of a decedent's property does, under certain circumstances, receive the decedent's basis even if it is higher than fair market value at date of death. However, this treatment is inconsistent with the gift tax law, and I suggest that it will not last. I do not believe that beneficiaries will long continue to be allowed to get built-in losses from a high cost basis to the decedent and a low fair market value at date of death. I feel that this provision of the present law, if it goes back into operation, is likely to be the subject of a recommended change in the future, resulting in a basis to the decedent's beneficiaries of the lower of fair market value or carryover basis.

Senator BYRD. Secretary Lubick said where there are no records available then he has some sort of a curve which that he uses.

Mr. HUGHES. The problem there, of course, is to find out the year of the initial purchase.

Senator BYRD. Thank you, Mr. Hughes.

I have a message here from Senator Bentsen. He asked me to say to you that he wanted to be here for your testimony but he is tied up on another meeting at the present time and cannot be here. He extends to you his warm good wishes. He is sorry that he could not be here while you were testifying.

Mr. HUGHES. Thank you, Senator.

[The prepared statement of Mr. Hughes follows:]

STATEMENT OF VESTER T. HUGHES, JR., ATTORNEY, DALLAS, TEX.

Mr. Chairman: My name is Vester T. Hughes, Jr. I have practiced law with particular emphasis on federal income, estate and gift taxation in Dallas, Texas, for twenty-three years. I appreciate this opportunity to appear before your Committee today.

Since 1942 there has been some impetus from time to time among certain academicians and some governmental employees for a modification of the tax law to impose, in addition to the estate tax, a capital gains tax on the difference between basis of assets and fair market value at date of death. Carryover basis at death is merely a variation of the idea of a capital gains tax imposition at death; the difference is simply a matter of timing.

An immediate capital gains at death has never gained widespread popularity and indeed the last strong push by its advocates was in 1963. However, in 1976 the proponents of a capital gains tax at death did bring the carryover basis proposal to the attention of Congress, and they persuaded Congress in a very rushed action without hearings on the subject to enact carryover basis at death. Hearings like these being held today should have certainly been a prerequisite to any such enactment, and I strongly applaud the fact that your Committee is conducting these Hearings to explore the matter further.

Equity is asserted to be the chief justification for carryover basis at death. One question proponents of carryover basis ask is, "Why should there be carryover basis in a transfer by gift and not on a transfer by death?"

A review of history may be helpful in dealing with this perceived inequity. From the history surrounding the enactment of the Revenue Act of 1921 and from the opinion of Mr. Justice McReynolds in *Taft* v. *Bowers*, 278 U.S. 470 (1929), one is left with the clear impression that Congress intended carryover basis in the gift situation to serve merely as a backstop to the income tax on capital gains. It appears that most thinkers felt that in both the gift tax setting and the estate tax setting, fair market value at date of gift or at date of death should be the rule but a problem developed in the gift situation. For example, as was noted at the time, if Mr. X gave his stock with $100 fair market value and $50 basis to his son and his son had a stepped up basis to $100 by reason of the gift, the capital gains tax upon a sale following a voluntary transfer could be avoided. So at a time when the gift tax was only a fraction of the estate tax, Congress determined that it would not be unfair to impose carryover basis on gifts in order to prevent avoidance of capital gains tax by a voluntary transfer which generated an excise smaller than the excise imposed upon the usually involuntary act of death.

The asserted inequality between tax treatment of sales while living and sales right after death is not so persuasive when to get this so-called advantage, a person must die. The oft-cited truck example of one man killed on the way to and the other man killed on the way from the stock sale is not any more persuasive than saying a tax rate should never be changed because someone will sell on December 31 and someone on January 1.

The answer to the argument that there is inequality in not giving stepped up basis to a transfer by gift as well as to a transfer by death is that there is a totally voluntary aspect to the transfer by gift. There is a capital gains tax imposed on a voluntary transfer by sale and a carryover basis resulting in a later capital gains tax imposed on a voluntary transfer by gift. It is inaccurate to characterize carryover basis at death as being a concept which reintroduces equality—the difference in treatment of voluntary lifetime transfers and transfers at death is a distinction that has been recognized and accepted since 1921 and indeed certainly appears to be worthy of continuation.

Other considerations that affect the imposition of taxes in the last quarter of the twentieth century may be even more important. The first of these is capital formation. During the period July 12–19, 1977, the Joint Economic Committee of the Congress held Hearings on The Role of Federal Tax Policy in Stimulating Capital Formation and Economic Growth. It is clear from these Hearings that each incursion of the tax system into the economy in such a way as to tax a part of the existing capital always has the effect of intensifying the problem of capital formation. The imposition of a potential capital gains tax through carryover

basis at death as well as the estate tax at death would result in further diminution of capital. After that, before growth in the economy can occur, the amount of capital reduced by successive estate and capital gains taxes must be restored. A careful study of the July 1977 Hearings indicates that it is not in the interest of capital formation and economic growth in this country to impose the two taxes with the resultant diminution of capital and the necessity of replacing such capital before growth can occur.

A second problem with carryover basis is that in order to generate the funds to pay estate and capital gains taxes, in many instances the total asset will be virtually consumed if there is a carryover of basis on transfer at death. Attached to this testimony is an example generated by a Dallas real estate man showing how $500,000 fair market value real estate net interest can be reduced to $60,000 after the successive estate and capital gains taxes. One effect of the very high capital gains taxes in the period 1970-1978 has been that in the real estate and other industries there has been a continuing concentration of ownership among tax exempt organizations, be they qualified profit-sharing and pension funds, universities and hospitals, or foreign interests. Further, institutional investors have entered the real estate business directly to an increasing extent and obviously would do so to a much greater extent were carryover basis to become the rule of the future. Rather than fostering the American dream of independently owned businesses, the effect of carryover basis would be an even greater concentration of ownership of both real estate and other businesses.

A consideration of the inflation figures of the past five years and of the most optimistic projections for the next five years indicates that the capital gains tax imposed by reason of carryover basis at death would exacerbate the effect of taxing "appreciation" which is due merely to inflation. Inflation not only increases the estate tax bracket but, if carryover basis were applied, would result in an eventual capital gains tax on an illusory increase in the value of the assets. Thus, the effect of carryover basis would be a double tax on inflationary gains.

Finally, and very significant from the standpoint of the considerations involved, there is the matter of complexity. The 1976 Act as initially passed was unworkable. The changes have not made it appreciably more workable for a great number of taxpayers. For example, a study of the Probate Court records in Dallas County, Texas, discloses that for estates of $250,000 and more the average age of decedents was 74.2 years. Why add this burden to a taxpayer who diligently kept records during his productive years but after retirement and the closing of his office failed in his later years to keep accurate records? The facts before the 1978 moratorium demonstrate that it is the elderly decedent whose estate is most often entangled in the carryover basis rules. Even if most taxpayers can reasonably be thought capable of adequate record keeping, should the elderly be expected to continue meeting such requirements in their later years? Must they abdicate to professionals or younger family members, robbing themselves of dignity and independence? And should the younger citizen not only have to keep records so that he can pay his taxes but write an accounting history for his executors and heirs?

The advocates of carryover basis respond to the more extreme examples of the adverse impact of the administrative complexities of carryover basis by proposing to remove more and more taxpayers from the scope of the provisions. If this be the answer, why isn't the real answer to remove all taxpayers from the burdens of carryover basis? It is not valid to answer the complexity argument with "only a few are affected"—the estate tax and income tax are generally applicable laws. America has been not a nation of bookkeepers and record keepers, but a nation devoted to increasing the value of its assets through labor. The time entailed in trying to keep records for carryover basis purposes or to find records, when the one man who has the facts from which such information can be ascertained is the one who is deceased, makes the proposition absurd. If the time, energy and effort that would go into trying to determine historical basis or keep records on historical basis is instead used for productive purposes, it is highly likely that any amount of revenue loss from additional capital gains tax generated by carryover basis will be more than made up by the increased tax collected from productive economic enterprises. The economy as a whole well benefit substantially from the removal of this burden.

Example

A owns lands and a building (acquired after the effect of the carryover basis rules) which has the following fact history:

	Original amount	Value at date of death
Land	$100,000	$150,000
Building	900,000	1,250,000
Debt	1,000,000	[1] 900,000

[1] Remaining principal.

The land and building were owned by A for ten years prior to his death. A has depreciated the building over a 33⅓ year life on a straight line basis. Total accumulated depreciation prior to A's death was $270,000 meaning A's adjusted basis in the building is $630,000.

A's estate pays an effective federal and state estate rate of 70 percent on the excess of fair market value of the property over the debt ($500,000×70%=$350,000).

A's heir has a basis in the property of $1,080,000 ($350,000 in estate taxes+$730,000). If the heir sells the property for $1,400,000, there is a $90,000 capital gain tax as follows:

Proceeds	$1,400,000
Basis	(1,080,000)
	320,000
Capital gain rate	.28
Tax	90,000

The net cash available on the project is:

Proceeds from sale	$1,400,000
Paydown of debt	(900,000)
	500,000
Estate taxes	(350,000)
Capital gain taxes	(90,000)
Net cash available	60,000

The carryover basis provision has significantly reduced the available cash left at the end of this project.

Senator BYRD. We have one additional panel of two individuals, Mr. Lat Turner, chairman of the Taxation Committee of the National Cattleman's Association and Mr. Robert Delano, president of the Virginia Farm Bureau and vice president of the American Farm Bureau. I am happy to welcome both of you.

Mr. DATT. Senator Byrd, I am John Datt. I am director of the Washington Office for the American Farm Bureau. Mr. Delano called me at 8:30 this morning and he expressed his regrets, but he developed a severe case of laryngitis and called me from the farm down at Warsaw and indicated that he could not talk and he said there is not much point in his coming up and testifying if he could not talk, so in his absence, I would like to present the statement.

Senator BYRD. Fine. We are very glad to have you. When you talk with Bob, tell him we miss him. He is one of the finest men in our whole State, and I have worked very closely with him. Tell him when his voice gets better to come see me.

Mr. DATT. Thank you.

Senator BYRD. You gentlemen may proceed as you wish.

Mr. TURNER. All right. Thank you, Senator,

My name is Lat Turner. I am a rancher from the State of Florida, by the way, Senator.

Senator BYRD. The State of Florida?

Mr. TURNER. That is correct, and I represent the National Cattleman's Association, which represents approximately 280,000 producing cattlemen all over the Nation.

We have a rather large exhibit for you here. I will not read it all, of course—we do not have the time—but we do have a summary which I would like to give you at this time, relative to carryover basis.

STATEMENT OF LAT TURNER, CHAIRMAN OF THE TAXATION COMMITTEE, NATIONAL CATTLEMAN'S ASSOCIATION

Mr. TURNER. The National Cattleman's Association submits that the carryover basis provisions enacted in 1976 are unworkable and therefore must be repealed. Because of its complexity, carryover basis is impossible to comply with and administer. Additionally, these tax provisions will increase the tax burden and compound the illiquidity of estates of farmers, ranchers and other family business operators who sell inherited property in the normal course of business or have to sell such property in order to raise sufficient cash to pay the death taxes and the administrative expenses.

The association further submits that attempts should not be made to "patch up" carryover basis in an attempt to make it workable because of the economic and social faults in the premise upon which it is founded. As the chairman so aptly put it, we should remember that carryover basis is not merely a technical problem of legislative drafting, but raises fundamental questions of social and economic policy which were not debated in 1976. Since I do not assume that death is a welcome event, I am not impressed with the argument that death is a tax loophole. I doubt that the average American is, either.

The National Cattleman's Association also finds that the two main alternatives which have been discussed in the past to carryover basis, the capital gains tax at death or an additional estate tax called an AET, are entirely unacceptable.

The proponents of the capital gains tax at death, and the AET argue that these proposals are needed to prevent unrealized appreciation from escaping taxation at death. However, what these proponents overlook or choose to ignore is that the present Federal estate tax already imposes a tax on unrealized appreciation by including it in the value of the property subject to the estate tax. The adoption of either of these alternatives would, in essence, constitute double taxation of the appreciation of these assets.

The only acceptable alternative or modification is to repeal the carryover basis, and to return to the law in existence prior to the enactment of the 1976 provision.

I certainly thank you for your attention.

Senator BYRD. Thank you, sir.

STATEMENT OF JOHN C. DATT, DIRECTOR, WASHINGTON OFFICE, AMERICAN FARM BUREAU FEDERATION

Mr. DATT. Senator Byrd, Senator Dole, Farm Bureau members were active in seeking estate and gift tax reform in the Tax Reform

Act of 1976. However, as our testimony before the Senate Finance Committee in July 1977 and the House Committee on Ways and Means in October of 1977 indicated, much of the relief provided by this act was offset by the burden of the carryover basis provision. Carryover basis is an unacceptable provision of the Tax Reform Act of 1976 and Farm Bureau members expressed their strong opposition at our 1979 annual meeting by making repeal of the carryover basis a priority issue for the Farm Bureau in the current year.

Most of the assets owned by farmers and ranchers, such as land, machinery, and livestock, fall within the definition of carryover basis property, thus the gain on its sale by an heir is subject to the increased capital gains taxes before the heir must take the decedent's basis.

The heir must pay tax on appreciation that accrued prior to his or her inheritance. Designed to remedy so-called inequities between taxpayers, carryover basis fosters an insidious bias against farmers and ranchers. It does this by taxing appreciation in capital assets which stems largely from inflation rather than an increase in the productivity of the land or other assets.

Statistics emphasize the contribution that inflation, largely induced by Government policy, has placed in increasing land values.

The Congressional Research Service indicates that between 1967 and 1977 the compound average rate of increase was 10.4 percent per year, and the average farmland price has not shown a year-to-year decline since 1965. In 1972, the average price for an acre of farmland in the 48 contiguous States was $216. By early 1977, the figure had reached $452, an increase of 109 percent in 5 years.

The national average prices jumped as much as 17 percent yearly and yearly increases in the Corn Belt and lake States have ranged from 20 to 40 percent.

It should be emphasized that much of the appreciation in land that may later be taxable to an heir under carryover basis is an artificial gain caused by inflation, not increased productivity. Modification of the provision will not remedy this inequity. Neither the fresh start adjustment, nor an increase in the minimum basis, can provide relief from the problems of heirs selling inherited farmland.

The further we move from the fresh start date of December 31, 1976, the greater will be the capital gains tax liability and the less effective any increased exemption.

Let me comment here, Senator, that while there has been discussion about revenue, that I do not have it with me, but while it may appear that in the immediate years there may not be much revenue, but we have seen some figures that down the road, 4, 5, 8, 10 years, that this area will become a substantial source of revenue as far as the Treasury Department is concerned.

In addition, the lock-in effect that some contend will be remedied by carryover basis will actually be intensified. Heirs will be more reluctant to sell inherited property because of the prospect of increased capital gains taxes.

In addition to the taxation of appreciation caused by inflation, carryover basis calculations for land, buildings, machinery, livestock, and timber have been described as, at best, potential nightmares. And let me say that if you talk to any of the Farm Bureau people who are in the business of estate planning and this sort of thing, the last 2 years

where they have had to deal with estates, to describe it as a nightmare is a mild statement.

When Congress passed the Revenue Act of 1978, it recognized the urgent necessity to provide greater incentive for capital investment in the Nation's business. We now urge Congress to provide incentive for farmers and ranchers to grow and prosper by repealing carryover basis. In so doing, Congress will recognize the contribution of a sector of our society and economy that has taken great economic risk to build a productive and efficient agriculture.

Heirs must not be penalized for the skill, enterprise, and vision of their benefactors. The Farm Bureau urges complete repeal of the carryover basis and a return to the stepped up basis provision of the pre-1976 tax law. We do not believe that the present law can be modified to address fairly the tax concerns of our 3 million member families.

Thank you for an opportunity to present this statement.

Senator BYRD. Thank you, sir.

Senator Dole?

Senator DOLE. I presume the full statements will be made a part of the record?

Senator BYRD. That is correct.

Let me ask this question. I assume you heard the Agriculture Department testimony. Were you surprised that the Department of Agriculture would take the view which it did in regard to carryover basis?

Mr. TURNER. Sir, I was shocked.

Mr. DATT. I was quite surprised that they would take this point of view, except that they are part of the administration.

I should say, Senator Byrd, that we have had several meetings with the administration and they have made it very clear that any attempt to repeal this will be literally over their dead body, in a sense.

Senator BYRD. Well, that was certainly the position they took last year—that any attempt to defer it would be over their dead body. Senator Dole and I were conferees, and the issue was debated back and forth all day long. We started at 9 in the morning, or maybe it was 8 and we took the first vote at about 2 that afternoon, and the Senate conferees approved overwhelmingly the deferral. But to show you how determined the Treasury was, they insisted that another meeting be called and brought the Secretary of the Treasury in to sit with us while they made another plea not to defer carryover basis. After that plea, the members seemed to look toward me, since I had introduced the legislation, and I said well, I will take only a couple of seconds; there are only two points that I want to make.

No. 1 is, just 2 hours ago we voted on this and made the decision; and No. 2, call the roll and let's vote again.

I cite that just to show that Treasury said last year over its dead body would carryover basis be deferred. So this is nothing new from their point of view.

But I must say that I was very much surprised that the Agriculture Department would testify because I have not seen any farmers who support carryover basis. Maybe they see farmers that I do not see; maybe they see farmers who farm in the District of Columbia, but I have not seen any farmers who have taken that view, and you gentlemen work every day with farmers and I gather that you feel that most farmers do not take the view that carryover basis is beneficial to them.

Mr. TURNER. I would say our association considers this one of the greatest threats to capital formation in agriculture that we have ever seen.

Senator BYRD. That is a very significant statement.

Mr. DATT. I would like to say, Senator Byrd, that this is a major priority because the Farm Bureau views this as a major threat to agriculture and to continue the kind of agriculture that we have had.

Senator BYRD. Agriculture and the small farm is so important to the future of this country.

Senator Dole?

Senator DOLE. I understand the statements. You are suggesting outright repeal rather than some patch up job.

Mr. TURNER. Very definitely, sir.

Mr. DATT. Senator Dole, we do not think you can patch this thing up. We think you ought to repeal it and get rid of it and get on with the business of allowing us to farm.

Senator DOLE. There is a lot of frustration. This is not a big revenue item but if it were a big revenue item, I could understand the Treasury's concern, but I guess that overall we are talking about $800 million in 20 years.

Senator BYRD. I do not think the revenue loss is anything like that.

Senator DOLE. Maybe we just ought to carry this over into another administration. It might be one way to solve it.

Mr. JONES. Mr. Chairman, might I identify myself and make one comment? My namei s B. H. Jones and I am with the National Cattleman's Association.

We would like to emphasize one point, I think, before leaving the bench. The Treasury people talked a great deal this morning about relieving this problem by exempting estates of $175,000, and said that this would exempt approximately 98 percent. I think we have to remind the subcommittee, however, that very few farmers would be exempted under a $175,000 exemption because of the equity that they hold in land and other assets of that nature.

Also, as inflation continues it would very definitely erode that exemption to where it would pull more and more family—and correctly defined as family farms—into the carryover and would not exempt them.

So we would like to make that point for the subcommittee.

Senator BYRD. I think that is a very important point, and I am glad you did make it. My guess is, and I must say I do not have any facts and figures to back it up, but my guess is that that so-called all but 2 percent is nowhere near correct. But let's assume that it eliminates 85 percent.

We get into a question of fairness here. We get into a question of fairness.

Politically it is desirable to eliminate 85 percent so we will not get any pressure from those 85 percent, but we will make the other 15 percent comply with a law that we cannot even administer.

Mr. JONES. Mr. Chairman, if you read our statement carefully you will find in there a statement that pretty much parrots what you have said, that the Treasury's main purpose in making this proposal is simply to take away enough of the opponents so as to dissipate their effect in stemming the carryover. This is the main reason why the exemption is coming through, that is, to just take enough of the opponents out of the picture so that it dissipates their objection.

Senator BYRD. I think you are quite right.

Mr. TURNER. One other point that I would like to make—and we did make this point—is that there is a capital gains at death built into the present estate tax, and it is a graduated tax. As to that point of equity, the bigger the estate, the more the tax, well, I think you have already got that built into current taxation policy.

Senator BYRD. It seems to me also that this provision will hit hardest farms and small businesses because farms and small businesses are not very liquid. They do not have the liquid assets to pay the estate tax, and that forces them into sales which, in turn, forces them into additional taxes at that point.

Mr. DATT. Senator Byrd, we have found another thing that has happened that deals with this, almost the opposite from that, and that is that because of this—and there has been a lot of discussion in recent weeks, you know, about young people, the ability of young folks not to be able to get into farming, and so on, you get somewhat the opposite effect, that if you have land and you are faced with paying this kind of a tax, you do not sell it, you just hold it, you just keep it. Therefore, instead of selling it and allowing some other young person who might want to get started, you lock in land in the hands of one family and so on and so forth and you make it, because of this, in our judgment, much more difficult for a young farmer to get started in agriculture than you would without the carryover basis.

This is the other thing that we have found.

Senator BYRD. Well, in that connection, Mr. Field, who prefers a death tax, but he testified in favor of the Treasury proposal, said in his testimony that this provision makes the lock-in problem worse, which is what you are indicating.

Mr. DATT. It makes it much more difficult for a young person who desires to get in there and buy farmland and get started.

There has been quite a lot of concern about that in recent years, as far as the Congress has been concerned.

Senator BYRD. Yes; I think it is an extremely important problem and, as each of you know, it came about not as a result of hearings before the Finance Committee, not as a result of Senate debate, but it came about at the last—at 5 minutes to midnight before the Congress adjourned in 1976 as a result of being put onto the tax bill in the committee of conference.

I am confident that hardly any Member of the Senate knew that it was in there. I am confident that had hearings been held, had it been debated in the Senate, that it would never have been enacted in the first place.

Thank you, gentlemen, very much.

Mr. DATT. Thank you, sir.

[The prepared statements of the preceding panel follow:]

STATEMENT OF THE NATIONAL CATTLEMEN'S ASSOCIATION, PRESENTED BY LAT H. TURNER, CHAIRMAN, TAXATION COMMITTEE, NATIONAL CATTLEMEN'S ASSOCIATION

SUMMARY

Carryover basis

The National Cattlemen's Association submits that the carryover basis provisions enacted in 1976 are unworkable and, therefore, must be repealed. Because of its complexity, carryover basis is impossible to comply with and to administer.

Additionally, said tax provisions will increase the tax burden and compound the illiquidity of estates of farmers, ranchers, and other family business operators who sell inherited property in the normal course of business or have to sell such property in order to raise sufficient cash to pay death taxes and administration expenses.

The Association further submits that attempts should not be made to try to "patch up" the carryover basis in an attempt to make it workable because of the economic and social faults in the basic premise upon which it is founded. As the Subcommittee Chairman so aptly stated, ". . . we should remember that carryover basis is not merely a technical problem of legislative drafting. It raises fundamental questions of social and economic policy, which were not debated in 1976. If one can assume that death usually is an unwelcome event, I am not impressed with the argument that death is a tax loophole. I doubt that the average American is either." [1]

The NCA also finds the two main alternatives which have been proposed to carryover basis—a capital gains tax at death and the additional estate tax (AET)—also to be entirely unacceptable. The only acceptable alternative or modification is to repeal the carryover basis and return to the law in existence prior to the enactment of the 1976 provisions.

STATEMENT

Carryover Basis Should Be Repealed

Since passage of the 1976 Tax Reform Act, there has been a ground swell of opposition to the carryover basis provisions from all quarters. This was evidenced in the widespread support given to the 1978 Revenue Act provision to postpone the effective date of carryover basis. Because of its complexity, carryover basis will be extremely difficult to comply with as well as to administer, will adversely affect the traditional manner of estate administration, and will increase the cost of such administration. As the Subcommittee Chairman recently noted.

"Today, virtually everyone acknowledges that the present carryover basis law is unworkable." [1]

Additionally, the carryover basis will increase the tax burden and compound the illiquidity of estates of farmers, ranchers, and other family business operators who sell inherited property in the normal course of business or have to sell such property in order to raise sufficient cash to pay death taxes and administration expenses.

The NCA agrees fully with the statement of the Subcommittee Chairman: "Indeed, carryover basis would not have been approved if Congress had been aware of what it was doing." [1]

A. Complexity of Carryover Basis Creates Problems of Compliance and Administration Which Are Burdensome and Unduly Expensive

On the death of a farmer, rancher or other decedent, the executor of such person's estate is required by the carryover basis provision to compile extensive and detailed information about the income tax basis of each asset (other than certain exempted property) owned by the decedent. When the decedent's income tax basis in each asset is determined, the executor must then make as many as four different adjustments to each income tax basis involving a number of separate computations.

Attached as Exhibit A is an outline entitled Computation of Carryover Basis drafted by William R. McDonald, an attorney and former trust officer of the First National Bank of Denver. This computation form, which represents over 100 hours of research, shows sixty-one separate steps which can apply in computing the income tax basis in property transferred at a decedent's death because of the carryover basis rules. Mr. McDonald has indicated that before this computation form may be used there are approximately seven additional computations which may be necessary in order to determine the figures to insert on the computation form.

It is clear that sophisticated and expensive computers will be requird to compute the correct basis figures under the carryover basis provisions. Even then,

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[1] Quotes throughout Statement are from speech before the New York Bar Association on Wednesday, January 24, 1979.

computation cannot be accomplished unless the correct information is first obtained by the executor.

Determination of the decedent's income tax basis in property acquired in the 1930s or 1940s is going to be extremely difficult—and in most cases a virtual impossibility—especially for family farm and ranch estates where the farm or ranch has been held for a number of years. This problem will be particularly acute if property must be traced through several transactions, or generations, to determine the decedent's income tax basis. During the period after enactment of the 1976 Tax Reform Act and prior to postponement of carryover basis in the 1978 Revenue Act, the impossibility of making this determination of basis by farmers' and ranchers' estates was clearly indicated.

Recognition of the record-keeping and basis-determination problems of carryover basis were addressed by the Subcommittee Chairman:

"Record keeeping problems associated with carryover basis deserve close attention. Even the most sophisticated taxpayers have difficulty producing adequate tax records when alive. This problem becomes almost impossible under carryover basis when the taxpayer is dead, and the estate must produce basis information for every conceivable asset—some held for decades or a lifetime." [1]

The provision that where the decedent's basis in property is unknown, such basis will be the fair market value of the property on the date the decendent acquired such property is more illusionary than helpful. In the case of farm and ranch properties acquired in separate parcels, and at various times over a number of years, such calculation will be very burdensome, if not impossible. Moreover, any fair market value so determined can be expected to be examined and questioned by the Internal Revenue Service, resulting in additional and further controversy and expense, since the burden of proving the decedent's original basis in farm or ranch land and other property will be on the decedent's estate. Also, the determination of the date and cost of acquisition of each and every head of livestock in an estate, required by carryover basis, will be virtually impossible for estates of farmers and ranchers.

In addition to the hardship of collecting information and making determinations of the basis in each item of property owned by a decedent, the executor must supply such information to the heir who inherits such property and also file such information with the Internal Revenue Service as may be required by regulations. Failure to supply or file such information will result in a monetary penalty being imposed on the executor.

Serious Equity and Legal Problems of Distributing Assets to Heirs

Carryover basis will adversely affect the traditional manner of administering the estates of farmers, ranchers, and other persons. Executors will have to drastically alter their preivous methods of handling estates, will be faced with additional burdens in distributing property to a decedent's heirs, and will be exposed to the likelihood of lawsuits claiming impropriety and breach of fiduciary duty.

If all the heirs of a decedent do not receive property of equal value and having the same income tax basis—which is a virtual impossibility where farms and ranches are involved—then the executor encounters an insoluble problem in determining which heir or heirs receive property with the highest income tax basis. Yet, the failure to consider the income tax basis of property in making distributions to heirs can, in some states, result in violation of local law.

Similar problems will be encountered by executors in determining whether to allocate high-basis assets to the marital deduction fund, thereby maximizing the basis step-up on the other assets in the estate, or allocate low-basis assets to meet the estate tax obligation, thus minimizing the estate's income tax obligation.

The Subcommittee Chairman has recognized this problem as evidenced by his statement:

"Another consideration is that carryover basis poses real dilemmas for fiduciaries. If a fiduciary wants to treat all beneficiaries fairly, he must take into account not only the market value of an asset, but also it basis. Otherwise, some beneficiaries will receive low basis assets and others will receive high basis assets." [1]

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[1] Quotes throughout Statement are from speech before the New York Bar Association on Wednesday, January 24, 1979.

Distrust, family inharmony, and litigation will be the natural consequences of these problems caused by carryover basis, in addition to the virtual impossibility of administering estates in compliance with existing law.

Uncertainty of Income tax liability on sales of farm assets

The fact that assets passing from a decedent will receive a basis increase for the estate tax attributable to the appreciation on these assets will also result in uncertainty and administrative problems where the assets are sold before the estate tax obligation is finally resolved. Until the estate tax obligation is finally determined, which could take considerable time, the basis of the property for purposes of determining gain or loss cannot be determined and, accordingly, the income tax liability in selling such property would be unknown. The result would be confusion, uncertainty, and the impossibility of determining the actual amount of income tax which is payable. This will be particularly harsh on farm and ranch estates where regular marketing of products is essential.

Administration costs inflated by carryover basis

The burdens imposed on executors by the carryover basis provisions will substantially increase the cost of administration of a decedent's estate. It has been estimated that such costs would be increased between 10 percent and 50 percent. (See letter of experienced estate planning attorney, Exhibit B.) A concomitant cost will also be incurred by the Internal Revenue Service in administering this provision. The result will be to increase the cost of transferring property at death, requiring more federal revenue to be spent in administering this complex and unnecessary provision. Further, to the extent carryover basis increases administration costs, federal revenues will be decreased because these costs will be deductible on the federal estate tax return.

The real beneficiaries of carryover basis are lawyers, accountants, and corporate fiduciaries who will reap larger fees in performing the additional work required by the carryover basis provision. However, many professionals do not want this kind of work (see Exhibit B), and the potential malpractice claims which it can spawn.

It is also possible that carryover basis will force most estates to have large corporate institutions as executors or as consultants to executors because of the problems inherent in complying with carryover basis. Such an impetus away from the traditional concept of having trusted family relatives serve as executors, especially where estates are composed primarily of farms, ranches, and other family businesses, is deplorable and unjustified.

The added complexity, burden of compliance and administration, the adverse effect on the traditional method of administering estates, and the attendant costs resulting from carryover basis clearly support repeal of this undesirable and harmful provision.

B. Carryover Basis Creates Additional Tax Burdens

There will be a pyramiding of federal taxes because of the interplay of the federal estate and income taxes under the carryover basis provision. This will be particularly acute in many estates, especially in estates of farmers and ranchers. Where estates have to sell property to pay death taxes and administration expenses, a "double tax" occurs which further compounds the illiquidity problem of farm and ranch estates. Also, the requirement for regular marketing of farm products following a farmer's or rancher's death will have the same deleterious tax impact.

An example of how carryover basis can virtually destroy a tenant farmer's estate is illustrative of this problem. A widowed tenant farmer dies in 1980 leaving an estate valued at $545,000 to a son. Most of the estate consists of corn and beans which were raised in 1980. The corn and beans are sold in the normal course of the farming business. After payment of federal estate taxes and state inheritance taxes and after payment of federal and state income taxes on the proceeds received on the sale of the farm crops, the son would have only $154,000 left from the total estate of $545,000. The estate shrinkage in this example is about 74 percent as a result of a combination of federal and state death and income taxes.

In most farm and ranch estates, there are few liquid assets available to pay death taxes and administration expenses on the death of a farmer or rancher,

largely because the bulk of the estate consists of farm or ranch land and other non-liquid assets owned by the decedent. Thus, the farmer's estate may be required to sell some of the assets to pay death taxes, even when the impact of such taxes may be lessened by the special farm use valuation and extended tax payment provisions. Such sale will increase the total tax liability of the estate, since the estate will have a "capital gains" tax to pay on the appreciation built into the assets plus a federal estate tax on the value of the assets.

Because the income tax basis of farm land is traditionally law, reflecting the number of years it has been held, the amount of capital gains can be quite high. The result of such a "forced" sale is a capital gains tax at death in addition to the federal estate tax. The estates of many farmers and ranchers will not be able to bear this double tax burden—even though the 1978 Revenue Act reduced the income tax rate on capital gains—forcing the liquidation, in whole or part, of the family farm or ranch.

Negative Impact of Carryover Basis on Capital Formation

The Subcommittee Chairman has placed the issue of the negative effect of carryover basis on capital formation in proper perspective in his statement:

"The idea of taxing appreciation of capital assets must be looked at closely in the overall context of American capital formation. American productivity lags greatly behind our competitors in Europe and in the East. If we are to have a strong, vigorous economy which is essential to maintain the American Standard of living, we must provide individuals with incentives to take risks and accumulate capital."[1]

Being highly capital intensive, it is essential that agricultural operations have sufficient capital at each generation level to permit efficient and effective operation. Typically in Agriculture, capital formation occurs primarily by the transfer of economic units from members of the older generation to younger generation members.

Carryover basis can strike a lethal blow to this system of capital formation. Said system is necessary to assure the continuation of family farm and ranch operations, which, in turn, is essential in maintaining a financially sound, productive Agriculture and an adequate supply of food and fiber for the consuming public.

Whether forced to sell farm property to pay death taxes and administration expenses, or whether sales occur in the normal marketing of farm crops and livestock following the death of a farmer or rancher, there will be significantly more tax ot pay because of carryover basis. The strain this added tax burden will place on many family farms and ranches can force liquidation of the operation.

Carryover Basis Causes Lock-In Effect

Carryover basis causes a lock-in effect in that it tends to freeze assets within estates because the heirs may not be able to afford to sell them and pay the tax which results. This can impede the free flow of capital and have an adverse effect on the economic structure of our country. With respect to Agriculture, specifically, carryover basis can have an adverse effect on the transfer of personal property used in farming and ranching. Additionally, this lock in can interfere with the orderly sale or disposition of farm land where it is advisable to transfer such land because of climatic conditions or other similar factors.

C. Amendments or Modifications Cannot Solve Problems Created by Carryover Basis

In an attempt to try to correct the multitude of technical and practical problems of carryover basis, a number of bills were introduced in both the House and Senate during the last session of Congress. Also, in light of the acknowledgement that carryover basis in its present form cannot be administered, the Treasury Department has undertaken a study of various ways to try to make the concept workable and susceptible to enforcement.

NCA submits that no number of modifications can cure the ills of carryover basis which have been previously described. The Association further contends that the very fact the bills were introduced and the Treasury studies undertaken

[1] Quotes throughout Statement are from speech before the New York Bar Association on Wednesday, January 24, 1979.

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underscores the impossibility of complying with or administering carryover basis and, also, supports the reasons enumerated above for its repeal.

One of the principal proposals advanced for amending carryover basis is to exempt estates of $175,000 or less from its provisions. The Treasury Department has indicated this would exempt 98 percent of the estates from carryover basis. This proposal raises the fundamental question of whether it is fair and equitable to have only 2 percent of the estates subject to carryover basis. The Subcommittee Chairman has addressed this question and observed:

"While such a proposal may be politically expedient, it certainly offends one's sense of fairness. By subjecting a very small minority of our population to a very complex law—one that cannot be complied with nor administered—we would violate the fundamental principle that tax laws should apply equally to all taxpayers." [1]

Moreover, because of inflation, almost everyone would be required to maintain the burdensome records required by carryover basis since there would be no assurance that at the person's death the estate would be under $175,000 and thereby exempt. In addition, inflation would also erode the $175,000 exemption, which would mean that, as each year passed, there would be a correspondingly larger number of estates which would fall outside the exemption.

This proposal would also discriminate against farm and ranch estates which usually exceed $175,000 because of their large investment in land, resulting in high asset value and low income production. Most farm and ranch estates would be placed in Treasury's 2 percent category, subject to carryover basis and its associated problems and attendant costs, but with fewer dollars available to pay thees costs and added tax burdens.

It would appear that the reason for this proposal is to assist the proponents of carryover basis by reducing the number of taxpayers subject to its provisions and thereby helping to dissipate the opposition. Such proposal is not supported by either tax equity or simplification, both of which are desired goals of the tax system.

NCA has carefully considered various proposals for change to carryover basis, including those introduced in bill form in the last session of Congress, and has come to the firm conclusion that neither the $175.000 proposed amendment nor any other amendments which have been offered to date, or which could be offered in the future, will solve the problems created by carryover basis. In fact, from the standpoint of simplification, many of the suggested modifications would create further complexities and could result in the cure being worse than the existing carryover basis disease.

D. Alternatives Proposed to Carryover Basis Should Also Be Rejected

The Treasury Department and others have suggested consideration of two primary alternatives to carryover basis: (1) A capital gains tax at death on unrealized appreciation in assets owned by the decedent and (2) An additional estate tax (AET) on assets included in the decedent's estate. NCA opposes both of these alternatives.

Both alternatives would create many of the same problems and complexities of compliance and administration as carryover basis. The income tax basis of each asset in the estate would have to be determined. The difficulties caused by such determination are legion and have previously been discussed.

In addition to the problems encountered in trying to determine the decedent's income tax basis in each asset would be the costs involved in making such determinations. Again, the chief beneficiaries of such added costs would be lawyers and accountants.

The additional tax burden caused by these proposals could be impossible for many farm and ranch estates to satisfy. The AET would in essence result in a "double tax" on appreciation of assets, and the capital gains tax at death could have a somewhat similar effect. Furthermore, the capital gains tax at death would be regressive in nature since, by virtue of the deduction of such tax from the federal estate tax, the larger estates would pay a proportionately smaller tax. The illiquidity problems of farm and ranch estates would be further compounded by the AET or the capital gains tax at death. In many of these estates, the resulting

[1] Quotes throughout Statement are from speech before the New York Bar Association on Wednesday, January 24, 1979.

problems of illiquidity would be formidable, forcing liquidation of many farm and ranch operations.

The proponents of the capital gains tax at death and the AET argue that these proposals are needed to prevent unrealized appreciation from escaping taxation at death. However, what these proponents overlook or choose to ignore is that the present federal estate tax already imposes a tax on this unrealized appreciation by including it in the value of the property subject to the estate tax. The adoption of either of these alternatives would in essence constitute double taxation of the appreciation in these assets.

E. Conclusion

NCA urges the repeal of carryover basis and contends that attempts to modify its provisions to make them workable will be fruitless. The AET and capital gains tax at death are equally objectionable and should be rejected. The Association takes the strong position that the only viable alternative is to repeal carryover basis and return to the law as it existed prior to the 1976 Tax Reform Act.

EXHIBIT A

COMPUTATION OF CARRYOVER BASIS

(As of May 15, 1977)

Complete this form for all items except excluded personal goods, life insurance, and transferred property disposed of prior to death.

I. Computation of fresh start basis (2). (If traded security complete lines 1 and 5, enter 12/31/76 value on line 10, skip lines 2-4 & 6-9) ______

1. Estate Tax value of asset. (If income in respect of decedent, Sec. 72 annuity, or certain stock options, enter decedent's adjusted basis here and on lines 10 and 26. Skip lines 2-9 and 11-25) ______
2. Date of death value of asset (2031 or 2032 A if elected; not 2032) ______
3. Decedent's cost or acquired basis ______
4. Total depreciation, depletion or amortization for total holding period ______
5. Decedent's adjusted basis at death (line 3 minus line 4) ______
6. Net appreciation of asset during total holding period (line 2 minus lines 4 and 5) ______
7. Pre-1977 holding period (days) (percent) ______
   Total holding period (days) ______
8. Assumed pre-1977 net appreciation (line 6 times line 7) ______
9. Actual pre-1977 depreciation, etc ______
10. Fresh start basis (total lines 5, 8 and 9), (Not to exceed line 1, except traded security) ______
11. Remaining allocable appreciation (line 1 minus line 10) ______

II. Computation of property subject to tax.

12. Non-recourse mortgage on property at date of death. (If none, enter amount on line 11 on line 14) ______
13. Amount of asset subject to tax (line 1 minus line 12) ______
14. Remaining appreciation subject to tax considering mortgage (line 13 minus line 10) ______
15. Net value of asset for Federal estate tax purposes ______
16. Amount of asset qualifying for marital or charitable deduction ______
17. Amount of transfer subject to tax (line 15 minus line 16) ______
18. Percent of transfer subject to tax (line 17 divided by line 15) (percent) ______
19. Amount of transfer subject to tax attributable to basis of asset (line 18 times line 10) ______
20. Remaining appreciation subject to tax considering deduction (line 18 times line 11) ______

III. Adjustment for taxes paid by estate. (3).

21. Maximum adjustment for taxes (lesser of lines 11, 14, or 20) ----------
22. Federal gross estate ----------
    Less:
        Marital deduction ----------
        Charitable deduction ----------
        Non Recourse mortgages ----------
    Total property subject to Federal tax ----------
23. Total taxes paid by estates:
    a. Federal estate tax ----------
    b. State death taxes ----------
24. Overall tax rate (line 23 divided by line 22) (percent) ---
25. Adjustment for taxes paid by estate (line 21 times line 24)
26. Basis after adjustment for taxes paid by estate (line 10 plus line 25) ----------

IV. Minimum basis adjustment.

27. Basis for purposes of minimum basis adjustment (for non-excluded personal and household goods, the lesser of line 1 or line 26. For all other items, line 26) ----------
28. Total aggregate adjusted basis of all assets subject to carryover basis rules (total all lines 27) ----------
29. Minimum basis adjustment ---------- 60,000
30. Maximum allocable minimum basis adjustment (line 29 minus line 28) ----------
31. Aggregate estate tax value of all assets subject to carryover basis rules (total all lines 1) ----------
32. Remaining net appreciation of all carryover basis property (line 31 minus line 28) ----------
33. Portion of minimum basis adjustment allocable to each asset (line 30 divided by line 32) ----------
34. Remaining allocable appreciation (lesser or line 11 or line 14, minus line 25) ----------
35. Minimum basis adjustment for asset (line 33 times line 34)
36. Basis after minimum basis adjustment (line 26 plus line 35) ----------
37. Remaining appreciation subject to tax (line 34 minus line 35) ----------

V. Adjustment for State taxes paid by beneficiary.

38. Amount of asset subject to State death taxes, minus line 36
39. Total State death taxes paid by beneficiary ----------
40. Value of all property subject to State death tax passing to beneficiary (separately computed) ----------
41. Overall tax rate (line 39 divided by line 40) ----------
42. Adjustment for State death taxes (line 41 times line 38) --
43. Final adjusted basis for purposes of determining capital gain or sale of asset (line 36 plus line 42) ----------

VI. Basis for loss purposes.

44. Net appreciation of asset for loss purposes (line 1 minus line 5) ----------
45. Remaining appreciation subject to tax considering mortgage (line 13 minus 5) ----------
46. Amount of appreciation of transfer subject to tax for loss purposes (line 18 times line 44) ----------
47. Maximum adjustment for taxes (lesser of lines 44, 45, and 46) ----------
48. Adjustment for taxes paid by estate (line 47 times line 24)
49. Basis after adjustment for taxes paid by estate (line 5 plus line 48) ----------
50. Remaining allocable appreciation (lesser of lines 44 or 45 minus line 48) ----------

51. Basis for purposes of minimum basis adjustment (For nonexcluded personal and household goods lesser of line 1 or line 49) For property subject to nonrecourse mortgage, line 45 minus line 48. For all other items, line 49__
52. Total basis all assets subject to tax (Total all lines 51)__
53. Minimum basis adjustment__________________________ 60,000
54. Maximum allocable minimum basis adjustment (line 53 minus line 52)_______________________________
55. Remaining net appreciation of all carryover basis property (line 31 minus line 52)___________________
56. Portion of minimum basis adjustment allocable to each asset (line 54 divided by line 55)_______________
57. Minimum basis adjustment for asset (line 50 times line 56)
58. Basis after minimum basis adjustment (line 49 plus line 57)_______________________________________
59. Remaining appreciation in asset (line 50 minus line 57)__
60. Adjustment for State death taxes (line 41 times line 59)__
61. Final adjusted basis for purposes of determining capital loss on sale of asset (line 58 plus line 60)__________

(1) H.R. 6715 proposes several changes to the carryover basis rules, including:
(a) Treating estate taxes on income items in the estate as an addition to basis.
(b) Ignoring non-resource debts against the property.
(c) Making the basis for loss purposes same as for gain, ignoring the fresh start adjustment.
(2) It is not necessary for the decedent to have actually held the property on December 31, 1976. If the property held by the decedent at his death was acquired in a non-taxable exchange for property that he did own on December 31, 1976, the fresh start adjustment will be available. Also the property on December 31, 1976.
(3) The adjustment for taxes paid does not include any additional tax imposed because of a disposition of property which qualified for the special form or closely held business valuation.

The taxes used in the computation of the second adjustment are the regular federal estate taxes and any estate, inheritance, legacy or succession taxes, for which the estate is liable, actually paid by the estate to any State or the District of Columbia.

EXHIBIT B

RIDER, BENNETT, EGAN & ARUNDEL,
ATTORNEYS AT LAW,
Minneapolis, Minn., October 11, 1978.

Vice President WALTER F. MONDALE,
Washington, D.C.

DEAR VICE PRESIDENT MONDALE: I am writing this letter as an attorney specializing in estate administration to urge the repeal, or at least the suspension, of the "carryover basis" rules contained in the Tax Reform Act of 1976. This letter has been simmering in my mind for many months, but I have never written it because I have never had any confidence that a letter such as this will even be read. I am making the effort now because I am so convinced that the new carryover basis rules are a drastic mistake. I sincerely hope that you will read and consider this letter.

The American people have been clamoring for the following reforms in the law in recent years:
(1) Simplification of the administration of estates (probate);
(2) Reduction of the cost of probate;
(3) Simplification of the tax laws;
(4) Reduction of the cost of compliance with tax laws;
(5) Reduction of bureaucracy;
(6) Enactment of laws which are obeyed because they are respected.

You certainly will agree that these are desirable goals, however, all the probate specialists I know agree that the carryover basis rules are a substantial setback to all of these goals.

Application of the carryover basis rules is very difficult and time-consuming. Public sentiment calls for a probate system which permits laymen to administer estates, but laymen cannot correctly handle carryover basis. Attorneys and ac-

countants have spent literally millions of hours learning how to handle carryover basis, but they remain intensely frustrated by the subject.

Carryover basis is not only difficult to compute, but it dramatically complicates estate administration and estate planning. For example, payment of bequests and division of assets are complicated by the fact that assets of equal value have different cost bases; liquidation of assets to raise money causes tax problems; and the final carryover basis cannot be determined until after the estate and inheritance tax audits have been completed (sometimes years later).

Carryover basis computations require a determination of original cost basis, and the task of obtaining this information is difficult and time-consuming. It is difficult enough to obtain original cost information from someone who is living, and it is often impossible to develop such information after the only person with knowledge of the subject is dead.

All of the foregoing difficulties translate directly into increased costs. The carryover basis rules dramatically increase the costs of probate while the American people are demanding reduced costs of probate. I estimate that the cost of administering an estate will increase from 10% to 50%, depending upon the facts, and this increased cost will occur in virtually every estate. I suspect the largest dollar increase in cost will be in larger estates, but the greater percentage increase in cost will be in smaller estates.

The consumers of professional services will have to pay the cost of this difficult and time-consuming work (except to the extent that the government pays its share because fees for estate services are deductible). I expect carryover basis to increase my gross revenues, but it is wasteful work and I do not want it. It will be many years before the revenues from the carryover basis "reforms" to the government will equal the direct nontax cost to the public of such "reforms" and even in the future this cost, when compared to revenues, will be an insult to the public which is entitled to an efficient system of tax administration.

It is no secret that our system of taxation is losing the respect of the people, and many commentators predict that we are moving toward the European system of taxation where cheating on taxes has become not only acceptable but expected. I deplore this trend, but I have observed it. Carryover basis is complicated, costly and frustrating, and too obscure to a layman, and I predict widespread ignoring of the law, guesswork, and even cheating. Carryover basis is a significant step toward a system that is losing respect.

If the carryover basis rules are going to be enforced, a greatly increased bureaucracy and vast computer storage capacity will be necessary. We have enough bureaucracy already, and our government might better spend its time enforcing our good laws.

Any advantage of the carryover basis laws in terms of taxpayer equity (there are arguments on both sides) is vastly outweighed by the numerous serious disadvantages described above. Every attorney I have talked to believes that carryover basis is a serious mistake. As one of the persons "out in the trenches" trying to work with this difficult and costly monstrosity, I urge you to repeal the carryover basis rules, or at least suspend them (and then repeal them later). I believe this action is consistent with one's political principles regardless of whether one is a liberal, conservative or moderate.

Very truly yours,

DAYTON E. SOBY.

STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION PRESENTED BY ROBERT DELANO, PRESIDENT OF THE VIRGINIA FARM BUREAU AND VICE PRESIDENT, AFBF

SUMMARY

1. Most farm assets are classified as carryover basis property and subject to increased capital gains taxes upon sale by an heir.

2. Much of the appreciation in a farmer's capital assets, particularly land, stems from inflation rather than an increase in productivity.

3. Farm and ranch heirs should not be forced to pay increased taxes on an artificial gain in land values, especially when the appreciation occurred prior to their ownership.

4. The fresh start adjustment, increased minimum basis, and other suggested reform are unworkable.

5. The lock-in effect will be intensified rather than diminshed by carryover basis.

6. Carryover basis presents an administrative burden to fiduciaries, valuation problems, and the spectre of double taxation through the aggragate effect of estate and income taxes.

7. Farm Bureau urges complete repeal of carryover basis and a return to the stepped-basis provision of pre-1976.

STATEMENT

The American Farm Bureau Federation, representing over three million member families, appreciates the opportunity to present its views on the carryover basis provision of the Tax Reform Act of 1976.

Farm Bureau members were active in seeking estate and gift tax reform in the Tax Reform Act of 1976. However, as our testimony before the Senate Finance Committee in July, 1977, and the House Committee on Ways and Means in October, 1977, indicated, much of the relief provided by this Act was offset by the burden of the carryover basis provision. Carryover basis is an unacceptable provision of the Tax Reform Act of 1976, and Farm Bureau members expressed their strong opposition at our 1979 annual meeting by making repeal of the carryover basis a priority issue for Farm Bureau.

Most of the assets owned by farmers and ranchers, such as land, machinery, and livestock, fall within the definition of carryover basis property. Thus, the gain on its sale by an heir is subject to increased capital gains taxes because the heir must take the decedent's basis. The heir must pay tax on appreciation that accrued prior to his or her inheritance.

Designed to remedy so-called "inequities" between taxpayers, carryover basis fosters an insidious bias against farmers and ranchers. It does this by taxing appreciation in capital assets which stems largely from inflation rather than an increase in the productivity of the land or other asset.

Statistics emphasize the contribution that inflation—largely induced by government policy—has played in increasing land values. The Congressional Research Service indicates that between 1967 and 1977, the compound average rate of increase was 10.4 percent per year, and that average farmland prices have not shown a year-to-year decline since 1955. In 1972, the average price for an acre of farmland in the 48 contiguous states was $216. By early 1977, the figure had reached $452, an increase of 109 percent in five years. The national average price has jumped as much as 17 percent per year (1977), and yearly increases in the Corn Belt and Lake States have ranged from 20 to 40 percent.

It should be reemphasized that much of the appreciation in land that may later be taxable to an heir under carryover basis is an artificial gain caused by inflation, not increased productivity. Modification of the provision will not remedy this inequity. Neither the fresh start adjustment nor an increase in the minimum basis can provide relief for the problems of heirs selling inherited farmland. The further we move from the fresh start date of December 31, 1976, the greater will be the capital gains tax liability and less effective any increased exemption. In addition, the lock-in effect, which some contend will be remedied by carryover basis, will actually be intensified. Heirs will be more reluctant to sell inherited property because of the prospect of increased capital gains taxes.

In addition to the taxation of appreciation caused by inflation, the carryover basis calculations for land, buildings, machinery, livestock and timber have been described as, at best, potential nightmares. The administrative burden placed upon the fiduciary, as well as the aggregate burden of both an estate tax and income tax upon the sale of inherited property, concerns Farm Bureau. An additional reporting burden with heavy penalties for failure to comply is imposed on all estates with carryover basis property. In the case of real property the so-called "fresh start" actually calls for the proration of gains that occurred before and after December 31, 1976. This makes it necessary to establish the decedent's basis. In many cases this is a practical impossibility due to the unavailability of adequate records. Where the decedent's basis is unknown, the basis is to be treated as the fair market value of the property as of the date of acquisition by the decedent or by the last previous owner who actually purchased the property. This, also, is difficult to determine in many cases and is, at best, only a rough approximation of the decedent's actual adjusted basis.

When Congress passed the Revenue Act of 1978, it recognized the urgent necessity to provide greater incentive for capital investment in the nation's businesses. We now urge Congress to provide the incentive for farmers and ranchers

to grow and prosper by repealing carryover basis. In so doing, Congress will recognize the contribution of a sector of our society and economy that has taken great economic risks to build a productive and efficient agriculture. Heirs must not be penalized for the skill, enterprise, and vision of their benefactors.

Farm Bureau urges complete repeal of carryover basis and a return to the stepped-up basis provision of pre-1976 tax law. We do not believe that the present law can be modified to address fairly the tax concerns of our three million member families.

Thank you for this opportunity to present our views.

(Whereupon, at 1:10 p.m. the subcommittee recessed, to reconvene at the call of the chair.)

[By direction of the chairman the following communications were made a part of the hearing record:]

STATEMENT OF WILLIAM P. MCCLURE, OF MCCLURE & TROTTER

It is essential that the legislative solution to the carryover basis controversy include a provision that will permit the executors of the estate (or heirs of beneficiaries) of a person who died while the carryover rules were in effect to elect to have those rules apply to assets included in the decedent's estate for Federal estate tax purposes. The failure to include such an elective provision will result in serious inequities in many cases. The fairness of not penalizing a person for relying on the law in effect when he made a decision is self-evident.

Between December 31, 1976 and November 6, 1978 the carryover basis rules required a decedent's estate and his heirs or beneficiaries to take his adjusted basis as their basis in assets included in his estate for Federal estate tax purposes. These rules permitted some upward adjustments to reflect various estate and inheritance taxes, the December 31, 1976 values of the assets then held, and certain other items. On November 6, 1978 these provisions were retroactively suspended by the Revenue Act of 1978, Public Law 95-600. The effect of this suspension was to reinstate retroactively the prior value-at-date-of-death rules.

Because property tends to appreciate in value, the date-of-death basis rules normally produce a higher basis for an heir than do the carryover basis rules. However, sometimes property depreciates, and the basis under the carryover basis rules will exceed that under the date-of-death basis rules. In addition, adjustments allowable under the carryover basis rules could result in a greater basis than under the date-of-death rules where property depreciated between December 31, 1976 and the date of death. For example, under the fresh start rules marketable securities worth $100 on December 31, 1976 but only $60 at the date of death will, nevertheless, have a basis of $100 for purposes of determining gain. In these situations, the retroactive suspension of the carryover basis rules works to the detriment of taxpayers.

Persons acquiring property from a decedent must decide every day whether to continue to hold that property or to sell it and reinvest the proceeds in other property. Numerous factors influence this decision, and the Federal income tax consequences are among the most impotrant. Thus, a taxpayer owning property worth $100 may decide to hold it if he believes his basis is $120 (since the next $20 of appreciation on that asset would not be taxed while appreciation on other assets would be taxed) but sell it and reinvest the proceeds if he believes his basis is $80. This is especially true where the property is depreciable since the amount of his depreciation deduction depends on the amount of his basis. Between December 31, 1976 and November 6, 1978 many investment decisions were made on the assumption that the basis in property acquired from a decedent was to be determined under the carryover basis rules. Many taxpayers sold property for an amount equal to or less than basis under such rules (but greater than basis under the date-of-death rules), and many taxpayers refrained from selling property (and reinvesting the proceeds in other assets) because they reasonably expected that subsequent appreciation on such property would not be taxed upon a later sale. The effect of the suspension of the carryover basis rules was to change retroactively the circumstances under which these decisions were made.

To illustrate, a beneficiary may have inherited an asset, such as an office building, whose basis in the decedent's hands was substantially greater than its fair market value at his death. This could happen where the building's cost was above its value because of factors beyond the decedent's control (labor strikes during the construction period, unforeseen additional costs, a decline in the value

of rental properties in the neighborhood, etc.). Under the now suspended carryover basis rules the beneficiary was permitted to depreciate the building by reference to its actual cost basis, just as the decedent did. Such a beneficiary had two incentives to retain the property until its value increased to its basis: (1) depreciation based on actual cost and (2) the prospect of nontaxable appreciation in the future equal to the difference between basis and the date-of-death value. With the suspension of the carryover basis rules, the beneficiary's basis has been retroactively limited to the date-of-death value and both of the mentioned incentives have been retroactively eliminated. It is quite possible that the lower depreciation and the absence of any prospect of future nontaxable appreciation under the value-at-date-of-death rules would have caused him to decide to sell the asset, but his reliance on the carryover basis rules caused him to retain it.

Another case in which a beneficiary logically would have retained an asset involves listed securities that declined in value between December 31, 1976 and the decedent's death. If the beneficiary had reason to believe that the inherited securities subsequently would increase in value, he would have had a very strong incentive to retain those securities at least until they appreciated to their December 31, 1976 values in order to realize the appreciation on a nontaxable basis. If the date-of-death value is used, however, this incentive disappears completely.

In both of the cases mentioned above, the carryover basis rules caused the beneficiary to retain assets that otherwise would have been disposed of soon after the decedent's death. The then existing law strongly influenced his investment decisions. Thus, retroactive suspension of the carryover basis rules without a transition rule permitting an election to continue to use the carryover basis provisions for such assets is patently unfair. Accordingly, an elective transition rule, such as the one recommended by the Finance Committee and adopted by the Senate last year, clearly should be included in the legislation to be enacted this year.

MT. VERNON UNITED METHODIST.
Wichita, Kans., March 5, 1979.

MICHAEL STERN,
Senate Finance Committee,
Washington, D.C.

DEAR MR. STERN: I request that you make my comments part of the hearing record.

I strongly urge you to support legislation to get "carryover basis" repealed.

Paying taxes on the appreciated value of property that my father struggled so hard to acquire, appreciation of property value before the property comes to me, is a tax revenue gimmick that we can do without.

The "carryover basis" rule, a new idea in estate tax law passed by Congress in 1976, amounts to double taxation. The law's formula makes accurate tax calculation a nightmare if not an impossibility.

With inflation running rampant the "carryover basis" tax bite becomes devastating.

I urge you to use your influence and your vote to repeal the "carryover basis" on estates.

In Christ,

GENE M. TROMBLE.

CLIFFORD AND LEONA LEHMAN,
Fairmont, Minn., March 2, 1979.

MICHAEL STERN,
Senate Finance Committee,
Washington, D.C.

DEAR COMMITTEE MEMBERS: We would like our comments on carryover basis on inherited property be made part of hearing record when Senate Finance Subcommittee has hearing March 12, 19, and 20.

We own 240 acres of land and have two children. Even if stepped-up basis is used we believe they would have to put a large mortgage on the land or sell some to pay the large inheritance tax.

If carryover basis with it's complicated formula is used the taxes would double or triple. For that reason we think the carryover basis should be repealed.

Over the last 35 years we have paid many thousands of dollars in income taxes. It's seems a shame that we can not give our heirs what we have saved without paying many more thousand of dollars in taxes.

We believe that all inheritance and gift taxes should be repealed.

Thank you,

CLIFFORD AND LEONA LEHMAN.

HINDALS HORSES AND HOGS,
West Concord, Minn., March 4, 1979.

DEAR MR. STERN: This letter is to inform you on our position on the Carryover Basis in the Revenue Act of 1978. As farmers, we are against the taxation that this represents. We feel the inflation and the double taxation is wrong.

We would like our comments to be part of the hearing record.

Thank you.

Yours truly,

MARY LOU HINDAL.
DEAN H. HINDAL.

OAKLAND, IOWA, *February 26, 1979.*

SENATE FINANCE COMMITTEE: Please make my comments a part of the hearing record on repealing the "carryover basis" tax law.

The American Indian was beaten because of his trust and vision in generations, as we American farmers are being beaten. At least I ask you this chance to slow it down while someone up in Washington comes to their senses!

We are the owners of a small family farm. The Myers' and Rocks of Pott County, Iowa are decendents of German immigrants who cleared and worked the land. Our grandson is the fifth generation of Myers' to walk, play, and work on our land.

We want to pass the honor and challenge of taking good care of this land, as our ancestors did, on to one of our six children.

You on this committee and in the Senate, can repair a cog in the chain that's slipping in the machine called America by removing this tax law now.

The inheritance taxes, both state and federal have tied one hand behind our backs now.

This law "carryover basis," with inflation as it is ties the other hand.

Didn't someone tell you, you people are supposed to be working for us taxpayers, not against us?

If you pass this law again you are setting up the governments license to steal, but you won't be stealing just money. It will be the honesty, faith, truth, years, and spirit of every young generation of family farmers, both male and female.

We farmers can't and God won't, compromise our integrity of the land with the United States Government!

Sincerely written from a heart in Iowa.

MRS. DOROTHY MYERS.

THEODORE M. FORBES, JR.,
Dunwoody, Ga., February 28, 1979.

In re Carry-over Basis.
COMMITTEE ON FINANCE,
U.S. Senate, Washington, D.C.

DEAR SIRS: This is in response to your invitation for comments concerning the carry-over of a decedent's basis in his property into the hands of his heirs.

As a tax lawyer and taxpayer, I am unalterably opposed to the carry-over basis concept. It is totally unfair and unworkable as well.

To say that property escapes taxation if there is no carryover basis is the worst kind of demagoguery. The property is taxed at its fair market value in the decedent's estate at the exceedingly high estate tax rates. A capital gain tax on top of the estate tax penalizes the decedent's surviving widow and orphaned children, who must look to their inheritance to keep out of the poor house.

Not only is the gain in value already taxed at estate tax rates, but most of the gain that is exposed to taxation is the consequence solely of economic inflation, over which the decedent and his heirs have no control whatever. It may be said fairly that inflation has been a conscious or unconscious United States Government policy ever since the end of World War II, to enable the Govern-

ment to pay its debts in ever cheaper dollars. To add the capital gains tax to the estate tax punishes the widow and the orphan for the economic sins of the United States Government.

If the decedent's basis is carried over beyond his death, then in fairness the estate tax also should be calculated on that amount.

The decedent's property was bought with after-tax dollars. A substantial income tax was extracted from the decedent before he bought the property, and to tax the inflated value of the property with a capital gains tax as well as with an estate tax is egregious.

The purpose of the carry-over basis is not to raise revenue; it would increase only minutely the total tax take of the United States Government. It is designed instead to insure that no widow or orphan should live upon an inheritance, but instead all should be equally poor on the government dole.

It is one thing for a taxpayer to pay his taxes as a part of the cost of civilization; it is something else again, however, to take money from the one who earned it and give it to someone who did not, as a matter of government policy to redistribute the wealth of the nation. That is plainly immoral.

In addition to the inequities and immorality of the carry-over basis, it imposes an undue burden upon an unsuspecting executor or administrator to have to ascertain the basis of his decedent in any particular piece of property. Records get lost after even a short time, and there just is no way that it can be done. The banks and professional fiduciaries will not be willing to undertake the responsibility unless they are granted some kind of indemnification, and the individual fiduciary—widow, son, brother and the like—will be penalized, perhaps even prosecuted criminally, if he comes up with the wrong numbers. Value at date of death is a readily ascertainable figure; value on the date of acquisition 25 years ago is asking too much.

I urge you to repeal the carry-over basis provisions and not to let them go into effect after the end of this year.

Yours very truly,

THEODORE M. FORBES, JR.

RIDER, BENNETT, EGAN & ARUNDEL,
Minneapolis, Minn., October 11, 1978.

VICE PRESIDENT WALTER F. MONDALE,
Washington, D.C.

DEAR VICE PRESIDENT MONDALE: I am writing this letter as an attorney specializing in estate administration to urge the repeal, or at least the suspension, of the "carryover basis" rules contained in the Tax Reform Act of 1976. This letter has been simmering in my mind for many months, but I have never written it because I have never had any confidence that a letter such as this will even be read. I am making the effort now because I am so convinced that the new carryover basis rules are a drastic mistake. I sincerely hope that you will read and consider this letter.

The American people have been clamoring for the following reforms in the law in recent years:

(1) Simplification of the administration of estates (probate);
(2) Reduction of the cost of probate;
(3) Simplification of the tax laws;
(4) Reduction of the cost of compliance with tax laws;
(5) Reduction of bureaucracy;
(6) Enactment of laws which are obeyed because they are respected.

You certainly will agree that these are desirable goals, however, all the probate specialists I know agree that the carryover basis rules are a substantial setback to all of these goals.

Application of the carryover basis rules is very difficult and time-consuming. Public sentiment calls for a probate system which permits laymen to administer estates, but laymen cannot correctly handle carryover basis. Attorneys and accountants have spent literally millions of hours learning how to handle carryover basis, but they remain intensely frustrated by the subject.

Carryover basis is not only difficult to compute, but it dramatically complicates estate administration and estate planning. For example, payment of bequests and division of assets are complicated by the fact that assets of equal value have different cost bases; liquidation of assets to raise money causes tax problems; and

the final carryover basis cannot be determined until after estate and inheritance tax audits have been completed (sometimes years later).

Carryover basis computations require a determination of original cost basis, and the task of obtaining this information is difficult and time-consuming. It is difficult enough to obtain original cost-information from someone who is living, and it is often impossible to develop such information after the only person with knowledge of the subject is dead.

All of the foregoing difficulties translate directly into increased costs. The carryover basis rules dramatically increase the costs of probate while the American people are demanding reduced costs of probate. I estimate that the cost of administering an estate will increase from 10 percent to 50 percent, depending upon the facts, and this increased cost will occur in virtually every estate. I suspect the largest dollar increase in cost will be in larger estates, but the greater percentage increase in cost will be in smaller estates.

The consumers of professional services will have to pay the cost of this difficult and time-consuming work (except to the extent that the government pays its share because fees for estate services are deductible). I expect carryover basis to increase my gross revenues, but it is wasteful work and I do not want it. It will be many years before the revenues from the carryover basis "reforms" to the government will equal the direct nontax cost to the public of such "reforms" and even in the future this cost, when compared to revenues, will be an insult to the public which is entitled to an efficient system of tax administration.

It is no secret that our system of taxation is losing the respect of the people, and many commentators predict that we are moving toward the European system of taxation where cheating on taxes has become not only acceptable but expected. I deplore this trend, but I have observed it. Carryover basis is complicated, costly and frustrating, and too obscure to a layman, and I predict widespread ignoring of the law, guesswork, and even cheating. Carryover basis is a significant step toward a system that is losing respect.

If the carryover basis rules are going to be enforced, a greatly increased bureaucracy and vast computer storage capacity will be necessary. We have enough bureaucracy already, and our government might better spend its time enforcing our good laws.

Any advantage of the carryover basis laws in terms of taxpayer equity (there are arguments on both sides) is vastly outweighed by the numerous serious disadvantages described above. Every attorney I have talked to believes that carryover basis is a serious mistake. As one of the persons "out in the trenches" trying to work with this difficult and costly monstrosity, I urge you to repeal the carryover basis rules, or at least suspend them (and then repeal them later). I believe this action is consistent with one's political principles regardless of whether one is a liberal, conservative or moderate.

Very truly yours,

DAYTON E. SOBY.

AMERICAN BANKERS ASSOCIATION,
February 26, 1979.

Hon. RUSSELL LONG,
U.S. Senate, Washington, D.C.

DEAR CHAIRMAN LONG: Enclosed is a statement of the American Bankers Association on carryover basis and related matters.

The Association has given detailed study to the entire issue of taxation of unrealized appreciation at death for a period of over nine years. It is our firm conclusion that neither carryover basis nor any of the known alternatives which depend on proof of basis can be made to work.

The enclosure discusses the problems of carryover and proposals to clean it up. Based on the enclosed analysis and the experience of its member banks during the 22 months that carryover was in effect, the Association urges the Congress to repeal the carryover basis provisions and retain the current stepped-up basis rule.

Sincerely yours,

W. KENNETH BONDS.

Enclosures.

Commentary of American Bankers Association on Carryover Basis and Related Matters

INTRODUCTION

The Tax Reform Act of 1976 changed the law with respect to the income tax basis of a decedent's property to provide in general for a carryover of the decedent's basis with certain adjustments. The change was very controversial and applicable to estates of decedents dying after December 31, 1976. The Revenue Act of 1978 delayed the effectve date of the carryover basis provisions for three years until December 31, 1979. The American Bankers Association (the ABA) is vitally interested in carryover basis and has prepared this commentary on the important subject which will be considered by Congress later this year.

SUMMARY OF POSITION

The ABA urges the repeal of carryover basis and a return to prior law, with the result that the income tax basis of property included in a decedent's gross estate would be its estate tax value. The carryover approach as applied to a decedent's property is in practice so deficient that no amount of "clean up" can solve its major defects. Carryover basis cannot be made to work in a relatively simple, fair and straight forward manner.

Our reasons for urging the repeal of carryover basis are several. First, the difficulty of, and not infrequently the impossibility of, proving basis, which will result in a significant increase in the time required in, and the cost of, administering estates; second, the inordinate complexity of carryover, which cannot be eliminated by "clean up"; third, the increased fiduciary responsibility combined with an uncertain state law; fourth, the excessive rate of taxation when the estate tax and income tax on appreciation are combined in effect and the regressive impact of the income tax; and fifth, the perpetuation of the "lock-in" problem.

The taxation of appreciation at death, whether in the form of an income tax or an additional estate tax, is also undesirable for essentially the same reasons.

COMMENTARY

Background

Carryover basis for a decedent's property was enacted in the Tax Reform Act of 1976 over the virtually unanimous advice of interested persons and organizations, including our association. Statements by three of the panelists, requested to testify by the Committee on Ways and Means, House of Representatives, are representative of the criticisms of carryover:

Professor Graetz: The carryover basis proposals seem to involve more inherent complexity than proposals for a tax on appreciation at death. This is true because the carryover proposals require not only determination of the basis of transferred assets but also maintenance of records of basis over several generations. Moreover, with a carryover basis, it would no longer be possible to divide assets by simple fractions or percentages. Each asset would carry with it a potential tax liability which would affect its real value. (page 1241.) [1]

Professor Casner: I think the worst thing to do is what some people are apt to suggest, and that is a carryover basis, because that just continues the lock in that we are faced with now with respect to the intervivos situation. The carryover basis sometimes is suggested as the solution and then you have, as I say, a lock in for people that prevents them from disposing of their property and causes them to think they are unable to dispose of it because of capital gains. (page 1435.)

Professor Halbach: We [a committee of the Real Property, Probate and Trust Section of the American Bar Association] concluded, however, and I certainly agree with this, that any proposal for carryover basis is fraught with problems. It continues the lock-in problem, in a sense anyway, and it also involtes great complexity. If you just think about planning a will under it, you have to start thinking about which beneficiary will get which asset, depending on beneficiaries' probable income tax brackets and the basis of each of the client's assets. Now there are carryover techniques other than item-by-item, but I think carryover is, in general, in the eyes of many people and certainly in my own right now, the worst of the possible alternatives. (page 1411.)

No panelist before the Committee on Ways and Means had a good word for carryover basis. It is rare when panelists, who are usually selected to represent

disparate views, are of one mind on any controversial tax subject. The Chairman of the Ways and Means Committee said "The carryover of basis is obviously difficult. No one seems to favor it very much." (page 1444). In retrospect, the last sentence is a monumental understatement.

The ABA's criticisms of carryover basis were more specific than those of the panelists and are contained in our materials filed with the Committee on Ways and Means in 1973 and again in 1976 (pages 117–120). The problems discussed were:

1. Determining basis;
2. Administrative complexity and "suspended basis";
3. "Lock-in";
4. No satisfactory way to increase basis;
5. Mushroom tax effect of carryover;
6. Funding pecuniary (fixed amount) bequests; and
7. Net tax increase

Only problems 6 was addressed (by section 1040 with only partial success) in the carryover basis law. Even a road map of the potential problem areas did not lead to a satisfactory end product.

Since the 1976 Act, criticism of carryover basis has come from all directions. For example, Professor Stanley Surrey of Harvard Law School has said it is "too complicated". [2] Dr. Gerard Brannon of Georgetown University has referred to carryover basis as a "disaster" involving "hopeless complexity".[3] Frederick W. Hickman, former Assistant Secretary of the Treasury for Tax Policy said "the administration of estates and transactions involving inherited property will be infinitely more complicated for everyone and forever."[4]

During the second session of the 95th Congress, many bills attempted to "clean up" carryover basis. The most publicized was S. 2461 introduced by former Senator William Hathaway of Maine. This bill, and all others, were inadequate responses to the real (not imaginary) problems presented by carryover basis. They contained numerous technical deficiencies and, at the same time, failed to deal with a host of problems presented by integrating carryover basis into a detailed and highly complex tax system.[5] Resolving many of the integration problems, such as what to do with so-called "negative basis" property, would be difficult and controversial and further clutter up an already unwieldy income tax law.

The integration problems have become more difficult as a result of the changes made by the Revenue Act of 1978 in section 121, which permits a "once in a lifetime" exclusion from gross income of $100,000 of gain from the sale of a principal residence for certain individuals. With carryover basis, a sale shotly before death ("in contemplation of death") would in many cases produce a significantly lower tax (or no tax) than a sale after death. Such a difference in result would be difficult if not impossible to justify, but what is the solution?

ABA Reasons for Repeal of Carryover

1. PROOF OF BASIS

Much has been said regarding the problems of obtaining a decedent's bases for assets included in his gross estate. The painful experience of our members during 1977 and part of 1978 in attempting to establish basis information for estates of decedents confirms our conviction that major difficulties would lie ahead in this area. Countless hours were expended in futile attempts to ascertain cost figures at considerable cost in terms of increased fees.

Statements of Treasury officials that difficulties in proving basis are limited to "esoteric assets or careless taxpayers"[6] are at odds with the facts disclosed in responses to an inquiry by the ABA as to problems encountered under the carryover basis law. The responses will be submitted as a part of the ABA testimony before Congress later this year. In virtually every case, little or no reliable basis information was available for most tangible personal property, which we do not regard as "esoteric". The Treasury's proposed increase to $25,000 in the exception from carryover basis for personal and household effects will not solve the proof problems for many estates required to file federal estate tax returns because the value of such property will exceed $25,000. Substantial proof problems also existed with real property and, to a somewhat lesser extent, securities. As an officer of one of our member banks stated, "Every estate seems to have at least one significant 'mystery' [basis] asset" (exclusive of tangibles).

The absurdity of the situation becomes apparent when one recognizes that wedding gifts could be carryover basis property. In order to be able to prove the basis of this property, the bride and groom will have to write to the wedding guests and ask them what they paid for the wedding gifts, or is it contemplated that basis information will as a matter of accepted practice be included with nuptial wishes on wedding congratulatory cards? Are the bride and groom "careless taxpayers" if they do not seek to discover the cost of the wedding gifts?

In many cases, basis information for property included in a decedent's estate dies with him, and in other cases the proof problems are magnified by death. This suggests the desirability of securing such information prior to death. However, as one Florida lawyer noted in a letter to one of our member banks:

"I concluded after several months of struggling with clients' poor efforts at obtaining information, or poor results after extended efforts at obtaining information, that the effort to obtain information amounted to a fruitless search at great expense to the client. It was indeed frustrating both to the client and to me. This frustration would no doubt be compounded immeasurably where the burden is placed upon the surviving spouse to begin anew the search for basis information. If I could not obtain it over a period of months in direct dealing with the individual who had the greatest access to the information, how heavy would the burden be for an executor who would be dealing without the first hand knowledge available to the decendent?

Further, clear and convincing evidence of the legitimate concerns in obtaining and retaining basis information is presented by the Internal Revenue Service's refusal to participate in the record retention process for carryover basis information despite a clear congressional mandate to do so. Section 6039A requires an executor to supply carryover basis information to the Service and to the persons acquiring carryover basis property from a decedent, and section 6694 imposes fines for failure to furnish such information. The fine for a failure to supply information to the Service is $100 for each failure with a total not to exceed $5,000; the fine for a failure to supply a beneficiary with information is only $50, with a total for all beneficiary failures not to exceed $2,500. The legislative history clearly stated that the Service was to receive carryover basis information.

"In order for the Service and the recipients of property from a decedent to know the carryover basis of that property, the act adds a provision which requires the executor to provide such information concerning carryover basis property to the Service as may be required by regulations."[7]

Nevertheless, in T.D. 7540[8] the Service, with the acquiesence of the Treasury "ran away" from its obligations in this regard by stating that no specific carryover basis information is to be sent to it. An executor is only required to provide the Service with answers to three questions:

1. Was a federal estate tax return filed?
2. Did the decedent have carryover basis property?
3. Has carryover basis information been supplied to the beneficiaries?

With only three questions and a $100 fine for each violation, why did Congress establish a maximum fine of $5,000 for failure to comply with section 6039A in terms of supplying the Service with carryover basis information?

We find it incredible that S. 2461, and other "clean up" bills, would eliminate the requirement to give the Service carryover basis information. Our position is simple. If the Service is not prepared to receive, retain and supply carryover basis information to persons who have a legitimate need for it, the carryover basis system srould be repealed for this reason alone. Any system which is too troublesome for the United States Government to participate in regarding the retention of such information should not be imposed upon its citizens.

No mechanism is created for establishing the basis of property included in a decedent's estate. Thus basis controversies cannot be resolved prior to the sale of carryover basis property. The Treasury has suggested the establishment of a procedure for securing a binding determination of basis. [9] Such a procedure would create additional complexity and raise problems of a substantial nature. This may explain why the details of the procedure have yet to be described by the Treasury.

2. COMPLEXITY OF BASIS ADJUSTMENTS

Much has been said about simplifying our tax laws, which the President has referred to as a "national disgrace". Carryover basis is not simple in operation

or, upon close study, in concept. The subject is so complex that significant errors have been made in temporary regulations issued by the Internal Revenue Service. Even a supposedly simple provision for an election "out" of carryover basis for certain personal and household effects is shrouded in mystery and confusion. The regulations do not even define the term "person and household effects", although the legislative history does so. What is the reason for this glaring omission?

Under carryover basis, adjustments are required for estate tax on appreciation, minimum basis and "fresh start". These adjustments are both defective and complex. In fact, the situation is so bad that accurate income tax returns reporting sales of property acquired from a decedent cannot in many cases be prepared until a substantial period of time after the returns are due. This makes no sense.

a. Appreciation Basis Adustment

If an income tax and an estate tax were imposed on the entire appreciation in a decedent's estate, the aggregate federal and state taxes on the appreciation could exceed 100 percent. The federal estate and income taxes alone could come close to this percentage since the highest estate tax rate is 70 percent and the highest capital gains tax rate (including any alternative minimum tax) is approximately 28 percent. In addition, state estate and income taxes must be considered. Thus four separate taxes—two federal and two state—may be imposed on the appreciation.

To prevent the obvious unfairness of multiple taxes on the appreciation, section 1023 provides in general for increasing basis by the federal and state estate taxes on the appreciation. We will refer to this increase as the "appreciation basis adjustment". The increase is determined for each appreciated carryover basis property by multiplying the total taxes by a fraction having a numerator equal to the appreciation in the individual property and a denominator equal to the total value of all property subject to the tax, viz., the gross estate reduced by the marital and charitable deductions. It cannot be computed accurately until the federal and state estate taxes are finally determined, which will usually not occur until several years after the decedent's death. In the meantime each appreciated asset will have a "suspended" basis. This point was made during the 1976 hearings before the Committee on Ways and Means of the House by Charles M. Walker, former Assistant Secretary of the Treasury for Tax Policy, when he said:

Allowance of an increase in the carryover basis for a portion of death taxes means that the exact amount of gain realized on sales made during administration of the estate cannot be computed until final determination of State inheritance and Federal estate tax liability, including the final calculation of the total value of the estate and the amount of unrealized appreciation. As a result, income tax returns filed prior to such final determination of death tax liability may have to be reopened and the tax recomputed. (page 1181).

The complexity of the appreciation basis adjustment is demonstrated by recounting the errors which have been made to date in attempting to make it work properly.

(1) Section 1023 originally provided a single adjustment for the federal and state estate taxes paid by the estate using the "final" federal figures. This approach was erroneous because the amount subject to the federal estate tax might be significantly different from the amount subject to the state estate tax. To illustrate, most states do not exempt from tax property qualifying for the federal estate tax marital deduction.

(2) In response to the point made in item (1), the Revenue Act of 1978 amended section 1023(e) to provide for separate computations of the federal and state appreciation basis adjustment. While the change is sound in theory, the basis adjustment computations are increased by one and are made more complex. Furthermore, the revised method of making the adjustments is defective. Section 1023(f), defining net appreciation, was amended by the 1978 Act to provide that, in computing the appreciation basis adjustment for state estate tax, the decedent's basis is increased by the appreciation basis adjustment for the Federal estate tax. This upward adjustment, which has the effect of reducing the basis increase for state estate taxes, is clearly wrong. If the net appreciation is less for state purposes than for federal purposes the "triple or quadruple tax" (federal estate and income tax and state estate tax plus in some cases a state income tax) element on the same property works imperfectly.

No unwarranted tax benefits results from using the same "net appreciation" for both federal and state purposes, as is indicated by the different (and correct)

way of computing the section 691(c) deduction. Furthermore, under the 1976 Act the section 1023(c) adjustment for state estate taxes was correctly based upon the same net appreciation amount as the adjustment for federal estate taxes. The full amount of the net appreciation for federal purposes is also taxed for state purposes. Current section 1023(f)(2) is also erroneous in making an upward adjustment for federal and state estate taxes in computing net appreciation for purposes of the subsection (e) adjustment for state inheritance taxes.

(3) Even if the changes described in item (2) are made, the basis adjustments will still not work properly. The computation method uses an average rate of estate tax. The adjustment should be made at the marginal estate tax rate, as the Treasury has acknowledged.[10] The method initially suggested by the Treasury was deficient.[11]

(4) The Treasury has now shifted to a different approach for computing the appreciation basis adjustment—the increase would be computed by multiplying the estate's marginal federal estate tax rate (as provided in section 2001(c)) by the appreciation in the particular asset involved, subject to the qualification that if the decedent does not have at least $50,000 subject to tax in the marginal rate bracket, the next lower rate shall be used.[12] This approach would be applied even though under a "pure" approach the appreciation would be taxed in several rate brackets and even when a foreign tax credit or previously taxed property credit is available. It would also be applied even though an estate pays no federal estate tax, but is required to file a federal return. To illustrate (and ignoring minimum basis), an estate of $300,000 with a $125,000 marital deduction and the unified credit of $175,000 would have a basis increase equal to 30 percent of the appreciation in appreciated carryover basis property, subject to the application of section 1023(f)(4), which we will discuss later. On the other hand, no basis increase would be permitted for any state death tax.

We agree that the Treasury's current proposal has the virtue of simplicity, but does it satisfy any reasonable fairness test? A basis increase is permitted for a "phantom" federal estate tax that is not paid because of the unified credit, but an increase for a state death tax in excess of the state death tax credit allowed by section 2011 is not permitted even though the tax exceeds the credit by a substantial amount. In some states, New York is one, the state death tax actually paid will almost always exceed the state death tax credit. In other states, Illinois is one, with inheritance taxes where the rate of tax depends upon the recipient of the property the tax on property passing to non-related beneficiaries may be at rates that produce a death tax substantially above the state death tax credit.

We are as bewildered as you no doubt are with the upside-down results of the Treasury's proposal. This indicates how bad carryover basis is. Significantly, the Treasury does not propose to use its simplified approach in computing the section 691(c) deduction for estate tax attributable to income in respect of a decedent or the basis increase under section 1015(d)(6) for gift tax attributable to appreciation, which involve the same adjustment problem. Further, the coordination problems presented by the dual application of sections 1015(d)(6), which applies to the basis increase attributable to the gift tax on appreciation, and the appreciation basis adjustment are difficult and not correctly handled in S. 2461. Finally, the appreciation basis adjustment is conceptually unsound when the decedent has "loss" property. For example, if a decedent owns asset A with a value of $300,000 and a basis of $150,000 and asset B with a value of $100,000 and a basis of $300,000, an appreciation basis adjustment is allowed for asset A even though the estate has no net gain. Why? Only the net appreciation should be taken into account in determining the adjustment.

The answer is not to "clean up" carryover with an irrational approach, but to repeal a concept that will not work in the real world without making changes which make no sense in terms of policy.

b. Minimum Basis Adjustment

The treasury would increase the minimum basis for carryover basis property from $60,000 to $175,000 and make this adjustment before the appreciation basis adjustment.[13] The first of these changes is, in effect, a repeal of carryover basis for a substantial number of estates that would be affected by carryover basis, namely, those that do not have to file a federal estate tax return.

The Treasury has asserted that as a result of the increase carryover basis would apply to only two percent of the estates of all decedents.[14] In terms of policy, it is saying that the "old" law is inequitable only for this two percent or that the burdens or carryover basis are sufficient to justify excluding substan-

tially all estates from its operation. We reject either of these positions, particularly when the inequity argument is premised upon what is appropriate under the income tax law. What does filing a federal estate tax return have to do with income tax concepts?

Caryover basis should be repealed for all estates and not just the smaller estates. Absent such action, serious problems would remain for estates not "protected" from carryover by the increased minimum basis amount, the Treasury's "lucky" two percent. Of course, a minimum basis of $175,000 would not free 98 percent of all individuals from the need to keep accurate basis information because an individual will not know for a substantial period of time whether he or she will have a gross estate of this amount.

c. Problem for Estates Above Minimum Basis

(*1*) "*Suspended*" *basis.*—When the estate has a value in excess of $175,000, the minimum basis must be allocated among the individual appreciated carryover basis properties. Under the current law due to take effect for decedents dying after December 31, 1979, the allocation would be made by multiplying the amount by which $175,000 exceeds the aggregate bases of all carryover basis property times a fraction with a numerator equal to the appreciation in the individual asset and a denominator equal to the appreciation in all appreciated carryover basis property. The result is the same as discussed above in connection with the appreciation basis adjustment, namely, a "suspended" basis problem for all appreciated carryover basis property where the decedent's provable basis does not exceed $175,000. Actually, the situation is worse than with the appreciation basis adjustment. If the basis of any carryover basis property is unknown or uncertain, the application of the minimum basis rule to every appreciated carryover basis property is uncertain because the common denominator of the fraction is uncertain. This result is intolerable. Further, if the minimum basis adjustment is made before the appreciation basis adjustment, as the Treasury suggests, then so long as the minimum basis adjustment is uncertain the appreciation basis adjustment must necessarily be uncertain. The Treasury describes its suggestion as "simplifying" the basis adjustments,[15] thus giving the word a meaning which is directly at odds with our view of the effect of the proposed change.

Some have said that the points of concern discussed above would be avoided by giving the executor the right to allocate the minimum basis increase to appreciated carryover basis property in any manner he determined. Such a right would not solve the problem because, as noted above, if the basis of any carryover basis property is uncertain the amount of the basis increase to be allocated remains uncertain. Further, as fiduciaries our members are concerned about choosing between beneficiaries in the sense of awarding a tax benefit to some but not to others.

(*2*) *Community property.*—The operation of the minimum basis rule for community property is deficient. The Treasury has advocated the increase from $60,000 to $175,000 so that no estate not filing a federal estate tax return will have to cope with carryover basis. However, the minimum basis rule applies to both halves of community property. If a decedent and his spouse own $300,000 of community property and no separate property, the decedent's gross estate will be $150,000 and no federal estate tax return will have to be filed. The minimum basis of $175,000 is split between both halves of the community property, the decedent's share is $87,500 and his estate is subject to carryover basis. This result is unsound, inconsistent with the stated purpose of increasing the minimum basis amount to $175,000 and also inconsistent with the Treasury's statement that:

"Where the decedent's estate was not required to file a Federal estate tax return * * *, the basis of the decedent's property would be its fair market value."[16]

The minimum basis provision should apply first to the decedent's share of the community property.

(*3*) "*Notch*" *problem.*—Before leaving the minimum basis adjustment, another problem should be mentioned. To eliminate carryover basis for smaller estates, gross estates of $175,000 or less would be governed by "old" law in the sense that the basis for assets included in the gross estate would be their federal estate tax values. On the other hand, a decedent's estate with a gross value of $175,100 would be subject to the carryover basis rules. Thus, a "notch" problem is presented. The income tax result may be considerably different depending upon whether the gross estate is under or over $175,000. For example, if debts are paid "in contemplation of death", the payment would have no estate tax consequences but may have a significant income tax effect if it reduced the gross estate below

$175,000. Also, cash is carryover basis property and enters into the computation of any minimum basis increase. Thus, a benefit may be derived in terms of maximizing the minimum basis increase from satisfying debts with cash before death rather than after death.

d. Section 1023(f)(4)

The complexity of carryover basis does not end with the basis adjustment difficulties previously mentioned. Section 1023(f)(4) states that, for purposes of the appreciation basis adjustment, property qualifying for the marital or charitable deduction shall be treated as not subject to tax. In theory, this result is correct—property not subject to tax should not be entitled to a basis increase. However, given the way estates (and revocable trusts) are administered, it is unworkable in many cases without major modifications. The needed modifications would be either (1) undesirably complex or (2) inconsistent in some respects with the theory of section 1023(f)(4) and carryover basis.[17]

In over half of the states and the District of Columbia, death taxes are imposed upon property which qualifies for the federal estate tax marital deduction.[18] When this occurs, is the basis of the property qualifying for the deduction entitled to a basis increase for the state death tax attributable to the appreciation in such property? Under S.2461 and other "clean up" bills, no basis increase would be permitted because the property was not subject to federal estate tax. This result is clearly wrong. An incerase should be permitted, but how is it to be determined? The resolution of this problem is made more difficult by the laws of many states granting exemptions from tax specified amounts for particular beneficiaries or classes of beneficiaries. Thus, a bequest to a surviving spouse may be taxable under a state inheritance tax law subjct, however, to an exemption which may or may not be limited to bequests to the spouse.

Assuming the problem mentioned in the preceding paragraph is solved, the application of section 1023(f)(4) is still uncertain in many respects.[19] Widely disparate results (which cannot be justified) occur depending upon whether sales of appreciated property are made before or after the funding of marital deduction formula bequests of either the pecuniary or fractional share type. The effect of section 1023(f)(4) is to require that appreciated property be treated differently depending upon its ultimate destination. Any such hybrid, or dual, basis system is troublesome in operation.

We believe the proponents of carryover basis should be required to explain in detail and in writing how this provision would apply. After two years of analysis, the Treasury is still searching for the answer. In a December 19, 1978 letter to the Chairman of our Taxation Committee, the Treasury solicited solutions for five carryover basis issues, including the "(f)(4)" issue. Frankly, we do not believe it can be made to apply in a relatively simply manner without doing violence to the underlying rationale of carryover basis.

e. "Fresh start" basis adjustment

The "fresh start" basis adjustment provided by section 1023(h) applies differently to marketable bonds or securities as compared with all other assets. In the case of a marketable bond or security, the adjustment (increase) is the amount by which the December 31, 1976 value of the asset exceeds its basis on that date. In the case of any other asset, the adjustment is determined by a formula pursuant to which the amount by which its appreciation at death is multiplied by a fraction having a numerator equal to the number of days the asset is held before January 1, 1977 and a denominator equal to the total number of days held until death. Thus a conclusive presumption is created that the appreciation in a nonmarketable asset occurs at an equal daily rate over the entire holding period. A special rule is applied when the asset's basis has been adjusted for depreciation, amortization or depletion, and if a "substantial" inmprovement is made in an asset, such improvement is treated as a separate property for fresh start purposes. The substantial improvement concept is uncertain in effect and needlessly complex. Its elimination would be a substantial simplification.

The result of the dual fresh start approach is to treat assets other than marketable bonds and securities as second class citizens. The basis of a marketable bond or security (after the fresh start adjustment) may exceed its estate tax value, but this cannot occur for any other asset. Under the time apportionment formula its appreciation is conclusively presumed to occur in an equal daily amount. Thus, except in rare cases, the sale of such an asset will result in some gain and the effect of carryover basis would be immediate if it takes effect on January 1, 1980. In addition, the dividing line between a marketable bond or security and any

other bond or security may be imprecise and disputes will arise because of the different results under the two approaches.

Preferred stock, or for that matter any other asset whose change in value is largely attributable to interest rate changes, receives widely disparate treatment depending upon whether it is a marketable security. If marketable, its fresh start adjustment is frozen and will remain constant. If the preferred stock is "nonmarketable," the time apportionment formula will apply and the fresh start adjustment will decrease as time passes. This difference in treatment is untenable. Proposals have been made to eliminate the difference by treating certain nonmarketable preferred stock as if it were a marketable preferred stock having a December 31, 1976 value equal to its par value. [20] However, other assets present the same problem. The response is to grant regulatory authority to change the fresh start rule for "certain other property" having "a relatively fixed value". [21] The vagueness of this concept is apparent. The creation of these special rules, and others, emphasizes the difficulties with the dual fresh start approach. When a company whose stock is "nonmarketable" owns substantial marketable securities no benefit is derived from the December 31, 1976 values of such securities. This result is not equitable.

In summary, we believe the dual fresh start approach is unsound in theory, uncertain in effect and unacceptable even after it is "cleaned up". A different approach is needed.

3. INCREASED FIDUCIARY RESPONSIBILITY COMBINED WITH UNCERTAIN STATE LAW

Carryover basis presents significant problems under applicable state law. In our opinion it would improperly intrude in the administration of estates, where the procedures developed have been premised upon the income tax bases of estate assets being equal to their estate tax values. We are concerned with the increased responsibility which would be imposed upon fiduciaries and would exist with substantial uncertainties. A law review comment inserted in the Congressional Record last year by Senator Kennedy says:

Not only are executors now burdened with the responsibilities of computing the bases of all the assets included in the estate—a diffrent task even with respect to decedents with excellent records—but they are also saddled with new and undetermined fiduciary duties toward the heirs and legatees." [22]

Is a fiduciary required to take income tax basis into account in distributing property in kind to different beneficiaries? The answer to this question is not clear. The duty of impartiality that a fiduciary owes to all beneficiaries suggests an affirmative answer, but this may depend upon the facts of a particular case. To illustrate, assume that a decedent by his will leaves a legacy of $50,000 to X and the balance of his estate to his surviving children. Under prior law if the legacy were funded with property in kind (as was permitted under the law of many states), the estate recognized a gain in an amount equal to the difference between the date of distribution value of the property and its estate tax value and X would have an income tax basis in the property equal to its date of distribution value. Under carryover (section 1040), the estate would recognize the same amount of gain but X would have an income tax basis in the property equal to the decedent's basis plus any basis adjustments and the gain recognized by the estate. X would, of course, prefer to receive cash. The children would, however, prefer to satisfy X's legacy with property having the greatest amount of appreciation. Courts would have to resolve this conflict. If a duty to take income tax basis into account exists under applicable state law when distributions in kind are made to different beneficiaries, this duty may be negated by a provision in the governing instrument, but the effect of specific language will in mnay cases be put before the courts for construction.

Section 1023(f)(4) creates a significant problem for a fiduciary, which may be illustrated by a hypothetical case. Assume that an estate of a decedent dying after 1980 consists of two assets, asset A with a basis of $100,000 and a value of $500,000 and asset B with a basis of $400,000 and a value of $500,000, that a maximum marital deduction pecuniary formula provision is used, with the result that the surviving spouse receives one-half of the adjusted gross estate, viz., $500,000 and that the value of each asset remains constant after the decedent's death. Using the Treasury's simplified appreciation basis adjustment and applying section 1023(f)(4), if asset B is used to fund the formula provision the basis increase of asset A attributable to the Federal estate tax is $400,000 x 34 percent, or $136,000, and if asset A is so used the basis increase of asset B is $100,000 x 34 percent, or $34,000. The executor is thus presented with an unenviable and unpleasant choice—he must choose between maximizing

the basis increase for the estate by selecting asset B to fund the marital bequest or minimizing the capital gains taxes that will have to be incurred to raise funds to pay these taxes and the federal and state death taxes by selecting asset B to fund the nonmarital bequest.

When the decedent's will leaves a fixed amount bequest to his spouse the amounts received by the residuary beneficiaries will vary considerably depending upon whether the executor funds the spouse's bequest in cash or with appreciated property. If the funding is in cash and appreciated property is sold to raise the cash, the capital gains taxes will be charged to the residuary beneficiaries. If appreciated property is distributed in kind in satisfaction of the bequest, capital gains taxes may be reduced or eliminated and the shares of the residuary beneficiaries "increased". In many states the law is not clear whether the executor my distribute property with pre-death appreciation in satisfaction of a pecuniary bequest.

4. EXCESSIVE AND REGRESSIVE TAXATION

a. Total tax burden

Carryover basis seems more palatable than a tax on appreciation at death because the timing of the tax may be controlled by the estate or its beneficiaries. This notion is, however, to a significant degree specious because there may be little difference between carryover basis and a tax on appreciation at death to the extent that sales are required to pay estate taxes and other estate obligations, which would include income taxes on sales required to raise funds to pay the estate taxes.

For medium sized estates—estates of between $175,000 and $500,000—the marginal rate of income tax and estate tax on appreciation is surprisingly high. The estate tax rate is between 32 percent and 34 percent and the income tax rate, after providing an appreciation basis increase and taking into account the capital gains changes made by the Revenue Act of 1978, may fall in the 10 to 12 percent range. Thus, the combined marginal federal estate and income tax rate on the appreciation is well above 40 percent when compared with only a 32 percent estate tax rate under old law. For larger estates, the highest combined rate will often be above the highest estate tax rate under the old law until the gross estate exceeds approximately $8,000,000. This result is not appropriate at any estate level.

The foregoing discussion has ignored the effect of state taxes which often reduce the disposable estate further. For a New York decedent, the highest combined income and estate tax rates for federal and state purposes may exceed 85 percent for estates in excess of $5,000,000. In many cases, the combined federal and state taxes on the appreciation will be above 50 percent for estates of not more than $500,000. This could occur, for example, in Vermont where the state death tax is 30 percent of the federal tax before the unified credit.

The opponents of a return to the "old" law pursuant to which property included in a decedent's gross estate will receive income tax basis equal to its estate tax value contend that such a result is unfair because the unrealized gain at death escapes income tax. This gain is, however, subject to estate tax. Therefore, the issue is whether a second tax should be imposed on the appreciation in addition to the estate tax. We reject the desirability of imposing a second tax because the present level of estate taxation is already substantial. Also, as estates increase in value they consist generally of proportionately more unrealized appreciation and the burden of the "additional" tax on farms and other closely-held businesses will be significant because the appreciation in these assets is higher than the average appreciation in estates of the same size without such assets. The progressive estate tax rate schedule does a fair job of taxing the appreciation at little or no administrative cost, which cannot be said about carryover.

The Treasury, in responding to the level of taxation argument, states:

"Both Treasury and Congress could review the burden of all taxes imposed upon property transferred by decedents, but that review should take place in the context of a comprehensive income tax base" [23]

We disagree and see no valid reason why a proper level of taxation at death (including unrealized appreciation) cannot be determined without being tied to an impractical and unwise goal.

When carryover basis was enacted in 1976, the estimated long term (18 to 20 years) annual revenue to be derived from its application to property included in decedents' estates was $1.08 billion. This figure would be reduced by the

proposed increase in the minimum basis (estimated to cost $243 million), the proposed marginal rate basis adjustment (estimated to cost $109 million) and be increased by an estimated $35 million as a result of a change in the allocation of the basis adjustment. The net reduction of $317 million would decrease the annual revenue yield from $1.08 billion to $763 million. A further substantial reduction must be made for the changes made by the Revenue Act of 1978 with respect to capital gains which reduced the taxable portion of the capital gains by twenty percent.

b. "Upside-Down" taxation

Assuming that revenue of the estimated magnitude referred to in the preceding paragraph is required from decedents' property, carryover basis obtains the revenue in an undesirable manner. During the 1976 Hearings before the Committee on Ways and Means of the House Charles M. Walker, former Assistant Secretary of the Treasury for Tax Policy, in commenting upon the capital gains tax at death proposal said:

"Moreover, because of the deductibility of the capital gains tax against the gross estate, the net effect of a capital gains tax would be more severe for smaller estates than for larger estates. As an example, consider two estates that both have $1,000 of appreciation taxed at a 25 percent capital gains rate but with marginal estate tax rates of 30 percent and 70 percent. For both estates the initial capital gains would be $250. But the reduction in estate taxes resulting from the deductibility of that $250 would be $75 for the smaller estate with the 30 percent marginal rate and $175 for the larger estate with the 70 percent marginal rate. The net tax on appreciation would be 17.5 percent for the smaller estate and 7.5 for the larger estate. Certainly many people would instinctively question the justice of a proposal that would tax small estates more heavily than large ones." (page 1189)

We believe most people would question this result.

Carryover basis is subject to the same criticism as capital gains at death in this regard. A panelist before the Committee on Ways and Means of the House during the 1976 hearings stated:

"The same problem is presented by the carryover basis approach. The basis carried over is increased by the estate tax attributable to appreciation. Large estates will have more estate tax per dollar of net appreciation because they are in higher estate tax brackets and pay a higher average [or marginal] tax rate. Thus partial 'step up' under the carryover basis approach benefits the heirs of large estates most." (page 1217)

The same point was made in another article discussing carryover basis where the author states:

"One curious effect of the interplay between the estate tax and the income tax should be mentioned. In each of the four variations of basis, more dollars of income tax will be collected on the sale of the asset from the lower bracket case than the higher bracket case, although the latter will pay more total estate and income tax. This is because the higher estate tax will produce more basis which in turn more than offsets the higher income tax rate." [24]

The point being made may be demonstrated by comparing a $1,000,000 gross estate and a $5,000,000 gross estate with each estate having a basis equal to one-fourth, one-half and three-quarters of the gross estate. The results are as follows:

	¼ basis	½ basis	¾ basis
Gross estate of $1,000,000:			
Gross estate	1,000,000	1,000,000	1,000,000
Basis	250,000	500,000	750,000
Appreciation	750,000	500,000	250,000
39 percent adjustment [25]	292,500	195,000	97,000
Gain	457,500	305,000	152,500
60 percent exclusion [26]	274,500	183,000	91,500
Taxable income	183,000	122,000	61,000
Gross estate of $5,000,000:			
Gross estate	5,000,000	5,000,000	5,000,000
Basis	1,250,000	2,500,000	3,750,000
Appreciation	3,750,000	2,500,000	1,250,000
69 percent adjustment	2,587,500	1,725,000	862,500
Gain	1,162,500	775,000	387,500
60 percent exclusion	697,500	465,000	232,500
Taxable income	465,000	310,000	155,000

Although the $5.000.000 estate has five times as much appreciation as the $1.000.000 estate at each level, the actual taxable income of the larger estate is only 254 percent more than that in the smaller estate at each level. Thus, the income tax burden of carryover falls proportionately harder on the smaller estate than the larger estate given the same percentage of appreciation in each estate. We question the soundness of any such result.

Since our testmony before the House Committee on Ways and Means in 1973, we have consistently opposed any change in the basis rule which has this "regressive" effect. The result is in part attributable to the Treasury's simplified appreciation basis adjustment giving a greater proportionate benefit to larger estates than smaller estates when compared with the results under an "exact" basis adjustment, particularly when the estate has a high percentage of appreciation. To illustrate, if gross estates of $1,000,000 and $5,000,000, with three-quarters appreciation, are compared, the Treasury's approach gives the $1,000,000 a basis increase which is 6 percent more than under the exact method but the spread becomes 23 percent for the $5,000,000 estate.

The "upside down" effect of carryover basis may be demonstrated clearly by use of the figures set forth above. With a $5.000.000 gross estate having a basis of $1,250,000, the taxable income is only $465,000. If this taxable income were taxed entirely at 70 percent, the income tax would be $325,000 and the effective rate of tax (325,000/3,750,000) would be 8.6 percent. The likelihood of the gains being taxed at 70 percent is remote. The estate could recognize gains of $200,000 (prior to taking into account the 60 percent exclusion) in a taxable year before the tax on the gains would exceed 50 percent. If a 60 percent rate of tax is used, the effective rate of tax becomes 7.4 percent. If a 50 percent rate of tax is used, the effective rate drops to 6.2 percent.[27]

With the $1,000,000 estate consisting of three-quarters appreciation, the taxable income is $183,000. If a 50 percent rate is used, the effective rate of income tax is 12.2 percent. Why should the effective rate of income tax in this case be almost doubt that in the $5,000,000 case using the same 50 percent rate of tax? There is no satisfactory answer to this question.

Taxpayers almost uniformly consider changes in the law in terms of whether their taxes are increased or decreased. When this is done, and the effects of carryover basis (as modified by the suggested Treasury changes) and the 1976 estate tax changes are considered in combination, the results confirm that the increased tax burden will be primarily upon the "middle" estates and not the "largest" estates, a result which we reject as sound tax policy. The same point was made in an article which states:

"An irony related to the amount of additional tax produced by carryover basis should be noted. Another part of the 1976 TRA altered the federal estate tax rates. At lower levels of the taxable estate, the marginal estate tax rates were increased slightly. But for the largest estates, the top estate tax rate was cut from 77 to 70 percent. Little publicity attended this change, as compared with the self-congratulation for achieving carryover basis.

"In the very largest estates, the combined effect of carryover basis as enacted and the lower top rate results at most in a total estate and income tax much the same as the old estate tax by itself. Indeed, carryover basis and a lower estate tax rate together ordinarily will reduce the death tax on the largest estates. They may increase the total tax on death in other estates, which are large when compared to the entire population, but middling as great family fortunes. At this point it becomes important to ask what the purpose of the exercise is. If the principal target of death taxation is the very largest estates, deflection of the tax from this target to smaller estates is no advance."[28]

5. PERPETUATION OF THE "LOCK-IN" PROBLEM

Economists and others have for many years referred to the "lock-in" problem created for assets with substantial appreciation. The theory is that an elderly person is reluctant to sell such assets and pay a capital gains tax because at death the assets receive a new income tax basis and may be sold without payment of an income tax. This result is criticized as inhibiting the flow of capital. The significance of the lock-in has been reduced by the increase in the capital gains deduction made by the Revenue Act of 1978.

Clearly, carryover perpetuates rather than solves the "lock-in" problem. It is a less satisfactory solution than current law which frees up the flow of capital assets no later than at death. Carryover has this effect only to the extent that

appreciated property must be sold after death to raise funds to satisfy estate obligations. For other property, the "lock-in" will continue. An article states:

"Since the heirs will have to pay capital-gains tax only when they sell the properties, they will have a strong incentive to hang on to assets that have greatly appreciated in value. That will perpetuate the 'lock-in' problem inherent in the old law, which influenced wealthy owners to avoid capital-gains tax by hanging on to appreciated property until death. The new lock-in will simply be one generation removed. How pervasive it will become nobody knows." [29]

6. "COST" OF CARRYOVER BASIS

The additional time required to ascertain the income tax basis of property included in a decedent's gross estate will result in higher executors' commissions and attorneys' fees. The law review comment inserted in the Congressional Record last year by Senator Kennedy and previously referred to states:

"At a time when the public often complains of the high cost of administering estates, the effect of imposing these additional duties upon the executor will be to increase those costs." [30]

In some cases, this increased cost will be higher than the additional income tax revenue that would be derived from carryover basis. For example, with a $175,000 minimum basis this cost for a decedent's estate having a gross value of $175,100 would exceed the additional revenue derived from carryover. The income tax on the largest possible potential gain of $100 could not exceed $28. The applicaton of carryover basis in such a case is absurd.

What percentage of estates filing federal estate tax returns would be in this "negative" position? With the "fresh start" provisions, a large percentage of such estates will be in this position in the early years of carryover basis. In later years the percentage will decrease. The latest statistics for estate tax returns (those filed during 1973) provide some long term guidance. [31] 174,899 returns, both taxable and nontaxable, were filed. 108,908 of these returns were for estates of less than $150,000. Thus, 65,991 returns were for estates of over this amount. Of these returns, 20,973 were in the range of $150,000–200,000 with 45,018 over $200,000.

If we assume that roughly 8,000 of these returns would fall in the $175,000–200,000 category, federal estate tax returns for gross estates of over $175,000 would total 53,018. We also believe a reasonable assumption is that the results of carryover basis would be negative for gross estates of at least $200,000 in the sense that the additional costs of it would exceed the revenues derived therefrom. In making this estimate, we have taken into account that a decedent's gross estate will usually include assets which are not carryover basis property, viz., household and personal effects covered by the section 1023(b)(3) election, life insurance and income in respect of a decedent and the fact that the income tax on the maximum possible capital gain of $17,500 (70 percent of $25,000), after allowing for the appreciation basis adjustment, would be $1,300 after providing for the capital gain deduction if this gain were taxed in one year to an estate with no other income and no deductions. 8,000 represents 15 percent of 53,018. Thus to us it is indisputable that carryover basis would be undesirable for a significant percentage of estates filing estate tax returns.

The discussion in the preceding paragraph has ignored the effect of the "fresh start" adjustment which would limit the revenue to be derived from carryover basis for a substantial period of time. During this period, and particularely during the early years, the "cost" of carryover would be high in relation to the revenue it would produce. Also, the increased administration expenses attributable to carryover basis will result in a reduction of federal revenues because of these amounts being deductible for estate or income tax purposes.

Restatement of ABA position on carryover

The Treasury asserts that:

"Carryover basis is a reasonable policy solution to the equity deficiencies of prior law." [32]

Whatever theoretical merit carryover basis may have, we believe this commentary demonstrates that in the real world it will not work and cannot be made to work in a reasonable manner. A letter to Vice President Mondale discussing carryover basis makes this point simply and compellingly and is attached for your consideration. In his State of the Union speech on January 23, 1979, President Carter said:

"We cannot resort to simplistic or extreme solutions which substitute myths for common sense.

To us, carryover basis is a myth and lacking in common sense.

Tax on appreciation at death

Two approaches other than carryover basis have been discussed as alternatives to a return to "prior law". They are imposing an income tax on unrealized appreciation at death or imposing an additional estate tax (AET) on such appreciation. The details of these alternatives are not clear and difficult issues as to their application exist. For example, should property qualifying for the marital or charitable deduction be subjected to the new tax?

We have analyzed these alternatives in terms of our reasons for urging the repeal of carryover basis, which were discussed above, and found each of them deficient.

Difficulty of proving basis.—Each alternative presents the same proof problems as carryover basis.

Inordinate complexity.—The complexity of each alternative depends upon its terms. The exemption of marital deduction property from tax would produce a complexity of significant proportions in that we would have a partial carryover basis and a partial return to prior law.

Increased fiduciary responsibility and uncertain state law.—Each alternative could be less objectionable than carryover basis, the degree of improvement depending in part upon the details of the alternative.

Excessive and regressive taxation.—Each alternative would in our opinion result in excessive taxation and an income tax on unrealized appreciation at death would be regressive.

Perpetuation of "Lock-In".—Each alternative would be less objectionable than carryover basis to the extent that an appreciation tax is imposed at death, thus increasing the basis of property to its estate tax value.

Since 1973 when the Committee on Ways and Means of the House of Representatives held hearings on estate and gift tax reform and a change in the basis rule for a decedent's property, the ABA has consistently taken the position that the basis rule should not be changed. During the 1973 and 1976 hearings our organization suggested an AET as the least objectionable approach if any change should be made. We do not intend to support any alternative to repeal at the 1979 hearings. Based upon the experience of our members for estates of decedents dying while carryover basis was effective during 1977 and 1978, the proof of basis problems have been more significant than we expected and only a return to prior law will avoid them.

AMERICAN BANKERS ASSOCIATION.

REFERENCES

1. Page references are to Public Hearings and Panel Discussions, Committee on Ways and Means, House of Representatives, 94th Cong., 2nd Sess., on Federal Estate and Gift Taxes (1976).
2. Forbes Magazine, December 15, 1976, at page 46.
3. Tax Notes, January 10, 1977, at page 9.
4. Across the Board, March 1977, at 76.
5. See Covey and Hastings, Cleaning Up Carryover Basis, 31 Tax Lawyer 615 at 657–82 (1978).
6. Lubick and Gutman, Treasury's New Views on Carryover Basis, 118 Trust and Estates 10 (1979). This article is hereafter cited as "Lubick and Gutman".
7. Staff of Joint Committee on Taxation, 94th Congress, 2nd Session, General Explanation of the Tax Reform Act of 1976, at 563 (1976).
8. IRB 1978–21 at 19.
9. Lubick and Gutman, supra note 6 at 16.
10. Hearings on Technical Corrections Act of 1977 (Including Carryover Basis Provisions) Subcommittee on Taxation and Debt Management Generally, Committee on Finance, United States Senate, 95th Congress, 1st Sess., 73–97 (1977).
11. See Covey and Hastings, Cleaning Up Carryover Basis, 31 Tax Lawyer 615, 645–646 (1978).
12. Lubick and Gutman, supra note 6, at 15.
13. Lubick and Gutman, supra, note 6, at 15.
14. Lubick and Gutman, supra note 6 at 15.
15. Lubick and Gutman, supra note 6 at 15.
16. Lubick and Gutman, supra note 6 at 15.

17. The legislative history of section 1023(f)(4) establishes two different rules for computing the appreciation basis adjustment—one if the marita deduction property is segregated and another if such property is a part of a single fund. Tax results should, to the extent possible, not turn on drafting niceties.

18. The states where death taxes are not imposed upon property which qualifies for the federal estate tax marital deduction are: Alabama, Alaska, Arkansas, Florid, Georgia, Mississippi, New Hampshire, New Mexico, Nevada, Utah, Massachusetts, New York, North Dakota, South Carolina and Vermont. In addition, community property states, Arizona, California, Idaho, Louisiana, New Mexico, Texas and Washington, do not tax the surviving spouse's share of such property.

19. For an extended discussion of these problems, see Covey and Hastings, Cleaning Up Carryover Basis, 31 Tax Lawyer 615, 682–693 (1978).

20. Lubick and Gutman, supra note 6, at 16.

21. Lubick and Gutman, supra note 6, at 16.

22. Congressional Record, October 10, 1978, S. 18013.

23. Lubick and Gutman, supra note 6, at 12.

24. Feld, Carryover Basis: An Observation, An Irony and a Proposal, Tax Notes, May 8, 1978, at page 500.

25. The 39 percent rate is the estate tax rate used to compute the appreciation basis increase under the Treasury's proposal.

26. 60 percent of capital gains are excluded from income.

27. With an estate in excess of $5,000,000, the aggregate basis of all assets after the appreciation basis increase will be at least 70 percent of this amount. This would leave a maximum of 30 percent to be treated as capital gains. After 60 percent of this 30 percent is excluded in computing taxable income, 12 percent of the gain remains subject to income tax. At the highest income tax rate of 70 percent. the effective rate of tax on the appreciation at death can never exceed 8.4 percent.

28. Feld, Carryover Basis: An Observation, An Irony and a Proposal, Tax Notes, May 8, 1978, at page 501.

29. Ross, The Tax Practitioners Act of 1976, Fortune, April 1977, 106–117.

30. Congressional Record, October 10, 1978, S. 18013.

31. Statistics of Income 1972, Estate Tax Returns, Internal Revenue Service, Publication 764 (4–75).

32. Lubick and Gutman, supra note 6, at 10.

DARREL N. VAN ALLEN,
Clearwater, Kans., February 17, 1979.

DEAR SIR: I ask that this letter be made part of the hearing record regarding the carryover basis in taxing estates.

The carryover basis is double taxation—or perhaps even quadrupled—we paid for the land with inflated dollars at inflated interest rates. The property is taxed when probated and again when sold by heirs. Our heirs are living with inflation—everything they buy or sell is inflated—what makes you think they are receiving a bonanza when they inherit property that is assessed on an inflated basis.

Besides being terribly unfair, it is, as a practicality, an impossible tax to determine—much of our property is impossible to know or guess the carryover basis (or original cost)—and then the tax formula requires 61 separate calculations to arrive at the carryover basis for each piece of property—do you realize the paper blizzard that requires and the attorneys fees that curtails?

This seems a very unAmerican process to take property away from heirs after we have worked very hard to accumulate something for our children. It smacks of socialism!

MRS. DARREL (ARLENE) VAN ALLEN.

LAW OFFICES FLAME, SANGER, GRAYSON & GINSBERG,
Encino, Calif., February 15, 1979.

Re Carryover Basis Repeal. File No. 20.29.

COMMITTEE ON FINANCE,
Dirksen Senate Office Building, Washington, D.C.

DEAR SIRS: Because I will be unable to personally be present to testify at the scheduled hearing set for March 12, 19, and 21, on the carryover basis provisions,

I am writing this letter in hopes that it might be considered by the Senate Subcommittee on Taxation and Debt Management.

I am a tax attorney, certified as a "Tax Specialist" by the State Bar of California and have an LL.M in tax. My law practice is restricted to tax related matters. Needless to say, I have more than a passing interest in the adoption by the Congress of meaningful tax legislation. It is to that end, that I'm writing this letter.

With respect to carryover basis, I urge total repeal of the concept. If Con-Congress wishes to raise additional tax revenue, then as President Carter said when he was running for office, enact laws that are clear and simple to understand and to administer. Do not raise taxes by making the law so complicated through carryover basis rules. I personally view as a fraud the "tax reduction" granted by raising the "exemption" from $60,000 to an "exemption equivalent" of about three times that figure . . . only to offset such action by creating income taxes through carryover basis rules where income taxes never previously existed.

Communicate to the Committee, and to the President, that if they wish to increase taxes, then just merely increase the tax rates. The Internal Revenue Code is complicated enough, and after ten years of experience practicing tax law, I'm convinced that the complexity of the law is in major part attributable to the lack of backbone of our Senators and Congressmen who seek to "reduce" taxes with one hand, and at the same time, with the other hand, increase taxes . . . camouflaging such increases by making the tax law complex, obtuse.

In summary, carryover basis rules are a horrendous morass. I urge total repeal of the carryover basis statute. And, if additional revenue is needed, I suggest that the President and Congress take the simple, straightforward approach, of merely increasing the estate and the income tax rates.

Sincerely yours,

HOWARD L. SANGER.

FOLLMER, WEST, ERDMANN & CLEM,
Champaign, Ill., September 12, 1978.

Hon. CHARLES PERCY,
U.S. Senate, Washington, D.C.

DEAR SENATOR PERCY: As an attorney practicing extensively in the area of probating estates of decedents, I have been pondering for some times what to say in a letter to you regarding the dreadful carryover basis provisions of the 1976 Tax Reform Act. Even if the wisdom of the theory of the provisions were conceded, which I do not concede, administratively the provisions are absolutely unworkable for the average modest estate. As noted in a recent issue of the Kiplinger Tax Letter, a xerox copy of the first page of which is enclosed herewith for your reference, I fear that a great many of my colleagues are not even aware of the substantial problems of the Act and that their clients may be incurring enormous civil, if not criminal, penalties for failure to comply with these unworkable new laws and the regulations which have only recently begun to come out.

For those of us who are well aware of the provisions and are trying desperately to meet the new requirements, the task is great and the cost of compliance to our clients must eventually reflect the enormous additional burden which has been thrust upon them by this most illconceived provision, which was rushed through the Congress at the eleventh hour without even a minute of debate.

Assuming that your own personal and household goods exceed $10,000 in value, including jewelry, silverware, furniture, automobiles, and other property held for your family's personal use, could you determine how much you paid years ago for a sofa or a set of china or a stamp or coin collection or a painting? What about your tax basis in items which were given to you, such as silver or china or crystal received as wedding presents (your tax basis is its cost to the people who gave it to you many years ago—do you know what they paid?)? What about the family heirloom which has been handed down by gift from generation to generation probably without any federal gift tax returns having ever been filed? If even you don't know these items of information—and I would suggest that many of them, such as the cost of the wedding presents, are unknowable—how in the world do you expect your Executor to be able to find out? The only help which the new provision gives for such unknowable situations is that in such cases the basis shall be treated as the fair market value of the property as of the approximate date that the property was acquired by the decedent or by a preceding owner (in the case of a gift to the decedent). In the

stamp collection and many other situations, this is no help at all because the Executor would have no idea even when the property was acquired. The kicker, of course, is that new Code Section 6694 provides for penalties up to $7,500 for failure to provide such information unless "it is shown that the failure is due to reasonable cause and not to willful neglect." The burden of showing such reasonable cause, of course, is on the Executor.

Beyond the penalties, the same problems of discovering tax basis apply if the estate or beneficiary sells the carryover basis property and is thereby forced to try to figure out how much income tax he owes.

As with so many other unduly complex provisions of the Internal Revenue Code, I fear the result is that our taxpayers, the overwhelming majority of whom are honest and want to file a proper and complete income tax return, are deciding more and more that there is no way in the world that an accurate return can be filed, even with the best of intentions. So why even try? I'm sure you can see the practical ramifications of Congress' playing an active, even if unintentional, role in making our country a nation of tax cheaters. I am absolutely convinced that this is becoming a serious problem.

I strongly urge you to introduce or support legislation to repeal the carryover basis provisions of the Tax Reform Act of 1976 or, in the alternative, to introduce or support legislation to postpone the effective date of the carryover basis provisions until a more workable system can be worked out.

I would also note that the several Internal Revenue agents with whom I have discussed this are as frusrrated and confused by the new law as my clients and I are. I don't think the IRS even has grass root support from its own agents in the field for this terrible change.

Very truly yours,

RICHARD O. ERDMANN.

Enclosure.

FOLLMER, WEST, ERDMANN & CLEM,
Champaign, Ill., September 12, 1978.

Hon. ADLAI STEVENSON,
U.S. Senate, Washington, D.C.

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Very truly yours,

RICHARD O. ERDMANN.

Enclosure.

STATEMENT OF THE TAX COUNCIL

The Tax Council is a non-profit business membership organization concerned with tax policy. Since its inception in 1967, The Tax Council has emphasized the benefits accruing to all sectors of our economy from increases in our nation's stock of capital. The Council consistently has advocated a tax return structure that would encourage capital accumulation and preservation.

These are important matters in the context of the current condition of our economy. Lagging capital investment in this country has contributed to low productivity levels and minimal real economic growth. The rate of private net savings (personal and corporate) as a percentage of GNP was only 5 percent in 1978, the lowest rate in thirty years.[1] We continue to save at a much lower rate than other western industrial countries.

Thus, it is important to avoid tax policies which have a negative impact on the formation and preservation of capital. The Tax Council believes that the carryover basis provision of the Tax Reform Act of 1976, if implemented, would have such an impact on the growth of capital in this country, particularly with respect to risk capital. We urge the repeal of the provision.

The Assistant Secretary of the Treasury for Tax Policy, Donald Lubick, has stated: "To us the issue is not the workability of the 1976 carryover rules. . . . The issue is instead whether income tax liability on gains accrued by a decedent at his death ought to be entirely and irrevocably forgiven." We would agree with the Secretary that the issue is not workability. We believe the real issue is whether additional taxation of capital should be imposed at death. We're not disturbed, as is Mr. Lubick, over the possibility of some income tax liability on accrued gains being entirely forgiven.

In the first place, the income that builds most estates has been subject to tax during the lifetime of the individual, often at high marginal rates. And secondly, there is the estate tax itself. Regardless of the liberalization of the exemption under the Tax Reform Act of 1976, the estate tax can still serve as a heavy impost on the transfer of capital.

In fact, the Treasury's argument as to forgiveness of income tax liability on capital gains is seriously undermined by its own proposal, in the name of equity and administrative feasibility, to raise the minimum basis for carryover purposes to $175,000, the same as the expanded estate tax exemption. Treasury would forgive a lot of gains but not those which most likely would be associated with a significant family business enterprise or farming operation that other public policies purport to encourage.

[1] The corporate net savings component is adjusted for the overstatement of inventory profits and the understatement of depreciation caused by inflation.

It is the position of The Tax Council that not only should the carryover basis provision be eliminated, but that we should encourage the preservation of such capital by enacting a credit for capital gains taxes paid during one's lifetime against estate taxes due at death. This may be too much to accomplish at this particular time but a worthwhile objective nevertheless.

The present carryover basis process does appear to be completely unworkable, especially with regard to establishing original basis and for determining a fair distribution of the assets of an estate. But no matter what "clean up" administrative procedures are advanced, we believe the concept of carryover basis is too badly flawed to retain in any form.

Because we believe the case against carryover basis to be basically one of capital preservation, The Tax Council emphatically rejects so called "trade off" alternatives such as imposing capital gains tax liability at death or an additional estate tax on appreciated assets. These measures might impose less administrative cost than carryover basis but would merely switch one economic burden on the capital sector for another.

Explanation of the provision

Under prior law, an heir was able to use the market value of inherited assets at the time of the decedent's death (or alternate valuation date) as the cost basis for calculating capital gains when selling the assets. The carryover basis provision of the 1976 Act would require that gains be calculated by using the original cost of the assets to the decedent as the basis. Estates with a gross valuation of less than $60,000 would not be subject to the carryover basis process.

Under carryover basis, a "fresh start" transition rule holds that the adjusted basis of an asset which the decedent held on December 31, 1976, is increased, for purposes of determining gain, to its fair market value on that date. With regard to this rule, every asset, except marketable bonds and securities, is assumed to have appreciated at a constant rate during the entire period the asset was held by the decedent. The value of marketable bonds and securities is to be based on the actual market value on December 31, 1976.

When carryover basis was enacted, the Treasury estimated the longrun annual revenue yield of the 1976 provision to be a little over $1 billion. A more recent estimate by the staff of the Joint Committee on Taxation suggested an annual yield of $830 million, based on the 1978 law revisions, and down to $560 million if the Administration's new minimum basis proposal were accepted.

Rationale for, and conceptual problems with, carryover basis equity

In testimony before Subcommittee on March 12, Treasury defended carryover basis on four points. First, carryover basis is intended to equalize the tax liabilities of those selling assets after death to those selling assets prior to death. But that intent is not necessarily met, as income taxes paid on predeath sales of assets can substantially reduced the estate and the impact of the federal estate tax. If an asset is sold after death, with no fresh start adjustment, the combined tax may be greater than if the asset had been sold immediately prior to death because of the sequence in which the estate and income tax obligations are incurred. Because of pyramiding taxes, a greater tax may be levied on the postdeath sale of appreciated assets. In such instances, carryover basis would operate counter to the intended impact, as pointed out in more detail in an excellent statement to this Subcommittee by Doris D. Blazek of Covington and Burling on July 25, 1977.

The Tax Council's position is that a double tax should not be imposed on capital, but that there should be a credit against estate taxes for capital gains taxes paid during life. The effects of our proposal would be a greater preservation of capital and a reduction of the disparity between predeath and postdeath sales.

Lock-in

The second reason given for the adoption of carryover basis was to overcome the tendency to freeze assets to avoid paying income taxes on predeath sales. Treasury contends that, under prior law, there was a "lock-in" of capital, as people in their later years who might otherwise sell assets hesitated to do so because the appreciation of the assets would be subject to income tax. On the other hand, no income tax would be imposed on assets held until death.

However, carryover basis could well encourage a different lock-in of assets. Because assets generally appreciate over generations and the applicable tax rates are progressive, heirs will be encouraged to retain investments, rather than liquidate them and pay taxes on the appreciation of assets increased by

carryover basis. The greater the tax rate, the greater the incentive for holding assets to avoid incurring the tax, thereby diminishing the capital available to finance new ventures. The expansion of the availability of risk capital was an objective of Congress when it reduced the capital gains tax rates in the Revenue Act of 1978. Implementing carryover basis would run counter to this objective.

It should be noted that the Treasury Department has acknowledged the potential new lock-in problem in carryover basis. Its testimony on March 12 states that ". . . if the [inherited] property continues to appreciate in value, the capital gains tax would be greater when the heirs consider selling, and then their lock-in would be somewhat increased."

Revenue yield

The third defense of carryover basis cited by Treasury was that implementing the provision will yield additional revenues to the federal Treasury. As noted above, if implemented, the present carryover basis procedure could result in an additional annual revenue yield of $830 million. The staff of the Joint Committee on Taxation estimates that Treasury's proposed revisions of carryover basis would reduce the long-term annual yield to $560 million.

Revenue estimating in the area of capital gains tax liability has been notoriously inaccurate in the past, particularly, of course, because it depends upon investment or other actions of taxpayers which are subject to change in changing circumstances. The above mentioned potential lock-in effect could greatly reduce the revenue yield of carryover basis.

On the other hand, continuation of a 8–9% annual inflation rate could greatly expand the extent of inheritances subject to carryover basis above the minimum—potentially at least well beyond the 2% of total estates currently projected for such liability.

Lifetime gifts

The fourth justification of carryover basis is the claim that lifetime gifts, which are currently subject to carryover basis, and deathtime transfers should be treated similarly for income tax purposes. It is our position that there is a vast difference between the act of a person who, in the prime of life, permanently foregoes further use of property by giving it away, and the act of a person in providing by will for the disposition of property at the time when he can make no further use of it.

When a person makes a gift of property, the continuity of ownership is broken and his capital worth is diminished accordingly. By contrast, when property is sold, the seller's capital worth is diminished only by the amount of the capital gains tax. Unless subsequently given away, the property remains in one form or another for inclusion in his estate when finally disposed of by will. Thus, there is no break in the continuity of ownership before death, except for the part of ownership taken away by capital gains taxation.

The Council's position is that continuity in ownership of capital, in whatever form through life and until disposed of at death, provides a connection between tax on lifetime transfers and on the final transfer at death, which should be reflected in a credit for the former against the latter. By the same reasoning, there is nothing to connect lifetime gifts and the transfer of property still owned at death, and thus, there is no rationale for connecting the taxes paid on the two. Despite the unification of the gift and estate taxes under the Tax Reform Act of 1976, we believe this reasoning still holds with respect to carryover basis.

ADDITIONAL PROBLEMS

Fresh Start

There are several additional reasons why carryover basis should be repealed. The "fresh start" rule of the 1976 carryover basis provision is inherently discriminatory and will work to the disadvantage of taxpayers whose assets were purchased after December 31, 1976. While the fresh start rule is designed to soften the impact of carryover basis, it will increasingly impinge on capital preservation in years to come.

In addition, the fresh start rule provides for inequitable treatment for assets other than marketable bonds and securities, the basis of which cannot exceed estate tax value. Treasury acknowledges this problem but the specific reform measures proposed would be applicable only to a fraction of such assets.

Inflation Penalty

Treasury minimizes the effect of inflation on the appreciation of assets and contends that the impact of inflation is neutral under carryover basis. We disagree.

The carryover basis provision subject assets sold after death to an inflation penalty, as it incorporates inflation into the tax base. Because of progressive tax rates and the inflation factor, the effective rate of taxation may be much higher than the statutory one. Thus, carryover basis would exacerbate the erosion of capital by inflation.

One thing is almost certain, if current rates of inflation are not substantially reduced, hundreds of thousands of what are now considered small or middle-sized estates are going to face a very substantial problem with a carryover rule, fresh start or not. Either assets will be frozen to the detriment of the most useful allocation of resources, or capital will be eaten away on its transfer.

Administrative costs

Carryover basis inevitably complicates the process of estates administration. Without going into detail, which has been developed by other, it is important to note that there will be obvious adverse economic impact. Because of the complex process in establishing asset valuations and fairly apportioning assets to heirs under carryover basis, the administration of a significant estate with a variety of assets could require much more professional assistance than is currently the case. Additional expenses would be incurred for the services of attorneys, accountants, financial institution trust departments, and quite possibly, for computer time. It is reasonable to assume that in many cases assets would have to be sold to meet such expenses, which would be particularly unfortunate for estates largely comprised of a farm or a small business. While the reform measures proposed by the Treasury Department may be of some help in simplifying carryover basis, it appears certain that there still would be considerable administrative complexity were the process implemented.

Raising the minimum basis

The Administration would exempt from the carryover basis process all estates exempt from the estate tax by raising the minimum basis to $175,000, the same as the estate tax credit equivalent by 1981. By so raising the minimum basis, Treasury estimates that only 2 percent of total estates would be subject to carryover basis. Our position is simply that if carryover basis is inappropriate for 98 percent of estates, the provision should be repealed.

Treasury, of course, claims that the 2 percent segment that carryover basis would apply to is the segment that own more than 75 percent of all appreciated assets. Implicit in this position is the notion that concentrations of wealth and capital are the problem and ought to be reduced through taxation. The amount of capital passing by testament or gift in any year is only a small fraction of our total capital and is small in relation to the contemporary rate of accumulation. According to Professor Michael Boskin, only about 20 percent of our nation's total stock of capital is passed from generation to generation through wills and bequests and less than 1 percent of the total is so distributed in any given year. But just as the accumulation of capital means the creation of new and better jobs and higher living standards for the public at large, so does the conservation of capital assure an even higher base from which to build. Capital preservation through generations can be a critical source for risk and small enterprise. Though no known econometric model has measured this effect, its importance is obvious.

The view of The Council, therefore, is that there is not a major problem of concentration of wealth in contemporary America. If there were such a problem moreover, the tax mechanism would be an inappropriate instrument for dealing with it because taxation destroys, rather than redistributes wealth.

CONCLUSION

Because of the considerable negative economic consequences of carryover basis and the inequitable treatment of estates that would result from its application, The Tax Council urges the repeal of the provision. We also suggest that serious consideration be given to the proposal for a credit for capital gains taxes paid during life against estate taxes due at death.

Statement of Thomas P. Sweeney, Member, Richards, Layton & Finger, Wilmington, Del.

Mr. Chairman and members of the subcommittee: I thank you for the opportunity to come before you to present our views with respect to the repeal of the carryover basis provisions contained in § 1023 of the Internal Revenue Code of

1954, as amended. I am submitting these comments as a private practitioner, having been actively engaged in the practice of tax law for approximately 19 years, 12 of which have been with the firm of Richards, Layton & Finger in Wilmington, Delaware and in my capacity as head of the Tax Department of that firm. As will be set forth later in this statement, the carryover basis provisions, if retained, will cause a very considerable increase in the amount of time and expense involved in the settlement of estates; therefore, it should be noted that we speak against our own economic interests as attorneys whose practice includes a substantial number of estates.

INTRODUCTION

The Tax Reform Act of 1976 introduced the concept of carryover basis with respect to assets acquired from a decedent dying after December 31, 1976. Prior to this the basis of assets acquired from a decedent was generally the value of the property at the date of the decedent's death.[1] This "step-up" in basis permitted the Executor and/or beneficiaries to sell the decedent's appreciated property without incurring an income tax on that portion of the appreciation occurring prior to death. Of course, any unrealized losses with respect to a decedent's property would also be lost for income tax purposes.

The announced rationale for carryover basis is to subject the appreciation in value of property to income taxation whether it is sold by a decedent during his lifetime or by his beneficiaries after his death, thereby removing any apparent inequity as between those who have accumulated wealth and those who have not, for whatever reason. Other reasons have also been given in support of the carryover basis provisions: (i) that prior law had a "lock-in" effect which discouraged the sale of appreciated assets thereby impairing the mobility of capital; (ii) that large amounts of possible revenue were being "lost" through the "step-up" in basis at death; and (iii) that there is already a carryover basis with respect to lifetime gifts.

On the other hand, the carryover basis provisions have met with increasingly vocal criticism as tax practitioners, fiduciaries and beneficiaries have had the opportunity to study, interpret, explain and administer these extremely complex provisions.

We are here today to emphatically support the repeal of the carryover basis provisions. In doing so, we would like to comment on the tax policies underlying carryover basis and on the extreme difficulties which will be encountered in administering estates.

TAX POLICY UNDERLYING CARRYOVER BASIS

Before getting into a more detailed discussion of the stated tax policy objectives of carryover basis, we would like to set forth what we believe to be 3 very important considerations in determining whether legislation, such as the carryover basis provisions, satisfies the overall Federal tax policy. These considerations are: (1) that the tax laws should be clear and should avoid complexity; (2) that the tax consequences of everyday events and transactions should be generally comprehensible to the individual taxpayer; and (3) that tax legislation must be enforceable as a practical matter so that all tax provisions may be fully and consistently enforced.

In other words, even if proposed tax legislation has the appearance of reducing alleged inequities in the current tax system, is this tax legislation going to be practical, or is it going to suffer from extreme costs in terms of complexity, misinterpretation, lack of enforcement, and financial cost to taxpayers (who must reexamine and perhaps overhaul current arrangements based on prior income, gift and estate tax laws) and to beneficiaries (who must bear the brunt of higher income taxes resulting from carryover basis).

The recent flurry of tax legislation has served to complicate rather than simplify the tax laws and their application. Something so ordinary as the sale of a residence by a husband and wife has become a major tax planning event, given the various elections which may be based on particular circumstances. This unfortunate trend away from simplicity is nowhere more evident than in carryover basis. The old system of permitting a step-up in basis with respect to assets acquired from a decedent has many practical advantages which we strongly believe far outweigh any disadvantages.

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[1] For these purposes, this is deemed to include the alternate valuation date.

(1) Equity

In his statement before this Subcommittee[2] Mr. Lubick reiterated the stated position of the Department of Treasury that step-up in basis creates significant horizontal and vertical inequities. He repeats the oft stated example of two taxpayers, A and B, who each own the same number of shares with the same basis in the same corporation. A goes to his stockbroker and sells his shares. After leaving his broker's office he and his friend B are both run over and killed by a car. It is stated that B was about to go to the stockbroker to seel his shares.

Because A sold his stock before he died, a capital gains tax is incurred on the appreciation of his stock. However, B's stock passes to his heirs with the increased basis and no capital gains tax. If B's heirs sell the stock the next day at the same price as A sold his stock, B's heirs would pay no capital gains tax because of the step-up in basis.

The fact that A's heirs receive less total value in property because the stock was sold prior to A's death is pointed out as demonstrating disparate income tax treatment occurring solely because of the timing of capital gains recognition. However, the argument that the above example illustrates a total lack of horizontal and/or vertical equity as between taxpayer A and taxpayer B says too much.

Mr. Lubick correctly states that the estate tax and the income tax systems are separate systems, the former applying to the transfer of property and the latter to the receipt of income. Let there be no mistake, however, that the primary reason for the existence of these tax systems is to raise revenue and that only in structuring these systems are a variety of other policies given consideration. As a result, there are various types of "inequity" throughout our tax system, such as graduated income, estate and gift tax rates, charitable and marital deductions, exemptions for dependents, credits to reduce or eliminate taxes for gifts and estates, exclusions for small gifts, and special treatment with respect to gains and losses on the sale or exchange of capital assets, to name a few. All of these are integrated into our tax system for social, economic and practical policy reasons, even though they may be inequitable on a horizontal or vertical basis.

There are also inequities in our tax system based on the timing of events, such as the one illustrated above. But to say that the illustration above stands out as an example of extreme tax inequities is going too far. For instance, assume that taxpayers A and B had a basis in the stock far in excess of its current market value. Is it not inequitable to have the unrealized losses disappear with respect to B and not with respect to A? Yet this is the current state of the law. Or suppose that taxpayer B's wife was killed earlier that day, thereby losing the marital deduction for taxpayer B's estate? From a tax standpoint, this unfortunate event may represent a financial catastrophe to B and his beneficiaries, solely due to timing.

In other words, hypothetical fact situations can be used to illustrate nearly any point desired. The basic questions are whether the "inequity", if any, is such that the carryover basis provisions represent a practical solution and whether the "solution" would produce other inequities.

For instance, it has been suggested (and apparently agreed to in principle by Treasury) that carryover basis is so complex that it should not apply to estates not required to file Federal estate tax returns, thereby eliminating nearly 98% of estates from the proposed carryover basis rules. However, this points up very clearly the implicit problem with carryover basis—that it is so complex that it would be unworkable to have it apply across the board to all decedents and, therefore, it is necessary to limit its application only to large estates. Is this "equity"? We think not.

(2) Lock-in effect

It is alleged that the owner of highly appreciated property will not sell such property during his lifetime but will, instead, make a decision to hold such property until his death so that his beneficiaries may receive a step-up in basis. Certainly, there are cases where this is true; however, we dispute the blanket statement that this is an overriding consideration. If the owner of several assets must sell one, he is going to choose to sell the one with the least tax impact to him, whether or not carryover basis is the law. It is simply a question of selective

[2] Statement of Donald C. Lubick, Assistant Secretary of Treasury for Tax Policy, before the Senate Committee on Finance, Subcommittee on Taxation and Debt Management, Mar. 12, 1979.

buying and selling, based on current income tax law. It should be noted that the Revenue Act of 1978 has increased the long-term capital gains deduction in an effort to soften the impact of the sale of appreciated capital assets. Therefore, assuming there is any "lock-in" effect with respect to highly appreciated assets, the Revenue Act of 1979 would appear to relieve this pressure.

More importantly, carryover basis would aggravate rather than relieve the "lock-in" effect because beneficiaries would receive the highly appreciated assets with a low basis (with certain adjustments), and would, therefore, be further discouraged from making any sales. The longer the beneficiary holds the appreciated property and the more the property appreciates, the more severe the "lock-in" effect will become.

If the proponents of carryover basis believe that decisions concerning the disposition of appreciated assets are distorted by the knowledge that if the asset were not disposed of there would be a step-up in basis upon death, then we believe that decisions concerning the disposition of appreciated assets will become even more distorted by the possibility of reducing one's assets below the limit for the application of the carryover basis provisions. We are not saying that we disagree with raising the minimum limit for the application of carryover basis; we are simply stating that the necessity for doing so illustrates clearly that carryover basis is so complex that it should not apply across the board and that this fact alone is sufficient reason to repeal carryover basis in its entirety.

(3) Revenue loss

The proponents of carryover basis have stated that up to $20 billion of gain escapes income taxation annually, although we are not sure how this figure was determined. Nevertheless, if carryover basis is simply a revenue-raiisng measure, then there are certainly other more simple ways of approaching the problem.

At the heart of this issue, however, are the questions whether there is any justification for simply increasing the revenues and whether there is any justification for taking this revenue from a very small segment of our society, simply based on some feeling that they should not profit from their investments. The inequity of singling out a small segment of taxpayers in order to raise the revenues is of serious concern to us, especially in light of the lack of fiscal responsibility demonstrated by the United States Government over the past 20 years. Government expenditures continue to rise, putting more pressure on Congress to increase the revenues. Because inflation has made it nearly impossible for the lower and middle classes of our country to contribute more to the revenue, revenue-raising measures are aimed at "soaking" those who have had the foresight to form, accumulate, and preserve capital. Rather than increasing the revenues in this way, we sincerely believe that cutting Government expenditures (and lowering the revenues) should be the primary task of Congress.

(4) Capital formation

As a corollary to the above we firmly believe that carryover basis would have a decidedly adverse effect on capital formation. This assumes that it is still the policy of the United States Government to encourage capital formation and not to remove capital from the economic system or to discourage capital investments. It would certainly appear to be anomolous for the United States Government to discourage capital investment when such investment creates jobs (thereby increasing taxable income) and gives the country a more sound economic base. It has been the desire and ability of the people of this country to start their own businesses or invest in business that has permitted this country to grow and expand as rapidly as it has and to provide a very high standard of living for most of its citizens. This is not a time to remove the incentives for individual capital formation.

(5) Gift tax carryover basis

It has often been mentioned by the proponents of carryover basis that because property transferred by gift during the donor's lifetime has a carryover basis to the donee that the same should apply to property passing through an estate to the decedent's beneficiaries. However, as has been often pointed out, a gift is a voluntary event and a donor must consider the various consequences of making a gift, including the fact that he should provide the donee with the basis of the gift. Also, gifts are usually isolated situations involving a small portion of the donor's overall estate.

On the other hand, death is an involuntary event and affects all assets owned by the decedent at the time of his death. There is certainly no reason to believe

a person dies to obtain a tax advantage, even though a person might know that by dying his appreciated assets will be subject to an estate tax and will receive a step-up in basis. More importantly, the decedent is not here to tell us what the basis is or to give useful information in determining the basis. The reasons for not applying carryover basis to the situation of a transfer related to the death of the transferor far outweigh the desire to make carryover basis apply to death-time transfers just because it applies to inter-vivos gifts.

(6) Tax on inflation

It is an inescapable fact that much of the appreciation in value of assets is a result of inflation. In other words, a house purchased for $30,000 in 1960 and sold for $70,000 in 1978 would simply permit the seller to buy another house of the same quality and size for $70,000. The problem is that after paying a capital gains tax (ignoring for these purposes any permitted deferral of such tax), the taxpayer will be unable to purchase an equivalent house because he has been deprived of his capital. Granted, not all appreciation is due to inflation; however, inflation is a significant consideration which should no longer by ignored by the tax laws.

(7) Liquidity

With step-up in basis an executor could sell appreciated property if, for instance, it were necessary to raise funds for the payment of debts, taxes, etc., without the threat of incurring high capital gains taxes. Under carryover basis an executor will have an exceedingly difficult problem because of the threat of incurring income taxes on the sale of appreciated assets, the incurrence of which taxes may necessitate further sales of property.

As a corollary to this liquidity problem it should be noted that carryover basis would serve to aggravate the problems of the owner of a closely-held family business. Section 303 of the Internal Revenue Code is designed to ease the burden of having to sell closely-held stock after the death of the owner, but the carryover basis provisions did not coordinate properly with § 303. Similar problems exist with respect to § 306 stock and the lack of any provision with respect to the removal of the "taint" upon the death of the owner of such stock. These two problems have been the subject of much comment and although the Revenue Act of 1978 partially dealt with these problems, they serve to illustrate the lack of coordination of the carryover basis provisions with the announced tax policy of Congress to relieve the overall tax burden on the owners of closely-held family businesses.

COMPLEXITY OF CARRYOVER BASIS

As we previously stated, we firmly believe that tax laws should be practical—i.e., they should be comprehensible to taxpayers, capable of being applied, and capable of being evenly enforced. Carryover basis does not fulfill any of these objectives.

(1) Proof of basis

Probably the most unworkable aspect of carryover basis is the requirement that the executor ascertain the decedent's cost basis in each of the assets in the estate, with few exceptions. It is our position that this proof of basis requirement will become a nightmare because of the passage of time between the date of acquisition and date of death, the fact that the owner of the property is not alive to explain whatever records he may have kept or their location, the probability that many taxpayers will not keep adequate records, and the extreme difficulty of ascertaining the basis of certain types of personal property and collections.

The proponents of carryover basis have said that the fact that taxpayers may not keep adequate records is an insufficient reason for repealing a tax law requiring the production of records. However, the problems arising from the failure of a taxpayer to retain adequate records with respect to the cost of various assets is not a matter to be taken lightly. Even though a taxpayer must know his basis for income and gift tax purposes, these are generally voluntary matters the result of lifetime decisions, and the taxpayer is usually alive to take the responsibility of proving his basis. However, it is difficult to explain to a 25 year old taxpayer that he must keep records of everything he purchases in case he still owns the property when he dies because the 25 year old taxpayer cannot imagine himself dying within the next 40 years. Neither is there any reason to expect that records with respect to closely-held businesses or capital improve-

ments to personal residences will be any more carefully retained, given the fact that these records have had tax significance for years and people simply ignored such record-keeping. There is no reason to expect this to change just because the basis in such assets will carryover to their beneficiaries. In fact, the attitude of many individuals is that what happens to his assets after his death is not his worry but is the problem of his beneficiaries. There comes a point when a tax provision becomes unworkable as a practical matter, and carryover basis represents such a situation.

Again, the need to substantially increase the minimum amount of personal property which would be subject to carryover basis points out the obvious hardships which would be created by having carryover basis apply across the board to all taxpayers. The Treasury Department is, in effect, admitting that it will not treat a taxpayer with a $15,000 stamp collection whose total estate is $100,000 equally with a taxpayer who also has a $15,000 stamp collection but whose total estate is $1,000,000. This is, of course, an inequity created by carryover basis.

Further, the fact that the owner of the property is no longer living will make it extremely difficult to find, interpret, and reconstruct whatever records the decedent may have left. If no records can be found, then it is the apparent intention of the Internal Revenue Service to make some sort of haphazard guess as to the cost basis of the decedent. If the executor attempts to construct a cost basis himself, and the Internal Revenue Service later wishes to challenge this basis, then any income tax return filed with respect to the sale of such assets is also called into question. This matter of "suspended basis" may continue for years. It is this type of provision that will make it extremely difficult to comply with or enforce carryover basis.

In our firm we have had some first hand experience with the problems of ascertaining the basis of property owned by a decedent. To illustrate, a decedent had a collection of silver spoons which had been acquired over a period of nearly 50 years from places all over the world. Some of the spoons had also been gifts to the decedent by her parents and by her husband. There were no records of the cost, time, nor place of acquisition of these spoons. Were it not for the suspension of carryover basis, we are sure we would still be trying to construct the basis of these spoons.

We were also involved in the settlement of an estate involving a number of valuable antiques and a book collection which had been passed down to the family by gift rather than by inheritance and the decedent had been given the book collection prior to the passage of a gift tax statute. Again, little or no information was available which would lead us to a reasonable determination of the basis of the books.

Another very real problem in ascertaining the basis of stock and securities is the need to account for capital changes, such as stock dividends, stock splits, etc. Our firm represents a corporate fiduciary and we have been informed that the following amount of time was spent determining the basis of securities in the estates listed:

Gross estate	$52,000
No Federal return	
11 securities (hours)	6
Gross estate	$138,000
Federal estate tax payable	$45
14 securities (hours)	12
Gross estate	$802,600
Federal estate tax payable	$80,787
30 stocks and 9 bonds (hours)	12
Gross estate	$490,700
Federal estate tax payable	$106,138
23 securities (hours)	23

It was reported that the reason it took so much time to ascertain the basis of the stocks in the above estates is that there were inadequate records from the decedent and that many assumptions had to be made, such as using the date of the stock certificate as a starting point, assuming fractional shares purchased, using values determined from capital change services, and determining sales on a first in, first out basis.

And even if adequate records are found by the executor and the executor complies with the reporting requirements by notifying the Internal Revenue Service and the beneficiaries of the basis of such assets, the sheer magnitude of the infor-

mation to be compiled would render the system unenforceable. Under the proposed regulations with respect to reporting requirements as promulgated, the executor does not have to supply exact information to the Internal Revenue Service but only to beneficiaries. How, then, will the Service enforce carryover basis?

Thus, the question is not whether taxpayers should be expected to keep records with respect to the costs of their acquisitions, but whether such expectancy is practical considering the difficulty of enforcing an executor's representations with respect to a decedent's basis in property or the beneficiary's representation years later when the property is actually sold.

(2) *Increased fiduciary responsibilities*

Another aspect of the carryover basis provisions that causes us great concern is the increased responsibility and liability of fiduciaries. Not only must a fiduciary ascertain the cost basis of the decedent's assets, but he must also make elections concerning which personal and household effects will qualify for the present $10,000 exemption; must decide which assets may be sold in order to raise funds for debts, taxes, etc., with the smallest amount of tax consequence; must decide whether high or low basis assets will be used to fund pecuniary bequests such as a marital deduction bequest; and may, under State law, be responsible for deciding how to distribute high or low basis assets among beneficiaries (possibly by taking into consideration the income tax brackets of the various beneficiaries).

It is argued by the proponents of carryover basis that executors already have various elections to make and the addition of a few more should cause them no problems. This is the same as saying that a person already has so many problems that the addition of a few more problems should not be noticed by him. When will it stop?

We have found that the administration of an estate under current law (and without carryover basis) is an extremely time-consuming, difficult job. There is absolutely no justification for making the death of an individual taxpayer even more of a burden on the family of the deceased and those who are attempting to administer the estate in good faith and in full compliance with current tax laws. Fees charged by corporate fiduciaries and attorneys are high enough as it is and the addition of more time-consuming work in the administration of an estate will most certainly increase the amount of these fees simply as a matter of recovering time and effort spent in compliance with the carryover basis provisions. Rather than seeking to complicate further the matter of administering an estate, thereby increasing the cost to the survivors of decedents, Congress should be seeking to simplify the passage of the assets at death so that the survivors may receive the same with a minimum of cost and time.

(3) *Computations*

The number of computations required in order to ascertain the carryover basis of an asset is staggering. If the asset was acquired prior to December 31, 1976, then the "fresh start" value of the asset must be determined as of December 31, 1976. This determination depends on whether the asset is a marketable security or not (a question that is replete with problems). After the "fresh start" value is determined, then the basis must be determined both for gain purposes and loss purposes. Thus, an asset will often have two bases that must be computed.

Once the fiduciary has made the above computations, then there are certain death tax adjustments that must be made, which death tax adjustments have been the subject of much controversy since it does not appear that they are workable. Of course, in the face of such an attack, the Treasury Department has decided to "simplify" the death tax adjustments. However, the simplified system suffers from a lack of equity as between taxpayers living in different states.

After the death tax adjustments are made then there is a minimum basis adjustment which is based on the relative net appreciation of all carryover basis assets. Since this adjustment can only be made if the basis of all carryover basis property is known, it is clear how problematical the unknown basis of only one asset will be.

The offer of Treasury to simplify these adjustments so as to remove much of the complexity of the computations is welcome. Nevertheless, it again points out the incredible imperfections of the carryover basis provisions, even though these provisions are supposed to be a method of making our tax system more equitable. We submit that the carryover basis provisions are a needless complexity.

THE ALTERNATIVES

The two primary alternatives that have been mentioned in connection with carryover basis are the additional estate tax (AET) and the capital gains tax at death, both of which are considerably simpler than carryover basis. However, these alternatives suffer from the primary problem of carryover basis and that is the requirement that the decedent's basis in his property be ascertained by his executor or beneficiaries. They also present liquidity problems since the taxes are triggered by the owner's death. Therefore, an estate may not only have to pay estate and inheritance taxes, but also income taxes based on the appreciation of assets in the estate, whether or not the assets are sold.

CONCLUSION

In conclusion, it is our position that carryover basis should be repealed in its entirety, based on our strong belief that it is too complex, too costly, too difficult to administer and enforce, and is not a satisfactory solution to whatever tax equity issues may be raised by step-up in basis. Our tax system is already so complex and is already taking so much money from taxpayers that the voluntary aspect of our tax system is being stretched to the limit. If people find the tax laws too complex to understand and also believe them to be confiscatory, voluntary compliance will quickly become the exception rather than the rule.

Carryover basis is an example of tax legislation that should be repealed because it does not fulfill the goal of practicality and enforceability that is the cornerstone of our tax system.

NATIONAL COTTON COUNCIL OF AMERICA,
Memphis, Tenn., March 22, 1979.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance,
U.S. Senate,
Washington, D.C.

DEAR MR. CHAIRMAN: We respectfully request that this letter and the attached statement of Mr. W. F. McFarlane on behalf of the National Cotton Council be put in the record of the hearing on carry-over basis provisions of the Tax Reform Act of 1976.

Mr. McFarlane's statement demonstrates (1) the bewildering complexity of those provisions, (2) the virtual impossibility of complying fully with them, and (3) the confiscatory impact on estates which include a commercial family farm or other real estate held for many years.

National Cotton Council delegates, at their 1979 annual meeting, unanimously instructed the Council to work for repeal of the 1976 carry-over basis provisions and return to those provisions of the prior law. Accordingly, we respectfully urge your committee to support such repeal.

Sincerely,

C. HOKE LEGGETT, *President.*

STATEMENT OF W. F. MCFARLANE FOR THE NATIONAL COTTON COUNCIL OF AMERICA

I am W. F. McFarlane, a cotton, grain and vegetable farmer of Clovis, California. My statement is in behalf of the National Cotton Council, the central organization of the raw cotton industry, representing cotton growers, ginners, warehousemen, merchants, cooperatives, manufacturers and seed crushers. It was prepared in collaboration with my personal tax attorney, Mr. Baxter K. Richardson, of Fresno, California.

I. BACKGROUND

(1) Prior to the Tax Reform Act of 1976, all property passing from a decedent took a new cost basis for all income tax purposes equal to the value thereof at the date of death (or, if the alternate valuation date were selected for federal estate tax purposes, then the value on that date). Thus, if an asset were purchased for $50 was worth $100 at the date of death, and was then sold for $110, taxable gain would be $10. Similarly, that asset would from the date of death, if depreciable, have a depreciation base of $100.

(2) Under the Tax Reform Act of 1976 (as modified by the Revenue Act of 1978), approximately speaking, the cost basis of property in the hands of a

decedent's successors shall be the same as in the hands of the decedent, subject to certain adjustments:

(*a*) The cost basis of marketable securities will be their value on December 31, 1976, if owned on that date.

(*b*) Appreciation in value since acquisition by the decedent will nevertheless be added to cost basis, in an amount which is proportionate to the percentage of days that the asset was held up to December 31, 1976, of the total number of days the asset was held from the date of acquisition to date of death (less, however, depreciation taken on the asset, if depreciable, prior to death).

(*c*) Approximately speaking, the amount of death taxes attributable to the appreciation in value of an asset will be added to cost basis (but basis can never exceed the fair market value at date of death).

(3) Revenue impact of carried-over basis: According to the Joint Committee on Taxation explanation of the Tax Reform Act of 1976, by 1981 all the estate and gift tax changes in that legislation would result in a revenue loss of $1,449,000,000. However, carry-over basis alone would result in a revenue gain of $162,000,000. Thus the carry-over basis provisions were projected to save to the Government an amount equal to about 10 percent of the revenue to be lost from the other provisions. (The principal revenue loss of $1,380,000,000 per year was attributed to the unified rates and credit.)

(4) Argument in favor of carry-over basis: A main argument in favor of carry-over basis is that elderly people would no longer hold off selling property in order that it might have a new income tax cost basis after death. Also, chance (sale of property immediately before an unexpected death versus inability to complete projected sale before death) would not affect the tax status of any taxpayer.

(5) Arguments against carry-over basis:

(*a*) Compliance problems will be formidable and substantial noncompliance will be widespread due to complexities and ignorance and lack of available time of tax return preparers and advisers, and neglect of property owners and their successors.

(*b*) Tax motivations will still enter into pre-death and post-death planning of transactions, in a substantial way, and indeed, tax consultants will have more work to do than before.

(*c*) As time passes, a substantial addition to tax burden at the death of the family farmer.

These arguments against carry-over basis are elaborated below.

II. DISCUSSION IN DETAIL

(1) To illustrate both the compliance problem, and the possible problem of prohibitive taxation of the successors of a family farmer, the impact of carry-over basis on a family farm may be illustrated by an example. In this example it is assumed that land and buildings were acquired on January 1, 1967; that equipment was all purchased from time to time after December 31, 1976; and that the date of death is December 31, 1996. (The assumption is further made that the dollar remains constant as to the property from this date to December 31, 1996, the date of death.) The details of the family farm example are as follows:

Item:	*Assets*
320 acres land at $1,750 per acre	$560,000
Buildings	56,000
Equipment (depreciated value)	123,000
Equity in growing and harvested crops	100,000
Cash and equipment	7,700
Cooperative retains	31,000
Total assets[1]	877,700
Liabilities (long-term and crop financing)	219,700
Equity	658,000
Total	877,700

[1] The example is for the most part constructed on the basis of appendix table 13 to "Returns to Equity Capital by Economic Class of Farm," Economic Research Service, U.S. Department of Agriculture, Agricultural Economic Report No. 347 (August 1976). These items are approximately twice the percentages shown on the table referred to. The larger percentages are used on the basis of the writer's experience with family farms in the area of Fresno, California.

Further, it will be assumed that there are many different items of equipment.

Under S1023 (carry-over basis provision enacted in 1976), the cost basis of each item must be computed separately. The formula to be applied in every instance is as follows:

$$X = A + B + C,$$

where:

X = total carry-over basis
A = cost basis of asset just before death
B = adjustment for appreciation (if purchased before Jan. 1, 1977)
C = adjustment for death taxes.

B is ascertained by application of the following formula:

$$B = \left[(DD - A - AD) \frac{OHP}{THP} \right] + Q$$

where

DD = date of death value
AD = total amortization or depreciation deductions taken with respect to asset
OHP = number of days asset held prior to Jan. 1, 1977 ("old holding period")
THP = total number of days asset held ("total holding period")
Q = pre-Jan. 1, 1977 amortization or depreciation allowed or allowable

NOTE.—The *B* adjustment cannot be made for the purpose of computing loss.

C is ascertained by application of approximately the following formula:

$$C = \frac{DD - (A + B)}{TA} \times (FT + ST),$$

where

TA = total fair market value of all assets subject to estate tax
FT = Federal estate tax
ST = State death tax.

NOTE.—This formula accurate only if the State death tax is an estate tax, and is an approximation. Most States impose death taxes not computed in the same manner as Federal estate taxes. In every such case there must be two computations—one for Federal estate tax and one for State death tax adjustments.

To illustrate application of the above formula, assume that when the property was purchased in 1969 $30,000 as properly allocable to a building depreciable over 40 years, and that straightline depreciation was taken. Further assume that federal estate tax is $103,000 and that state death tax is $17,000. Application of the formula would then be as follows:

Application of Formula

Assumptions:	
Original cost of asset	(A)$30, 000
Value at date of death	40, 000
Depreciation taken to date of death	22, 500
Federal estate tax	103, 000
State death tax	17, 000

$$B = \left[(40{,}000 - 7{,}500 - 22{,}500) \frac{3{,}650}{10{,}950} \right] + 7{,}500$$

$$= 3{,}333 + 7{,}500 = 10{,}833$$

$$C = \frac{40{,}000 - (7{,}500 + 10{,}833)}{877{,}700} \times (103{,}000 + 17{,}000)$$

$$= 2{,}962$$

Carry-over basis thus is:	
A = pre-death cost	$7, 500
B = adjustment for appreciation	10, 833
C = adjustment for death taxes	2, 962
Carry-over basis	21, 295

The frightening complexity of compliance is apparent if it is assumed, instead of as set forth above, that death occurred in, say, 1985, at which time there were still on hand ten pieces of equipment purchased at various times prior to January 1, 1977. The above formula must be applied separately for each and every such item to determine carry-over basis. The complexity does not disappear as to items of equipment purchased after January 1, 1977; rather, the adjustment for appreciation, item B in the first formula above, is not made, but the adjustment for death taxes must still be made—separately as to each item.

Suppose further, as is certainly often the case, that the decedent had acquired some of the real estate and buildings from his parents many years ago by gift, and that the parents had purchased the property long ago and records were no longer available; or perhaps, the parents had inherited the property in, say, 1910. Under these circumstances the ascertainment of original cost and interim depreciation would be impossible, yet the computations must be made under the statute, somehow. In this connection one must keep in mind that each improvement to the real property is a separate item for the purpose of computation of carry-over basis.

In a typical case, the farm may not be the only asset of the family. Let us assume that the family has in addition the following assets:

Item	Cost	Acquisition date	Date of death value
Baby grand piano	$3,500	1959	$8,000
Antique chest	700	1959	5,000
Other items of furniture	(?)	(?)	3,500
Stamp collection	(?)	(?)	20,000
Personal automobile	6,000	1978	4,000

In the first place, there is no authority in the statute for aggregation of assets. Therefore, a separate carry-over basis computation would have to be made, except for a point discussed below, as to each and every of the above items, including each and every single stamp in the stamp collection and each and every single item of furniture. However, the present law allows a $10,000 exemption to the computations for personal items. The executor would have to select which personal items against which to use this exemption. Presumably, he would select low-cost, high-value items, such as the piano. Supposing the grand piano is given to *A*, the antique chest to *B*, and the stamp collection to *C*; and the executor allocates $5,000 of the $10,000 exemption to the chest, $5,000 to the piano, and none to the stamp collection: do *A* and *C* have a right of action against the executor for discriminating against them? If so, may they require the exemption to be prorated to each and every appreciated asset in some manner? If so, would the executor further be required to consider different probable income tax brackets of the various distributees, should they sell the asset distributed? That these questions are not frivolous is shown by the decisions already in the books that remaindermen are entitled to an adjustment if an executor deducts administration expense for income tax purposes rather than estate tax purposes, *Estate of Bixby*, 140 Cal App. 2d 326, 295 P.2d 68, and that a proportionate share of postdeath appreciation of estate assets must be allocated to the widow's share when distribution is to be made at the lower of date of distribution or estate tax values, *Matter of McDonnell*, 45 MISC. 2d 57, 256 N.Y. Supp. 2d 149 (Surr. Ct. Nassau County, 1965).

Possibly a suggestion would be made for aggregation of household furniture items or all stamps in a stamp collection, but any such aggregation would miss the mark as to specific, unusually valuable items. If aggregation were permitted except for such items, who would make that decision, and according to what criteria?

Thus it is seen that the problems of compliance are formidable. The writer of this memorandum recently conversed with a well-respected, old-time attorney, who has practiced in the writer's county for 50 years and has for years specialized in probate work. He remarked, as to carry-over basis, that in his opinion most practitioners would not give it any consideration at all, and that non-compliance (not deliberate, but because of inability to cope) would be massive. Informal conversations with examining Internal Revenue agents shows that they have the same expectation and consider the problem formidable. There is no question but that most practitioners would prefer an increase in the estate tax rates, in the rather minor percentage amount that would necessarily be involved, to offset the revenue loss that would result from permanent repeal of the carry-over basis

provisions. Many taxpayers would undoubtedly prefer this because the increased tax would likely be less than the extra practitioner fees required to work out the complexities of the tax liability.

The 1978 Act provided some relief, by providing for a "minimum basis." Where records do not exist or it is more advantageous, that provision can be applied. However, no fiduciary would dare to neglect making all the computations so that if the computed carry-over basis were more advantageous it could be used. Therefore, under principles of estate and probate law, it is doubtful that the minimum basis provision will be helpful to fiduciaries. It is to be kept in mind that fiduciary problems exist even though family members serve as fiduciaries. Other family members may well criticize the fiduciary in question, involving the family in expensive litigation.

The compliance problem is compounded by the face that one must assume that a death tax return may be audited, and that aduit will produce changes in the federal or state death tax. Audits frequently do not occur, or are not even commenced, until two years or more after death. Changes in the taxes would necessarly produce changes in the carry-over basis adjustment for death taxes. Thus, every income tax return filed until completion of audit proceedings may be wrong and, due to the possibility of lengthy litigation over the death tax returns, it would appear that protective claims for refund of income tax must be filed in every case.

At this time, there is a $60,000 overall exemption to carried-over basis. It will be apparent that such exemption is meaningless for a family farm of 320 acres. The suggestion has been made that the problem would be alleviated if the exemption were increased to $175,600. The foregoing discussion shows that such increased exemption will be of little help to the family farms. In the wirter's area (Fresno County, California) there are many 40- and 80-acre operations improved to vineyards or orchards, almost all of which would greatly exceed $175,600 in value on today's market. For true relief from formidable compliance problems, the exemption would have to be a minimum of $500,000.

(2) Overall tax effect. The foregoing discussion has pointed out the problems of compliance which render carry-over basis undesirable. However, the combination of death tax and income tax can render taxation on top-bracket assets almost confiscatory. Let us assume that the estate above posited must sell 60 acres of unimproved land in order to meet demands of the bank for pay-off of financing and of the state for death taxes. (The estate tax payment would probably be deferred under S6166 or S6166A.) Assume further that the 60 acres cost $400 in 1969. Carry-over basis is computed as follows:

$A=400\times 60$	$24,000
$B=\frac{1}{3}\times 1350\times 60$	27,000
$C=\frac{54{,}000}{877{,}700}\times 120{,}000$	7,383
Total carry-over basis	+58,383

If the property is then sold at $1,750 per acre, the death tax value, the total price is $105,000, for a taxable gain of $46,617. Probable maximum federal capital gains tax would then be amout 28 percent of the gain or $13,053. Thus, on the 60 acres, total taxation would be as follows:

Item	*Amount*
Federal estate tax (top bracket, 33 percent net of State death tax credit	$34,650
State death tax (top bracket, estimated at 10 percent)	10,500
Capital gains tax	13,053
Total taxation	58,203

It is thus seen that on this moderate-sized family farm, top dollar taxation is in reality at 55 cents on the dollar. The only solution to the family is not to sell any property for a long time, if ever. It is argued that carry-over basis removes taxation as a consideration in economic decisions, because elderly people will, with carry-over basis, have no motivation to freeze or hold onto property. To the extent, if any, that that might be so, it is obvious that the converse result will obtain after death, so that heirs will be tempted to assume unreasonable debt burdens (to pay death taxes—state death taxes usually are not deferrable), expenses and debts, rather than making sales which otherwise might be economically more desirable.

What if family farmers, and fiduciaries among them or involved with them, simply ignore the provisions? Under S6039A, and applicable regulations, any executor must furnish a notice to the Internal Revenue Service within 9 months after the date of decedent's death as to whether or not certain information has been provided to the distributees. That information consists, essentially, of the basis adjustments to determine carry-over basis, broken down to each step in that adjustment. If there are subsequent adjustments because of examination of the estate tax return, then amendatory information must be furnished within 3 months after completion of those proceedings. Failure to do so involves $100-per-failure penalty as to the Treasury (per item?) with $5,000 maximum, and $50 per failure (each item?), with $2,500 maximum, as to each beneficiary of the estate. It would also seem that failure to comply might be a crime as defined in $7206 (felony of filing a false return—false because of erroneous basis information), or S7203 (wilful failure to file a return or supply information). Upon the basis of the writer's experience, it appears there would not be enough prosecutors and judges to handle the volume of these offenses which almost inevitably must occur with continuation of the carryover basis provisions, because of the near impossibility and burdensomeness of compliance.

III. REVIEW OF ARGUMENTS FOR AND AGAINST CARRY-OVER BASIS

The argument is made, as pointed out, that with carry-over basis, elderly people will no longer hesitate to sell property because of the near-confiscatory level on moderate-sized estates of the combination of death taxes and income taxes. However, an implication of the pro-carry-over basis argument is that less tax planning will be involved. The opposite will, however, be true. Following are only some tax planning points which will have to be considered and done if carry-over basis becomes and stays a part of the law:

(*a*) Plan for sales before death, so that the capital gains tax will be removed from the taxable estate. Careful computations would of course be required to determine relative brackets and the profitability of this approach.

(*b*) If a corporation or partnership exists, which has been held for a long time before 1976, or which was formed in a tax-free transaction from assets held for a long time before 1976, then transfer new assets as acquired to that entity. Thus, "new" assets will be turned into "old" assets.

(*c*) Gift planning must be done with cost basis in mind—select "new" assets rather than "old" assets for lifetime gifts.

(*d*) Give substantially appreciated assets to charity.

(*e*) Avoid cash bequests in wills—instead, provide specific gifts, which under new S1040 can be distributed without incurring tax, whereas, cash gifts might require sale of assets by the estate with income tax consequences.

(*f*) As already indicated, estate distributions must be planned with allocation of high- and low-cost-basis assets to various distributees to minimize taxes overall, with broad area for possible controversies among distributees or among distributees and fiduciary.

(*g*) Do lifetime mergers with conglomerates in order to receive conglomerate stock which will then be an "old" asset—thus destroying the family farm.

IV. CONCLUSION

Carry-over basis should never become effective and should be repealed permanently, for the following reasons:

(1) Compliance in many cases will be burdensome and expensive, possibly involving litigation within the family or with fiduciaries, and may be practically impossible.

(2) Because of the near-confiscatory effect of a combination of death taxes and income taxes on appreciated assets sold after death, assets will be "frozen" after death.

(3) Many new complexities will be introduced into tax planning, with artificial tax considerations interfering seriously with economic decisions.

(4) A point not made above—state laws are at this point in confusion: the federal government should promptly take a clear position that there will be no carry-over basis so that state legislatures may be encouraged to drop the idea once and for all and the handling of estates be simplified and clarified.

INTERNATIONAL COUNCIL OF SHOPPING CENTERS.
New York, N.Y., March 21, 1979.

Senator HERMAN E. TALMADGE,
Russell Senate Office Building,
Washington, D.C. 20510

DEAR SENATOR: I am Executive Vice-President of the International Council of Shopping Centers (ICSC), the trade association of the shopping center industry.

The ICSC is a business association of more than 6,500 members consisting of shopping center developers, owners, operators, tenants, lenders and related enterprises. ICSC represents a majority of the estimated 18,500 shopping centers in the United States.

It is my understanding that this year the Senate Finance Committee will be considering the carryover basis provisions of the Tax Reform Act of 1976 which were suspended by last year's tax bill.

ICSC testified before the Finance Committee during the last Congress on the serious deficiencies and inadequacies of the carryover basis provisions, and urged their repeal. (A copy of this testimony is enclosed.)

We continue to urge the repeal of these provisions. Further examination of these provisions by ICSC has deepened our conviction that the 1976 Act created an administrative nightmare for taxpayers, added substantially to the cost and complexity of managing a decedent's estate, and produced provisions which violate the basic goals of tax reform: simplicity, fairness, and efficiency.

The carryover basis provisions will have an adverse impact on the economy by reducing the total supply of investment capital and inhibiting the free flow of capital through a disincentive to sell appreciated property.

The carryover basis provisions are theoretically unsound and administratively unworkable, and we urge your support of efforts to repeal them.

If you have any questions or comments regarding our position, please contact our Washington counsel: Edward C. Maeder, Winston & Strawn, Suite 1040, 1730 Pennsylvania Ave., N.W., Washington, D.C. 20006, 202/393-5550.

Thank you for your consideration.

Sincerely,

ALBERT SUSSMAN.

Enclosure

INTERNATIONAL COUNCIL OF SHOPPING CENTERS,
New York, N.Y., October 6, 1977.

SUMMARY OF STATEMENT OF INTERNATIONAL COUNCIL OF SHOPPING CENTERS ON H.R. 6715

A. Carryover basis of property acquired from or passing from a decedent under the 1976 act.

1. The carryover basis provisions of the 1976 Act have increased the tax burden upon owners of small businesses, discriminating against small business and favoring large corporations.

2. The 1976 Act has also created an administrative nightmare for taxpayers, adding substantially to the complexity and cost of managing a decedent's estate.

3. The carryover basis provisions are diametrically opposed to the basic goals of tax reform—simplicity, fairness, and efficiency.

(*a*) *Simplicity.*—(1) The carryover basis rule has added greatly to the complexity of the laws which will be manifested in higher professional and administrative costs.

(2) Because most taxpayers did not have notice of the necessity of keeping records of the purchase of various items, few if any records of purchases have been maintained. Many taxpayers acquired assets with the intention of holding them until death and had no need under prior law to maintain records. They acquired such assets in good faith with thoughtful planning and now the ground rules have been suddenly and drastically changed.

(*b*) *Fairness.*—(1) The "fresh start" formula which determines the carryover basis as of December 31, 1976, is based on an erroneous assumption that the appreciation in the value of the property occurs ratably over the period the decedent held the property. A shopping center's value does not increase in a steady continuum.

(2) The arbitrary nature of the "fresh start" formula will encourage heirs of a decedent-owner to dispose of a business by means of a tax-free merger. The affect of the carryover basis provision, thus, is to encourage mergers between small busines and larger companies.

(3) The "fresh start" formula fails to account for the actual high inflation rate occuring during the several years preceding December 31, 1976.

(4) The "fresh start" formula also discriminates against owners of property other than marketable securities. Holders of other securities, small business owners and shopping center developers are penalized because they have no public market and because they have created the value in their assets rather than making initial, substantial capital investments.

(c) *Efficiency.*—(1) Income tax revenues are generated only if the heirs sell the property acquired from the decedent.

(2) Carryover basis provisions have an incentive which encourage heirs of property acquired from a decedent to hold on to the property unles it can be transferred by means of a tax-free merger.

(3) As a result, investment capital, rather than having mobility may become frozen, thereby limiting the supply of capital required for economic progress and depriving the Treasury of revenue from its accretion.

4. Recommednations.

(a) The carryover basis provision should be repealed.

(b) Alternatively:

(1) The carryover basis provisions should be amended to permit assets owned by decedent prior to 1977 to fall within the provisions of the old law. Gains and property previously acquired would still be subject to income taxation when sold by living owners, and there would be notice so that adequate records could be kept.

(2) The law should be amended to give taxpayers the option of either computing the basis under the "fresh start" formula or establishing a date of death value or basis by an independent appraisal.

(3) The provisions should be amended to apply prospectively from a date sufficiently in the future which would permit banks, executors, and other interested parties to comprehend the new rules and plan accordingly.

I. Introduction

Mr. Chairman and members of the Committee: This statement is submitted on behalf of the members of the International Council of Shopping Centers ("ICSC"). The ICSC is a business association of more than 5,000 members. About 60 percent of our members develop and/or own shopping centers. About 15 percent are retail companies, the major share of whose stores are operated in shopping centers. Most of the developer-owner members of ICSC own from two to four shopping centers each, and collectively represent a major share of the estimated 16,000 shopping centers in the United States.

New shopping center construction requires a total annual investment of over $6.6 billion per year for buildings, stores, fixtures, and equipment. It is estimated that shopping centers provide regular employment for more than 5 million sales and store personnel and that several hundred thousand more are engaged in the construction end of the business. The rippling affect on employment and related businesses, among them display advertising, maintenance and cleaning, legal and accounting, and the manufacture of goods sold in the centers, is considerable. We have a significant influence on the total United States economy. Previously, retail trade was concentrated in individual stores and center business districts. But, by 1976, 36.3 percent of all retail trade amounting to $217 billion was conducted in 17,523 shopping centers. It is estimated that in the 1977–78 period 80 percent of total new retail square footage constructed will be in shopping centers. In the same period 88 percent of new department stores square footage will be constructed in shopping centers.

One of the principle purposes of the 1976 Act was to reduce the tax burden upon the owners of small business, many of whom are participants in shopping centers. The 1976 Act, however, has increased the tax burden for these taxpayers, discriminating against small business and favoring large corporations.

The 1976 Act has also created an administrative nightmare for taxpayers, adding substantially to the complexity and cost of managing a decedent's estate.

II. Carryover Basis of Property Acquired From or Passing From a Decedent Under the 1976 Act

A. Prior Law

Under prior law, the cost or other basis of property acquired from or passing from a decedent generally was "stepped-up" to its fair market value at the date of death or the alternate valuation date.

B. 1976 ACT CARRYOVER BASIS PROVISION

1. General.

The 1976 Act provides that the basis of most property acquired from or passing from a decedent who dies after December 31, 1976, is to be the same as the decedent's basis immediately before his death (with certain adjustments). The basis of appreciated property is increased by Federal and State death taxes attributable to the appreciation in that property. In addition, the aggregate basis of all carryover basis property may be increased to a minimum of $60,000. A $10,000 exemption is provided for household and personal effects of the decedent. However, the basis of property cannot be increased above the estate tax value by these adjustments.

The carryover basis provision is effective for property acquired from, or passing from, a decedent after December 31, 1976.

2. *Transition rule.*

(*a*) *Fresh start.*—As a transitional rule, the adjusted basis of property which the decedent is treated as having held on December 31, 1976, is increased, for purposes of determining gain (but not loss), to its fair market value on December 31, 1976. In essence, this rule was designed to continue the application of prior law with respect to appreciation in property occurring before January 1, 1977, and to provide everyone with a "fresh start" with respect to the carryover basis rule for property acquired from a decedent.

(*b*) *Special valuation rule.*—In order to avoid the necessity of obtaining an appraisal on all property held on December 31, 1976, the 1976 Act contains a provision which requires that all property, other than a marketable bond or security, be valued under a special valuation method for purposes of this transitional rule. In general, the special rule determines the adjustment by assuming that any appreciation since the acquisition of the property until the date of the decedent's death occurred at the same rate over the entire time that the decedent is treated as holding the property.

The special valuation method must be used for all property other than marketable bonds or securities. Thus, the special valuation method must be used even though the executor or beneficiary of the decedent can establish that the fair market value of the property on December 31, 1976, is other than the value determined under the special valuation method. Under the 1976 Act, the value of marketable bonds or securities for purposes of the transitional rule is to be based on actual market value on December 31, 1976.

Under the special rule, the amount of the increase in basis is equal to the sum of (1) the amount of all depreciation, amortization, or depletion allowed or allowable with respect to the property during the period the decedent is treated as holding the property prior to January 1, 1977, and (2) the portion of the appreciation on the asset since its purchase that is assumed to have occurred during the period that the decedent is treated as holding the property prior to January 1, 1977.

The appreciation treated as occurring before December 31, 1976, is determined by multiplying the total amount of appreciation over the entire period during which the decedent is treated as holding the property by a ratio. The ratio is determined by dividing the number of days that the property is considered to be held by the decedent before January 1, 1977, by the total number of days that the property is considered to be held by the decedent.

The total amount of appreciation is computed by subtracting from the fair market value of the property on the date of the decedent's death a recomputed basis, which is basically equal to the purchase cost of the property.

3. *Example of carryover basis provision applied to shopping centers*

This complex provision can best be explained by an example of the computations necessary to arrive at the "fresh start" basis. Although the example concerns the owner or developer of a shopping center, its principles are applicable to small businessmen and other parties comprising a shopping center.

Mr. Jones died in 1979 owning a shopping center which cost $500,000 and was worth $2,500,000 at the time of his death. In his will, Mr. Jones devised the property to his son. Mr. Jones held the property for 3,000 days, 2,000 of which occurred before 1977. Total depreciation allowed or allowable on the property up to the time of his death amounted to $100,000, and of this amount $70,000 was allowed or allowable before 1977. The fair market value of the property on December 31, 1976 was $2,000,000. The adjusted basis of the property immediately before Mr. Jones' death was $400,000. For purposes of determining the son's

adjusted basis in the shopping center for purposes of future depreciation or gain on sale, Mr. Jones' basis at death is increased to the December 31, 1976 value as follows:

(a) $70,000—depreciation allowed or allowable before 1977; plus

(b) $1,333,333—$2,500,000 fair market at death less the $400,000 adjusted basis at death, less the $100,000 total depreciation taken by Mr. Jones up until his death, multiplied by the fraction $\frac{2{,}000}{3{,}000}$;

(c) $1,403.333—pre-1977 appreciation adjustment.

The son's basis for the property would therefore equal his father's basis at death of $400,000, plus the pre-1977 appreciation adjustment of $1,403,333 or $1,803,333 (plus adjustments made for Federal and State death taxes and minimum basis). This is the result even though the actual fair market value on December 31, 1976 was $2,000,000.

C. PROBLEMS WITH THE CARRYOVER BASIS PROVISIONS

Three of the acknowledged basic goals of tax reform are simplicity, fairness, and efficiency in the tax laws. The carryover basis provisions are diametrically opposed to all three of these goals.

1. Simplicity

The concept of tax simplicity refers to the ease of administration and comprehension of the tax laws. The carryover basis rule has added greatly to the complexity of the laws which will be manifested in higher professional and administrative costs.

As illustrated above, the computation of the appropriate carryover basis which an heir will report upon the sale of property acquired from a decedent will require at least four separate sets of calculations for each item of property. These calculations are further complicated by the requirement of records substantiating the cost of these items.

For the average taxpayer, this will involve many items, perhaps thousands, bought at different times for various prices. Some of the items may have been purchased in groups without a price allocation for each item but for a total unallocated sum.

Because most taxpayers did not have notice of the necessity of keeping such records, few if any records of purchases have been maintained. Many taxpayers acquired assets with the intention of holding them until death and had no need under prior law to maintain records. They acquired such assets in good faith with thoughtful planning and now the ground rules have been suddenly and drastically changed.

Moreover, determining the purchase price of items acquired many years ago, occurs at a time when the individual-purchaser is not available to recall the transaction. In many circumstances it will be difficult even to determine the date on which the decedent acquired the property. This problem is further aggravated in situations where post-acquisition costs are associated with various items of property. Without adequate records the potential for disagreement and litigation between the taxpayer and the federal government is enormous.

Consider the confused situation where an individual purchased property in 1960, added to it again in the form of land and/or building in 1965, then put an addition on the building in 1970. How can one possibly determine the basis under these circumstances under the prescribed "fresh start" formula?

2. Fairness

(a) *Erroneous assumption of ratable appreciation.*—The "fresh start" formula which determines the carryover basis as of December 31, 1976, arbitrarily prorates appreciation over the period from the date a business first began to the date of death of the owner. The formula is based on an erroneous assumption that the appreciation in the value of the property occurs ratably over the period the decedent held the property. This assumption is invalid and inequitable when applied to property where the actual rate of appreciation prior to January 1, 1977 is greater than the rate of appreciation after Janury 1, 1977. The example above illustrates this inequitable result.

With respect to a shopping center, the execution of long-term leases prior to the completion of the project substantially enhances the value of the center. As the appreciation rate of the shopping center slows down, the longer the owner keeps the shopping center, the greater the amount of value which will be subject

to capital gains tax. For example, if a shopping center is constructed in January, 1975 and long-term leases are executed in March, 1975 and the owner of the shopping center dies in January, 1980, the "fresh start" formula would pro-rate appreciation evenly over the full period the decedent owned the shopping center even though substantially all of the increase in value occurred before December 31, 1976. This would preclude the heirs of the decedent-owner from a proper stepped-up basis reflecting the more rapid appreciation rate occurring prior to January 1, 1977.

Assume that the shopping center was owned equally by two partners. The heirs of the two partners would be arbitrarily treated differently where one partner dies early in 1977 and the other partner dies many years later, even though there may be very little difference in the value of the shopping center between the two dates of death.

Similarly, the heirs of a decedent who developed a shopping center many years ago would have a significant difference in their tax treatment compared to the heirs of a decedent who developed a shopping center in the 1970's.

(*b*) *Discrimination against small business.*—This inequity will encourage heirs of a decedent-owner to dispose of a shopping center by means of a tax-free merger. Instead of selling for cash and paying a large capital gains tax on the gain resulting from the lower basis, the heirs will look for a tax-free combination with a larger enterprise. The affect of the carryover basis provision, thus, is to encourage mergers between small business and larger companies. Because of the desirability of merger, moreover, the heirs will be in a weaker negotiating position vis-a-vis, a larger company, and the law results in a discrimination in favor of big business at the expense of small business.

(*c*) *Failure to account for actual inflation rate.*—The "fresh start" formula also fails to account for the high rate of inflation occurring during the several years preceding December 31, 1976. This rate was significantly greater than the present or reasonably foreseeable rate of inflation. The formula thus arbitrarily denies an heir the higher step-up in basis for pre-January 1, 1977 inflation and unrealistically requires a lower basis for the property.

(*d*) *Discrimination against owners of property other than marketable securities.*—The "fresh start" formula also discriminates against small business owners and holders of property other than publicly traded bonds and securities. The quoted price of listed securities on December 31, 1976 determines the basis on that date, but other property is arbitrarily deemed to be a value determined by a mere proration from the acquisition to the value at date of death. Holders of securities in small businesses, many of whom are tenants in shopping centers, are penalized because they have no public market. This is aggravated by the fact that very small companies have their greatest growth during early years and the rate of appreciation levels off as companies approach their maximum potential and their founders age. Moreover, this formula discriminates against real estate developers, especially shopping center developers who initially create the value in their assets during the development and construction periods of the project—in contrast to taxpayers who make substantial initial capital investments and thus have a relatively higher initial cost basis.

3. Revenue raising efficiency

Income tax revenues are generated only if the heirs sell the property acquired from the decedent.—According to legislative history, the reduced tax on capital gains was designed to encourage the sale of assets so that capital can flow to new enterprises and move into new industry. The carryover basis provision has an opposite incentive which encourages heirs of property acquired from a decedent to hold on to the property unless it can be transferred by a means of a tax-free merger as discussed above. As a result, investment capital, rather than having the mobility desired by Congress, may become frozen, thereby limiting the supply of capital required for economic progress and depriving the Treasury of revenue from its accretion. This is particularly serious in light of the necessity to encourage capital formation in industry.

The following example of "negative basis" property illustrates a potential reason for the reluctance of heirs to sell appreciated property acquired from a decedent which is subject to a mortgage or other liability.

Assume that the decedent bought real estate in 1960 for $20,000; the real estate appreciated in value to $150,000. The decedent took out a loan secured by a mortgage in the amount of $100,000 on the property and died when the property—apart from the mortgage—was worth $110,000. Assuming that the

"fresh start" adjustment and the addition of the estate taxes on appreciation raise the decedent's $20,000 basis to $70,000 for his daughter to whom he left the property by will. The heir thus acquires property from the decedent with a net worth of $100,000 to her ($110,000 minus $100,000 mortgage). However, if she sells the property, she will have a taxable gain of $40,000 ($110,000 minus $70,000 basis). If she is in the 35% tax bracket, the sale costs her a tax of $14,000 (35% of $40,000). The tax would be $4,000 more than her economic benefit of $10,000. Consequently, she would incur an economic loss and would not sell the property.

The 1976 Act has enhanced the "lock in effect" of a large gain in the value of an asset. The testator-to-be used to be locked in to a gain, knowing that it would disappear for income tax purposes if he would hold the property until death. The heir is now also locked in. This carryover of basis thus promotes ever increasing concentration among successive generations of a successful wealth-accumulating family, as each heir faces a substantial tax if he disposes of the appreciated property. This provision provides a permanent disincentive to sell appreciated property which becomes greater the longer the property is held.

D. RECOMMENDATIONS

Because of the complexity and problems created by the carryover basis provisions, we recommend that these provisions be repealed.

A less desirable alternative would be to permit assets owned by a decedent prior to 1977 to fall within the provisions of the old law. This would be a great step toward alleviating some of the hardships and gross inequities inherent in the new law.

Gains on property previously acquired would still be subject to income taxation when sold by living owners, and there would be notice so that adequate records could be kept for use where the sale was eventually made by an estate or by heirs.

We also recommend that if the carryover basis provisions remain in the law that they be amended to give taxpayers the option of either computing a basis under the "fresh start" formula or establishing a date of death value or basis by an independent appraisal. This would also alleviate much of the burdens and inequities existing in the present law.

If, because of the very complex and substantial problems presented by the carryover basis provisions and the relatively short time for study of these provisions since the enactment of the 1976 Act, the time for immediate action is inadequate, we recommend that the provisions be amended to apply prospectively from a future date. Setting an effective date sufficiently in the future (sometime after December 31, 1978) would permit banks, executors, trustees, attorneys, accountants, the Congress and other interested parties to comprehend the new rules and plan accordingly.

NATIONAL ASSOCIATION OF WHEAT GROWERS,
Washington, D.C., March 30, 1979.

Hon. HARRY F. BYRD,
Chairman, Subcommittee on Taxation and Debt Management Generally, Senate Committee on Finance, U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: The National Association of Wheat Growers, a commodity organization representing wheat producers in the states of Arizona, California, Colorado, Idaho, Kansas, Minnesota, Montana, Nebraska, New Mexico, North Dakota, Oklahoma, Oregon, South Dakota, Texas, Washington, and Wyoming, wishes to express its support for the repeal of the carryover basis provision established by the Tax Reform Act of 1976.

Prior to the enactment of this provision, beneficiaries inheriting appreciated property received a stepped-up basis on the property at the time of inheritance, and each generation of a farm family was subject to capital gains tax only on the appreciation which occurred while they owned the property. This procedure, however, was radically changed by the carryover basis provision which bases capital gains on inherited property on the decedent's acquisition price.

An efficient wheat unit requires a substantial investment in property to be economically viable. Tax policy which imposes a heavy capital gains liability on top of the regular estate tax, will force liquidation of family farm property to satisfy tax bills and lead to the division of family farm enterprises into less efficient, uneconomic units. Estates which are valued below the exemption and do not have to pay any estate tax are also hit by the carryover basis provision, if some of the

property or assets must be sold by the heir. Additional and potentially insurmountable problems can be seen in the distribution of farm property to a decedent's heirs when the property to be divided is not of equal value and carries different tax bases. Also, the determination of the basis on farmland acquired forty to fifty years ago will be extremely difficult and must be made even if the decedent's estate is exempt from any estate tax.

We see no relief from the impact of the carryover basis on family farms through an increase in the step-up basis to a higher dollar amount. Any figure which might reflect present conditions will soon be rendered meaningless by further unrealized appreciation. Repeal of the carryover is the only workable solution to the problem as it affects wheat farming operations.

We appreciate your consideration of our views and ask that they be included in the record of the Subcommittee's hearings on this matter.

Sincerely,

WINSTON WILSON, *President.*

COMMITTEE OF BANKING INSTITUTIONS ON TAXATION,
New York, N.Y., April 27, 1979.

COMMITTEE ON FINANCE,
U.S. Senate,
Dirksen Senate Office Building,
Washington, D.C.

GENTLEMEN: The Committee of Banking Institutions on Taxation is an association of officers of various financial organizations who are charged with the responsibility for tax compliance. Founded in 1913, CBIT represents nearly 60 financial institutions as set forth in the attached directory. Its membership includes representatives of most of the major trust departments in the nation.

We do not wish to join the trend to politicize the subject of carryover basis; the thrust of our Committee's statement is from the point of view of the professional executor in his role as a tax practitioner. Our membership has been actively engaged in working with complexities of carryover basis and has encountered a variety of substantial difficulties. Statements from various individual member banks will be found in the appendix. These statements are extracted from comments by the following banks:

Chase Manhattan Bank, N.A.
Chemical Bank.
Garden State National Bank.
Morgan Guaranty Trust Company of New York.
New Jersey Bank.
Provident National Bank.

I. *Complexity Defeats Compliance.*—Our experience to date proves that the entire concept is extremely complex for most executors, attorneys and testators. In a very substantial number of cases we have found that most people have not kept correct and complete records of costs and dates of acquisition.

The law may be unenforceable. While every estate is subject to these provisions, even those that may not file an estate tax return, we believe that most non-corporate fiduciaries have made little or no attempt to comply with the law. Furthermore, the Internal Revenue Service has abdicated its statutory function of enforcing the statutes in this area as evidenced by Form 5970 and Treasury Decision 7540, which did not answer the requirements of the law nor demonstrate ability so to do by the IRS.

II. *Is There Really a Loophole?*—The current trend in legislation is directed toward reduction of tax on capital gain as evidenced by recent legislation. Carryover basis is in conflict with this trend. Appreciation in assets is subject to the estate tax on death so that carryover basis is an added tax burden. Some consider the traditional "step-up" on death to be a "loophole" for income tax purposes. What is a "loophole" or is not is really a philosophical and political question. For example, there are those who suggest that not subjecting the proceeds from life insurance to income tax is also a loophole—most would disagree with this conclusion.

Most appreciation in assets results from inflation. The asset has not increased in value; rather the dollar has decreased. Witness the fact that the Consumer

Price Index based upon 1967 as 100 has just crossed 200. This leads us to the concept of "indexing" which would also be a burden to administer.

Capital gains are certainly not the same as interest, dividends and wages. Most nations do not tax capital gains at all, and those few that do, have rates much lower than in the United States.

III. *Is Cost Worth the Results?*—Carryover basis provisions have proven to be far too costly to administer by those who have made tne attempt. Added to this burden are the lengthy and complicated computations necessary to compute the fresh start or Section 1023 adjustments particularly where a marital or charitable bequest is made. This problem is compounded when there is one simple "line adjustment" on audit of the estate tax return since it will cause a recomputation of all adjustments.

Dealing with carryover basis is an extremely expensive procedure, the cost of which must ultimately be borne not only by an estate but also by the public generally. For examples, see attached exhibits. Chase Manhattan estimates an additional $50,000 of expense annually. Chemical Bank has already experienced a 15 percent increase in time to administer the average estate. Morgan Guaranty cites an example where 100 hours of time was consumed in determining the cost basis of certain property.

IV. *Solution is Repeal.*—If loss of revenue is a factor, then the tax rates for taxable estates of $5,100,000 or more may be increased to make up for the loss in revenue.

Banking institutions acting as professional fiduciaries feel that it is in the best interest of the public we serve to recommend repeal of this statute. We make this recommendation even though the more complexity that is enacted into the tax law the greater the opportunities for the appointment of a professional fiduciary such as ourselves. Nevertheless, we support the repeal of this ill-conceived plan of taxation.

In reviewing the various alternatives proposed, we note that for the most part all take into account the decedent's basis. This is the crux of the problem. It is our recommendation that if an alternative is found necessary, it not be dependent upon the cost basis of the decedent.

Respectfully submitted by,

COMMITTEE ON BANKING INSTITUTIONS ON TAXATION,
By ROBERT A. GARBER, *Vice Chairman.*

THE CHASE MANHATTAN BANK, N.A.,
New York, N.Y., January 11, 1979.

MR. RICHARD J. BUSHELON,
Vice President, United States Trust Co.,
45 Wall Street, New York, N.Y.

DEAR DICK: CBIT Response on Carryover Basis.

In response to your memo of January 5th, a canvass of our administrative officers and estate tax staff reveals that in approximately one-half of all estate assets administered since the 12/31/76 carryover basis rules no determinable cost basis could be found and 12/31/76 values were employed.

The most severe case was one estate of 300 listed securities where through the years the assets had passed through a number of brokerage accounts and street names and the decedent maintained no cost records. In this instance over $20,000 in long term gains resulted from the use of 12/31/71 values with no offsetting losses.

In those instances where some records were available, invariably the establishment of cost became an after hours or weekend activity on the part of the administrator since our work loads are such that they do not easily adjust for additional non-fee productive jobs.

In my earliest estimate I projected that carryover could add $50M to my tax expenses and have no reason to change this estimate based upon our experience to date.

Sincerely,

Jack
JOHN K. DALY,
Vice President.

MARCH 2, 1979.

RICHARD B. COVEY, Esq.,
Carter, Ledyard & Milburn, Esqs.,
2 Wall Street, New York, N.Y.

DEAR DICK: In response to your recent request for information concerning the Chase experience with carryover basis in estates, a canvass of our estate administrative officers and our estate tax staff reveals that in approximately one-half of the 30 estates administered between the 12/31/76 introduction of the carryover basis rules and the announcement of the postponement of the effective date, no determinable cost basis of assets could be found and 12/31/76 values were employed. In the case of tangible personal property no basis could be found in all 30 estates except for a few recent purchases discovered in check books. We detected no discernible trend that the size of the estate influenced the development of basis information. If the decedent was a careful recordkeeper, facts to determine basis existed. If the decedent was careless, no useable records could be found. The one significant discovery we made was that if the decedent had maintained either a custody or investment management account with our bank and subscribed to our tax service, rather complete basis record as to securities were in our possession.

The most serious case we encountered was one estate of 300 listed securities where the decedent was a heavy trader and through the years his assets had passed through a number of brokerage accounts and street names and the decedent did not maintain cost records. Estate Counsel engaged the services of an outside broker who devoted 57 hours to research at $50 an hour and produced nothing in the way of usable basis records other than a bill for the estate for $2,850.

In those instances where some records were available, invariably the establishment of basis became an after hours or weekend activity on the part of the estate administrator as our account work loads are such that they do not easily adjust for additional non fee productive jobs.

In my earliest estimates to Bank Management, I projected that carryover and the introduction of systems to maintain these records could add $50,000 per annum to Trust Department expenses and I have no reason to change this estimate based upon our experience to date.

Cordially,

——— ———,
Manager, Tax Services Group.

CHEMICAL BANK—INTEROFFICE

FEBRUARY 16, 1979.

To: John Fisinger V. P.
From: Paul F. Feilzer.
Subject: Administration of Estates in reference to establishing information to determine tax basis of assets in accordance with the Tax Reform Act of 1976.

Since the 1976 Tax Reform Act took affect on January 1, 1977, 170 New Estates have entered Administration under the authority of The Chemical Bank as Executor, Co-Executor or as agent for individual fiduciaries. The additional time and personnel used in the administration of these new estates has been considerable.

The efforts of the Estate Administration staff is outlined below, but does not take into consideration the time spent by the Fiduciary Tax Department, who must calculate the tax basis of assets, when and if adequate information can be obtained. I know that this procedure takes a great deal of time in itself.

As of January 1, 1977 the Estate Administration officers and administrators made extensive reviews of all records on decedents after January 1, 1977. This procedure included the collection of all of the decedents records (when available), including check records, investment records, personal correspondence, tax records, statement of paid bills, inventories of tangible property, and, interviews with associates and business partners. Although this review would ordinarily appear impressive, the facts show that in the majority of Estates the decedent did not maintain records that provided the necessary information to prepare new basis information.

The Estate Administration staff has spent many hours on each new estate, in review of check book records to determine when stocks, real property or tangibles were acquired. In most cases, the assets were purchased and/or received by the decedent in years prior to the records available. (On average, most estates have available checking records for six to eight years prior to death).

It is a very rare case, when we find detailed records that describe a period longer than ten years. Most assets of v lue that have appreciated on date of death, were owned for twenty or thirty years. This is particularly the situation in regards to personal property, real estate and stock interests.

We have found that it is not the exception, to find literally no records at all. This situtaion exists in the $100,000 estates and the $1,000,000 estates. Even in these situations, (where no apparent records are found) the estate administration staff will spend several days looking for records, and duplicating information that may be found. For instance, duplicating stock and bond certificates to record registration dates (which will be lost when these assets are transferred into the estate names). The registration dates often give a clue as to when a stock may have been acquired, but in no way can this information be considered accurate. Checkbook records are reviewed, a procedure that often takes several days. When checkbook records are not available, attempts at receiving duplicate records from banks has proven fruitless.

For one reason, bank records are usually destroyed after a period of years, and, if records are available the effort needed by the issuing bank to recover the records is often very time consuming. Another bank does not want to take the time of their staff to recover old records on an account that is usually closing, or may have closed several years prior to a decedents death. Even in cases when Chemical Bank as Executor, has offered to pay the other bank for their efforts, we have not been able to obtain adequate information. In most cases it is simply not available.

The exception to the above, is in those estates where the decedents employed an accounting firm to audit their records, or, when a decedent had an investment advisory account at Chemical or another banking or investment institution. There are several estates that fall into this category, but for this procedure the decedent paid accounting and/or investment fees of several thousands of dollars a day.

The time spent on obtaining (trying to) information to properly document estate records in accordance with the 1976 law, has averaged almost 15 percent over and above the average estate administration time. Even with this extra time, proper information has not been found in the majority of the accounts.

I understand, that in those estates where complete information was found, that there still remained many long days by the tax department before proper basis information was calculated.

GARDEN STATE NATIONAL BANK,
Paramus, N.J., February 2, 1979.

Mr. RICHARD J. BUSHELON,
Secretary, Committee of Banking Institutions on Taxation, United States Trust Co., 45 Wall Street, New York, N.Y.

DEAR MR. BUSHELON: I am writing with respect to the carry-over tax costs about which you wrote over a month ago. Our greatest difficulty is learning the decedent's costs. The fresh start valuation on listed securities is useful for one set of adjustments only.

In the suburbs, real estate frequently is an asset, but no cost records are found.

Example A. (46-02856). Real property acquired by decedent as vacant land. Executor can find no records of cost of construction or otherwise finds obviously incomplete records.

Example B. (41-02549). Improved real property acquired by decedent who from time to time made additions and improvements. Executor has copy of original closing statements but has no knowledge of dates and costs of improvements and additions.

Personal effects present a similar problem where the value at death greatly exceeds the $10,000 exclusion. Stamp collections, coins, and various collections are other examples. Under that Example A (46-02856), we have an estate with a collection of paintings appraised at $110,000. The decedent displayed the collection as being entirely of old masters that he had acquired at various times at bargain prices. Upon death, it was found that many were not genuine but were good pictures by artists of the same period who commanded lower prices. Our question is whether or not there was a loss on the basis of the decedent's

costs? There are no formal records of the purchases. Although we do have checkbooks, we have no knowledge who sold him the paintings.

Parenthetically in this estate, recomputing the Federal Income Tax Return of the Executor under the 1978 Tax Reform Act resulted in additional Federal income tax.

Although we have some records of man hours employed in working out the carry-over cost basis in estates, these records are not complete. We have not had the staff to have someone work uninterruptedly on such matters. I am informed that we estimate we must budget 15 minutes per investment when costs are known. Without costs, we estimate the time to be fifteen minutes to one hour per investment.

Example A. (46–02934). In an account having 59 securities with an accountant who could supply most of the initial costs, four and one-half (4½) hours were consumed in developing costs of those few investments for which there were no records.

Even when the decedent's costs are on his records, we find such records are not complete when the investments include stocks of corporations which characteristically pay "return of capital" dividends. Usually the decedent takes no notice of the fact that such dividends result in a reduction in his cost basis.

Example A. (41–02854) (46–02934):

American Electric Power Company, common.
Central Vermont Public Service, common.
Pacific Telephone and Telegraph Company, common.
Philadelphia Electric Company, common.
Consolidated Edison Company of New York.

Example B.:

Pacific Gas and Electric Company, common.
Hackensack Water Company, common.
Public Service Electric Company, common.
General Public Utilities, common.
United Corporation, common.

We have no experience after the carry-over basis became effective with estates holding E. I. duPont deNemours stock. You will recall that many years ago there was a spin-off of General Motors capital stock. There is a foreseeable calculation in estates having holdings of duPont before the spin-off dates. The General Motors stock will be a part of the computation if that stock is also on hand at death.

You will observe that the latter two kinds of adjustment that stockholders are required to make themselves on such holdings call for a measure of knowledge and recollection by the fiduciary. Because it is not self-evident which corporations paid "return of capital" dividends, the fiduciary must investigate *ALL* stocks to make sure the costs are properly adjusted.

Very truly yours,

JOHN P. ROSE,
Senior Vice President.

MORGAN GUARANTY TRUST CO. OF NEW YORK,
New York, January 31, 1979.

MR. RICHARD BUSHELON,
Vice President, U.S. Trust Co.,
New York, N.Y.

DEAR DICK: In accordance with your letter of January 5th, I have attached data on several estates in which the determination of cost basis has been particularly troublesome.

With respect to carry over basis itself I think our committee's position in favor of repeal is correct. As for any alternative, I believe we should oppose any plan that requires the determination of the decedent's cost basis such as the taxation of gains at death. A discounted valuation of a percentage each year with a maximum limitation on the total discount might be an acceptable substitute provided the annual percentage was not too high. For simplification there should be no adjustments to this discounted value. One drawback of this route would be that tax cost figures and estate tax values would be different and might well lead to administrative problems.

Perhaps the best and most simple route would be an additional estate tax of a certain percentage or a scaling back of the unified credit or a combination of both. This puts us basically back to pre 1976 reform act law.

Finally, it is conceded by just about everyone including the Treasury that carry over basis is incapable of administration and in order to correct some of its defects changes have been suggested that would eliminate all but 2% of all estates from its provisions. It seems to me, and I think that this point should be emphasized, that if carryover basis is bad law for 98% of all estates it is bad law for 100% of them and 2% should not have to suffer under a bad law merely because of their size.

Sincerely,

BOB
ROBERT F. NEUBURGER,
Vice President.

CARRYOVER BASIS EXAMPLES

Case No. 1

This estate included a stamp collection of over 500,000 stamps held in a corporation of which the decedent was the sole stockholder. After many hours of research it was determined that it was imposisble to determine the decedent's costs. However, since the estate was primarily distributable to charity, the tax problem was mitigated. In this same estate over sixty hours time was spent in determining the cost of some of the decedents securities. For other securities it was impossible to determine costs.

Case No. 2

This involved a very substantial estate where the tangible personal property exceeded $5,000,000.00 covering thousands of items acquired over a prolonged period of time. Over 100 hours time was spent in determining the cost basis of these items from the decedents records. Some costs were impossible to determine.

Case No. 3

This estate involved a very elderly lady who had no cost records for either her personal property or securities. Her brokerage firm is no longer in existence nor was possible to secure any information from transfer agents. In all, over thirty hours were spent in a futile effort to determine costs.

NEW JERSEY BANK, N.A.,
Paterson, N. J., January 18, 1979.

Mr. RICHARD J. BUSHELON,
United States Trust Co.,
45 Wall Street, New York, N.Y.

DEAR MR. BUSHELON: I am responding to your letter of January 5, 1979 wherein you ask us to supply you with examples where we have had difficulty with carryover basis. We have had a few problems in this area which this letter will outline:

1. Specific examples of cases in which proof of basis was not possible: a) we had a decedent who had inherited stocks from her mother and father's estate who died in the 1920's and 1930's. The Estate tax returns of the parents were not available and there were no colse relatives to confirm dates of death. b) we had a decedent who was single with no close relatives and had acquired stocks and bonds through purchases and kept no records. The brokerage agency which the decedent had dealt with no longer had records or knew when the assets were acquired.

2. Specific example of cases in which determining the basis involved an extraordinary amount of time and expense in relation to the size of the estate: we had a decedent who acquired stocks and bonds through purchases, inheritance, and subscriptions. Only the brokerage slips were kept. Tax costs had to be worked up by hand checking all capital changes for each lot. Sometimes we had to ask for quotes from brokerage agencies if only the dates of acquisition were available.

If I can be of any further assistance to you please do not hesitate to contact me.

Would you please correct your mailing list to reflect the correct address of Mr. Richard F. Ward, a member of CBIT, as follows:

c/o New Jersey Bank, N.A.
P.O. Box 2177,
Paterson, New Jersey 07509.

Sincerely yours,

(Mrs.) GAIL M. CASS,
Tax and Accounting Supervisor.

PROVIDENT NATIONAL BANK,
Philadelphia, Pa., January 15, 1979.

Mr. RICHARD J. BUSHELON,
Chairman, Conference Committee, Committee of Banking Institutions on Taxation, % United States Trust Company of New York, 45 Wall Street, New York, N.Y.

DEAR MR. BUSHELON: In response to the Committee's request for information describing specific examples of problems encountered with carryover basis, we are pleased to submit the following:

1. Specific examples of cases in which proof of basis was not possible and the reasons.

a. In an estate grossing more than $1,500,000, the decedent had absolutely no records of cost bases or dates of acquisition of any of his assets. Repeated, strenuous and very time-consuming attempts were made by the Bank, counsel for the Estate, the individual Co-Executor, who was a close business associate and friend of the decedent, and the surviving spouse to uncover information relating to basis; but it was impossible to do. Causing the greatest problems was the decedent's tangible personal property—more than 400 items valued over $332,000. The lack of information concerning both cost bases and dates of acquisition made it impossible to even estimate the carryover basis of these items. Although the amendment by the Revenue Act of 1978 to Section 1023(h) of the Code could be assumed to have provided some relief for us in this specific estate, this would definitely not be true if death had occurred even during the early 1980s, since no assumption could be made validly which items, if any, of this property had been owned by the decedent on December 31, 1976.

b. To date, our experience has shown that it is impossible to definitively establish bases of assets in more than 25 percent of the estates we are handling because the needed records are not available either among the decedent's papers or from any other sources, such as stock brokers, attorneys, or other lifetime advisers.

2. Specific examples of cases in which proof of basis involved an inordinate amount of time and expense in relation to the size of the estate.

a. During his life, the decedent was an extremely active trader (not a broker) of securities. Although he had maintained reasonably good (although not always legible) security records, the sheer number of individual assets owned at death involved an inordinate amount of time and expense required to be devoted to computing carryover basis in relation to the size of the estate. The estate was valued at $580,000, composed primarily of more than 120 individual securities, representing over 200 individual tax lots. The time required to prove the basis of these assets consumed more than 80 hours, considerably increasing our costs (including overtime wages) for the administration of this estate.

b. In 1972, our customer purchased for $10,000, 897 shares of a mutual fund. Dividends were reinvested in additional shares, and she receives a $75 quarterly cash distribution from the fund. Although our customer is still living, we felt that it was advisable to develop cost information concerning this asset now, rather than in the future. As of December 31, 1977, the total holding was valued at approximately $13,100, and was composed of 29 individual tax lots. It required 19 hours to compute the basis for each lot of this asset.

3 The details of any time studies made by trust institutions or law firms in complying with the carryover basis requirements, and particularly the proof of basis aspect of the law.

a. A time study of the work involved with carryover basis was made by an in-house specialist in that field. Based on a detailed collection of data during a continuous six-week period, it was concluded that, on average, 52.9 minutes was required per asset per tax lot to handle the requirements of carryover basis. Although the study did not allocate this time between proving basis and computation of the adjustments to basis, it can be categorically stated that at least two-thirds of the total time, or 35 minutes, is required to prove basis. Moreover, the study did not include any time required for re-computation of adjustments to basis by reason of changes in estate of inheritance tax liabilities, which would tend to further increase the amount of time needed to fulfill the requirements of the carryover basis law.

We have provided the American Bankers Association with a similar response to their request for this same information.

Please let us know if we can provide you with further information or assistance in any way.

PAUL A. GERNEY,
Vice President.

LAW OFFICES OF MILLER & CHEVALIER,
Washington, D.C., June 15, 1979.

Hon. HARRY F. BYRD, Jr.,
Chairman, Subcommittee on Taxation and Debt Management Generally, Committee on Finance, U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: Pursuant to the Subcommittee's press release of January 31, 1979, the following comments are submitted to encourage the Subcommittee and the Congress to repeal the carryover basis provisions of the Internal Revenue Code. These comments are submitted on behalf of the H. E. Butt Grocery Company of Corpus Christi, Texas, a family business of the type which Congress has frequently sought to protect but which could be subjected to serious injury if carryover basis remains in the tax law.

The Subcommittee has been presented with ample evidence that carryover basis is unworkable and unfair. It is unfair to the investor, and especially the entrepreneur, who is confronted by a radical change in the tax rules applicable to his investment. It is unfair to the executor, who bears the brunt of the enormous administrative burden imposed by carryover basis. And it is unfair to the heir or other recipient of carryover basis property.

UNFAIRNESS TO THE INVESTOR

Small businesses in America derive their strength in large part from the willingness of investors and entrepreneurs to risk their capital in new and developing business ventures. In the context of the family business, it cannot be gainsaid that an important, and often paramount, factor in motivating such investments is the prospect of passing the business on to one's descendants, free from substantial encumbrances. The potential income-tax liability imposed in a carryover basis system is such an encumbrance. It is true that the tax is not due until the business or part of the business is sold. Meanwhile, however, like an unpaid mortgage, it will limit the beneficiary's freedom and frustrate the businessman's natural ambition to pass the business on to his children intact. To the extent that any business property must be sold to pay administration expenses and taxes, including the new income taxes imposed on such sales under carryover basis, the difficulties of passing a family business intact to one's descendants are only aggravated.

At the hearing on March 12, 1979, members of the Subcommittee correctly pointed out the particularly oppressive effect of carryover basis on small businesses. In the estate tax provisions of the Tax Reform Act of 1976, Congress revealed a commendable concern for small businesses, in providing for special valuation, deferred payment of estate taxes, and, more generally, an estate tax credit equivalent to an exemption substantially greater than under prior law. Nevertheless, with the enactment of carryover basis, also in the Tax Refrom Act of 1976, Congress may well have taken away with one hand even more than it had intended to give with the other.

Continuing concern for small businesses in the present Congress is indicated by the introduction of various bills, including S. 545, to increase the amount of depreciation allowed with respect to certain small business property, by Senator Chafee, a member of the Subcommittee; S. 653, the "Small Business Capital Preservation Act of 1979," by Senator Nelson, chairman of the Committee on Small Business; and S. 655, the "Small Business Investment Incentive Act," by Senator Weicker, the ranking Republican on that Committee. To honor its demonstrated commitment to small businesses, it is necessary that Congress relieve them from the burdens of carryover basis.

UNFAIRNESS TO THE EXECUTOR

Perhaps the most conspicuous burden imposed by carryover basis is the burden of determining cost basis itself. It is one thing to expect a living person to recall the cost of property he has acquired long ago. It is an almost impossible task for his executor in the absence of complete records. It must be remembered that

in family businesses which have grown from small beginnings to substantial enterprises, the recordkeeping in the early stages of development may have been minimal. In a noninvestment context such as the acquisition of household goods, records of cost simply do not exist. It is no answer to provide a so-called "minimum basis," like that contained in § 1023(h)(3) of the Internal Revenue Code. An executor is a fiduciary, under a high standard of duty to the beneficiaries of the estate, including, we suggest, the duty to establish a basis higher than the minimum if he can. Moreover, the minimum basis provided under § 1023(h)(3) is available only for computing the "fresh start" adjustment for property held on December 31, 1976. Thus its availability will decline as time passes. The assumption seems to be that in response to the 1976 Act the public has now begun to keep complete records. That this will never be the case is illustrated daily to those involved with the administration of decedents' estates.

Even where it is possible to determine or reasonably estimate the carryover basis, the process will greatly increase the expenses of administration. Moreover, because of the many complex interrelated computations required, the process will be slow. At the same time, the executor will be required to raise the cash needed to pay debts, taxes, and expenses—frequently by selling assets for which a basis has not been finally determined. In other words, he will be selling blind, without the opportunity to assess the tax consequences of his actions that simple fairness dictates every taxpayer should have. Under present law, in effect through December 31, 1979, the executor always has that opportunity. He can be certain that the basis of any property he sells will be its value on the date of the decedent's death. Even if he later elects the alternate valuation date provided under § 2032, he knows that the basis of any asset sold before that date is its value on the date of sale.

Under carryover basis, once an executor does determine basis, if he can, he still faces the formidable task of distributing property to beneficiaries in a manner consistent with his fiduciary duty to treaty all beneficiaries equally. The proponents of carryover basis have not suggested how the executor can do this when he must consider not only the value of property he distributes, but also the large potential income-tax liability he thereby imposes on beneficiaries. While executors have experience under present law dealing with the appreciation that occurs during the administration of the estate, these amounts of appreciation are scarcely to be compared with the unrealized appreciation accumulated during a lifetime (or even successive lifetimes) that the executor in a carryover basis system would have to allocate among beneficiaries.

Proponents of carryover basis sometimes charge that professional fiduciaries and tax practitioners have had no difficulty employing carryover principles in the case of lifetime gifts and income in respect of a decedent. But these alleged precedents are by no means the same. A gift, unlike death, is a voluntary act, and a carryover basis is an appropriate means of preventing abuse. The property which is the subject of a lifetime gift is specifically selected for that purpose, and the gift tax return provides a record of the basis, made by the donor while he is alive. Moreover, the donor of a lifetime gift is not a fiduciary and has no duty to treat donees equally. Income in respect of a decedent, on the other hand, typically results from a recorded transaction, frequently entered into only shortly before death, and generally basis is considered to be zero in any event.

Under carryover basis, the executor's problems are aggravated by his increased need for cash to pay the income taxes generated by his sales, even when those sales themselves are compelled by his need for cash to pay debts, expenses, and other taxes. As previously stated, when Congress passed the Tax Reform Act of 1976, it was clearly concerned about the liquidity of estates—especially those including small and closely-held businesses. If Congress at that time had understood the adverse effects of carryover basis on liquidity, it is doubtful indeed that carryover basis would ever have been enacted.

It is no answer to provide a minimum aggregate basis for estate assets or exemptions for various types of assets, even with the increased limits now proposed by the Treasury Department. Estates which fall below the limits will be benefited because, for those estates, carryover basis will have been effectively repealed—which is the correct solution. But executors of estates above the limits will have all the problems previously described, plus the additional problem of selecting the property to be eligible for the various exemptions, all within the rigid requirement that a fiduciary treat all beneficiaries equally. Thus, any rationale for such exemptions and exclusions applies with equal force to estates

of any size and compels the conclusion that carryover basis should be entirely repealed.

Finally, either of the currently proposed alternatives to carryover basis—a capital gains tax at death or an additional estate tax on unrealized appreciation—would be at least as objectionable. Under such alternatives, the problems of uncertainty and fiduciary duty might be somewhat relieved. But the problem of estate liquidity and the effects on closely-held businesses would be greatly aggravated. And, of course, the chief problem—the problem of determining a decedent's basis—is common to all three proposals. Only a forthright and simple repeal of carryover basis will solve these problems in a manner that is fair and administrable.

UNFAIRNESS TO THE HEIR

Carryover basis not only produces difficulties in its administration, it is unsound in principle. In the first place, the soundness of taxing any capital gain as "income" is open to considerable doubt, especially to the extent that gain merely represents the well-recognized effects of general inflation. At least it must be acknowledged that the views of reasonable people differ on the subject. Thus, the method under present law of assigning property a basis equal to its date-of-death value produces a rough compromise to compensate for inflation. As a result, under present law, the heir or other beneficiary of a decedent's estate begins to measure his taxable gain or loss approximately at the time he receives the property. In other words, his tax consequences depend on a holding period which is within his control. If he recognizes a taxable gain, it is attributable to his decision to hold the property for as long as he does, and to dispose of the property when he does, thus maintaining consistency with the fundamental principle that realization of income is somehow related to the taxpayer's voluntary acts or choices. Carryover basis subverts this principle by compelling the heir to pay tax on gain accrued during a period for which he is not responsible.

The proponents of carryover basis frequently distort the issue by referring to the result under present law as a "stepped-up" basis, thus implying a windfall to the taxpayer. Although the present law frequently produces a "stepped-up" basis, in most instances this merely reflects the fact of general inflation, for which such step-ups are rough compensation. In fact, basis under present law is simply the date-of-death value, whether "stepped up" or "stepped down." Thus, the heir is properly held accountable for both gains and losses accruing while he holds the property, and none before. For example, marketable stocks generally declined during 1977 from their December 31, 1976, "fresh start" values. When carryover basis was deferred from 1977 to 1980, some heirs of decedents who had died in 1977 found that the basis of those stocks was lower than the "fresh start" basis they would have had. In other words, some of those heirs might have actually saved income taxes as a result of carryover basis. Congress might provide transitional relief for those taxpayers who sold property in reliance on the law Congress had enacted, but carryover basis remains an unsound concept, even in 1977 when it might have saved some tax.

The unfairness of imputing to the recipient of carryover basis property the gain accruing before it comes under his control is magnified when that recipient is the executor. Proponents of carryover basis often cite the example of the two investors who decide to sell their stock and are run over by a truck one minute after the first investor has made his sale and realized his gain, but the second investor is still on his way to the broker's office and his sale must be made by his executor. Under present law, these two salse are indeed treated differently, simply because they are indeed different. The lifetime sale is a voluntary act of realization. In contrast, the executor's primary task is liquidation. In addition, he is made responsible not only for the decedent's debts but also for administration expenses, including taxes. Thus, the executor's sale is pursuant to duties thrust upon him; it is no more "volnutary" than death itself. There is no inconsistency in treating the executor's obligated liquidation differently from an investor's voluntary act to realize his gain. The mere "intention" to visit the broker's office cannot be given any tax significance, any more than would an "intention" to make a charitable donation. The law should tax only the act of realization, and for that reason both carryover basis and any alternative system of taxing appreciation at death are altogether unsound.

RECOMMENDATIONS

For the reasons stated and for other reasons amply demonstrated by the testimony and comments submitted to the Subcommittee, carryover basis should be entirely repealed.

The problems raised by carryover basis are fundamental and cannot be solved by "cleaning up" the statute. If Congress nevertheless decides to retain carryover basis in a modified form, then, as a minimum, assets acquired before the date of enactment of the legislation should be exempted. In this way, the investor or entrepreneur who has made investments over a lifetime in reliance on present law would not find the rules changed in the middle of his life or, worse, at the end of his life. Such an exception would also create the greatest likelihood that citizens would respond by beginning to keep adequate records, at least of major purchases.

Any attempt to make carryover basis acceptable, short of outright repeal, should give consideration to the special circumstances of family businesses, including the unusual problems which can be caused by illiquidity. For example, stock which is redeemed to pay death taxes and administration expenses under § 303 should be exempt from carryover basis, in addition to any other exemptions that might be applicable. Similarly, the Subcommittee should recommend an exemption from carryover basis for an "interest in a closely held business" which qualifies an estate for deferral of estate taxes under § 6166 or § 6166A. In addition, whenever any corporate stock is valued with reference to the value of the assets owned by the corporation, in accordance with Treasury Regulation § 20.2031-2(f)(2), and the underlying assets themselves would qualify for an exemption or other special treatment under the carryover basis rules, then the stock should also qualify for the same exemption or special treatment.

Consideration should be given to preferred stock, which plays a critical role in the capital structure of many closely-held family corporations. Of course, a "fresh start" adjustment will not be needed if previously held assets are excluded from carryover basis, as they should be. But if a "fresh start" adjustment is needed, provision should be made to recognize the fact that nonparticipating, nonconvertible preferred stock never appreciates above its stated redemption price, and the fiction of constant day-by-day appreciation, now reflected in § 1023(h)(2), should be abandoned. New § 1023(h)(5), which would have been added by S. 2481 in the 95th Congress and which the Treasury Department supported, would have achieved this desirable result with respect to preferred stock issued before 1977. But obviously, it is only fortuitous if stock qualifies for such a limited provision. The appreciation taken into account with respect to preferred stock issued in exchange for common stock at any time should be limited to the period of time attributable to the common stock before the exchange.

In conclusion, carryover basis should be entirely repealed, or at least its effectiveness should be made purely prospective and its severe impact on closely-held family businesses should be reduced. The Subcommittee is urged to use its best efforts to secure such a legislative solution before January 1, 1980, to avoid the uncertainty that prevailed throughout the consideration of the "Technical Corrections Act" in 1977 and 1978.

Respectfully submitted,

DAVID W. RICHMOND.

APPENDIX

BACKGROUND AND ISSUES

RELATING TO

CARRYOVER BASIS

I. INTRODUCTION

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

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

II. SUMMARY

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

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

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

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

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

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

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

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

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

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

A. Prior to the Tax Reform Act of 1976

1. *Summary of provisions*

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

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

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

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

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

2. *Previous proposals for change*

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

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

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

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

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

B. Carryover Basis Under the Tax Reform Act of 1976

1. *In general*

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

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

2. *Description of provisions*

General

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

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

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

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

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

Definition of carryover basis property

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

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

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

Adjustments to carryover basis

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

Adjustment for "fresh start"

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

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

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

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

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

Adjustment for Federal and State estate taxes

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

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

Income in respect of a decedent

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

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

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

Basis of property acquired by gift

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

Procedural aspects of carryover basis

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

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

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

C. Revenue Act of 1978

1. *Postponement of the carryover basis provisions*

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

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

2. *Technical corrections*

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

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

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

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

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

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

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

IV. CARRYOVER BASIS ISSUES

A. Tax Equity Issues

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

B. Liquidity Issues

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

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

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

C. Lock-In Issues

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

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

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

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

D. Administrative Problems

1. *Proof of basis problems*

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

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

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

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

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

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

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

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

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

2. *Fiduciary responsibilities*

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

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

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

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

3. *Complexity of computations, exemptions and adjustments*

Cost basis

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

Personal and household effects exemption

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

Fresh-start adjustment

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

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

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

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

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

Death tax adjustments

Opponents of carryover basis argue that the adjustments to basis for death taxes are perhaps the most complicating aspect of carryover basis. As indicated above, the opponents argue that there is a basic question of which property will qualify for an adjustment because only property subject to tax is eligible for the adjustment. Thus, tax consequences may be uncertain for sales by an executor, or for distributions to a surviving spouse, during the estate's administration because at that time it may not be certain as to how much property will not be

subject to the estate tax under the marital or charitable deduction. Moreover, for sales by an executor, the amount of gain for the fiduciary's income tax return may not be readily determinable until after the estate tax has been calculated finally for purposes of making the adjustment to basis. It is argued that this problem will arise frequently because the administration of many estates can span several taxable years.

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

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

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

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

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

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

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

Minimum basis adjustment

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

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

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

4. *Finality of basis determinations*

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

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

5. *Reporting requirements*

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

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

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

V. ALTERNATIVES

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

A. Single Rate Additional Estate Tax (AET)

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

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

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

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

B. Graduated Appreciation Tax at Death

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

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

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

C. Taxing Gains at Death

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

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

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

VI. TRANSITIONAL ISSUE

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

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

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

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

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VII. REVENUE EFFECTS

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

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

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

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

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

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

TABLE 1.—ESTIMATED APPRECIATION PASSING AT DEATH IN 1979

[Billions of dollars]

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

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

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

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

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

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

[Millions of dollars]

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

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

APPENDIX B

QUESTIONS SUBMITTED BY SENATOR DOLE TO TREASURY DEPARTMENT AND THEIR RESPONSES TO THEM

MARCH 14, 1979.

Mr. DONALD C. LUBICK,
Deputy Assistant Secretary for Tax Legislation,
Department of the Treasury,
Washington, D.C.

DEAR DON: Pursuant to the March 12 hearings before the Subcommittee on Taxation and Debt Management on "carryover basis," I have additional questions which will be made part of the Record. I would appreciate the answers before the hearings are resumed.

1. Please explain how life insurance is treated for minimum-basis purposes under the 1976 carryover basis rules? What is the current Treasury position?

2. The economic "lock-in" theory, is based on the proposition that an elderly person is reluctant to sell assets and pay an income tax because at death the assets will receive stepped-up basis. If there is validity to the economic lock-in theory, has the lock-in effect been reduced by the liberalization of the capital gains tax made by the Revenue Act of 1978?

3. The Committee has received testimony that carryover basis can perpetuate, rather than solve, the "lock-in" problem. Because beneficiaries of an estate will have to pay capital gains taxes when the assets are sold, under carryover basis, there will be a strong incentive to hold on to assets that have greatly appreciated in value. Which type of "lock-in" effect does the Treasury prefer?

4. Do you believe that death should serve as a taxable event? Would the Treasury support legislation for capital gains at death?

5. What is the position of Treasury on including in the decedent's gross estate cash and the basis of assets transferred within three years of death for the purposes of the minimum basis adjustment?

6. Would the Treasury support a proposal to allow the estate or the beneficiaries of an estate to succeed to the decedent's unused net operating loss? Would the Treasury support a proposal to allow the capital loss carryover to go forward into an estate where it can be used to offset gains which may be realized by the estate on carryover property?

7. It has been reported that approximately $20 billion of appreciation a year goes untaxed. Could you supply the necessary information, accounting, and explanation on how such a figure is derived?

8. The Revenue Act of 1978 permits a once-in-a-lifetime exclusion from gross income of $100,000 of gain from the sale of a principal residence for certain individuals. Under carryover basis, it appears that a sale shortly before death would, in most cases, produce a significant lower tax than a sale after death. Would you agree with this conclusion, and how do you justify this result?

9. Section 2039(a) of the Internal Revenue Code provides that an executor is required to furnish the Internal Revenue Service and the recipient of carryover basis property with certain information. Section 6994(a) of the Internal Revenue Code imposes substantial penalties of the executor do not comply with the law. What is the current Treasury position on regarding the policy of these provisions. Do you know if the Internal Revenue Service is prepared to receive, retain, and supply carryover basis information to individuals who have a legitimate need for it?

10. Under carryover basis, the sale or redemption of stock may result in a recognized gain. It is possible that multiple sales will be required to satisfy the increased income tax liability generated by prior sales. Would you agree that carryover basis could have this effect;

11. S. 2228, introduced by Senator Byrd and myself last year, provided a grandfather clause for pre-carryover basis assets. What is the current Treasury position on grandfathering pre-carryover basis assets?

12. On page 9 of your prepared statement before the Subcommittee, you stated that "there is no new tax imposed if step-up is repealed." Under step-up basis, if an estate sold property that was equal to its fair market value, there is generally no income tax liability. However, under carryover basis, it is now possible for an income tax to be imposed. Could you elaborate why the Treasury Department does not believe that this is a new or additional tax?

13. On page 10 of your prepared statement, you discuss the taxation of inflationary gains. You state that "there is no way that inflation can account for increases in the value of that magnitude." Could you provide for the Committee the amount of income tax increases that will occur this year because of inflation? Please supply data to support your statement.

14. On page 2 of your statement you indicate the "Administration is committed to the principal that income tax appreciation accrued at death should not be forgiven." However, it appears that the Treasury Department is willing to forgive the accrued appreciation for some taxpayers but not for others. Why should some taxpayers be subjected to carryover basis and possible income tax liability while others be exempt? If the old law is inequitable in your opinion, why is the Treasury Department willing to let it apply for a vast majority of taxpayers?

I will look forward to a reply at your earliest convenience.

Sincerely yours,

BOB DOLE,
U.S. Senate.

OFFICE OF THE SECRETARY OF THE TREASURY,
Washington, D.C., September 17, 1979.

Hon. ROBERT J. DOLE,
U.S. Senate,
Washington, D.C.

DEAR SENATOR DOLE: This is in response to your question of March 14, 1979, requesting answers to 14 questions for inclusion in the record of the March 12, 1979 hearings on carryover basis before the Senate Finance Subcommittee on Taxation and Debt Management.

Answer to Question 1

Under the 1976 carryover basis provision, life insurance proceeds includible in a decedent's gross estate pursuant to section 2042 are not included in the term "carryover basis property" (Section 1023(b)(2)(B).) The Treasury does not propose any change to this rule.

Answer to Question 2

The 1978 reduction of taxes on realized long-term capital gains has the effect of reducing lock-in for almost all taxpayers. However, lock-in remains significant under any system which permits taxpayers to avoid income tax entirely by holding appreciated property until death.

Answer to Question 3

As I stated in my March 12 testimony, insofar as lock-in is related to the forgiveness of income tax on appreciation in property held at death, carryover basis is a second best approach to its elimination. Lock-in is somewhat reduced for investors concerned with estate planning since carryover basis eliminates the complete forgiveness of income tax on appreciation which accrued during the lifetime of the investor. Thus, an investor who knows that appreciation will be subject ultimately to income tax will no longer take into account the unwarranted benefit provided by step-up in basis at death. However, it is also true that if the property is not sold prior to death and it continues to appreciate, the amount of capital gains tax will be greater when an heir considers selling. In this case, lock-in would be somewhat increased. As a result, in a carryover basis system, lock-in would be decreased for some taxpayers but increased for others. The net effect on aggregate lock-in cannot be determined fairly.

If lock-in due to step-up were the sole consideration, it could best be reduced by treating death as a recognition event. If unrealized appreciation was taxed at the current long-term capital gains rate at death, a significant amount of the lock-in effect would be eliminated.

Answer to Question 4

In my March 12 testimony I stated that Treasury believes treating a transfer at death as a recognition event is an entirely acceptable solution to the step-up

problem. Depending upon the form of such a proposal, Treasury could support legislation treating death as a recognition event.

Answer to Question 5

Under the present carryover basis statute, "the term carryover basis property means any property which is acquired from or passed from a decedent (within the meaning of section 1014(b))", and which is not excluded pursuant to statutory exclusions. (Section 1023(b)(1).) Under section 1014(b)(9), property transferred within three years of death is considered to have been acquired from or to have passed from the decedent within the meaning of section 1014(b). Accordingly such property, unless it has been disposed of by the transferee prior to the decedent's death in a transaction in which gain or loss is recognizable, is carryover basis property and the basis of such property is taken into account for purposes of the minimum basis adjustment.

Treasury believes this is an appropriate rule. It eliminates what would otherwise be a strong incentive for a decedent to make deathbed transfers of cash and other high basis assets to manipulate the minimum basis adjustment.

Answer to Question 6

Section 6(a) of H.R. 4694, the Carryover Basis Simplification Act of 1979, introduced by Congressman Fisher, permits a decedent's estate to succeed to any capital loss carryover of the decedent which otherwise would be lost. Upon termination of the estate, the present rules under section 642(h) would provide for the further allowance of the unused capital loss carryover to the beneficiaries of the estate. Treasury supports this provision.

Treasury would not oppose a similar provision regarding unused net operating losses provided that artificial net operating losses generated through tax shelter investments and the like are not available to the decedent's estate or successors in interest.

Answer to Question 7

The gross estates of all decedents in 1979 will contain approximately $20 billion of unrealized capital gain. Gross estates of $60,000 and above will contain an aggregate of about $16.5 billion of unrealized capital gain. The balance of $3.5 billion will be found in estates of less than $60,000.

The amount of unrealized capital gain on assets held at death is not required to determine Federal estate tax liability and is thus not reported on estate tax returns. Using income tax return information, however, a reasonably accurate measurement can be made.

The estimate of unrealized capital gain on assets held at death is made by using four basic sources of data: (1) a computer file of actual income tax returns for taxpayers reporting capital gains. (2) a computer file of actual Federal estate tax returns, (3) *Balance Sheets for the United States Economy* furnished by the Board of Governors of the Federal Reserve System, and (4) the *Statistics of Income of Personal Wealth.*

Taxpayers reporting sales of capital assets on income tax returns must report the original cost of the asset and the year the asset was purchased. For every return, the ratio of capital gain to selling price was computed for each type of asset.

Assuming the same capital gain ratios for assets held at death, the amount of unrealized capital gain in assets reported on each estate tax return was computed by multiplying the ratio relevant for each asset type times the market value of each asset type in the return. The result, $16.5 billion, is an estimate of unrealized capital gain in assets held at death for gross estates of $60,000 and above (the pre-1977 law Federal estate tax filing population). Table 1 (attached) shows the amount of unrealized capital gain by asset type.

The remaining $3.5 billion of unrealized capital gain was accrued by decedents with estates of less than $60,000. The Internal Revenue Service estimates the personal wealth of individuals with at least $60,000 of assets. These estimates are derived by dividing the value of assets of each estate tax return by the mortality rate specific to the age/sex group of the decedent. The estimate of total wealth for individuals with at least $60,000 of assets is subtracted from the estimate of total household wealth reported in the *Balance Sheets of the United States Economy.* The remaining wealth then is the value of assets controlled by individuals with less than $60,000. By assuming that the mortality rate for individuals with less than $60,000 is half that of individuals with more than $60,000, an estimate of the value of assets passing at death for pre-1977 law nonestate

tax filers was made. The relevant capital gain ratio was then applied to the value of assets yielding the $3.5 billion of unrealized capital gains.

Answer to Question 8

Under current law, the benefits of section 121, relating to the $100,000 exclusion from gain on the sale of a principal residence will not be available to a surviving spouse who has not attained age 55 even if the decedent spouse qualified for the exclusion, nor will the exclusion be available to any other heir unless that heir independently satisfies the age and holding and use requirements of section 121. Section 2(d) of H.R. 4694 provides that if a decedent's spouse could have qualified for the $100,000 exclusion if a sale were made prior to death, then the surviving spouse will be treated as having satisfied the age requirement with respect to the principal residence and therefore will be eligible for the $100,000 gain exclusion if the principal residence is sold. Treasury supports this provision.

However, Treasury does not believe it is appropriate to make the exclusion available to all heirs of a decendent who would have qualified for the exclusion had the sale of the decedent's principal residence been made prior to death The principal reason for the exclusion is to permit individuals who have owned residences which are appreciated in value over a relatively long period of time to select alternative living arrangements without regard to tax consequences. Thus, the exclusion is personal and should be available only if the residence was the principal residence of the seller. This may or may not be true in the case of an heir other than the decedent's spouse. Second, the age 55 requirement of current law, when combined with the holding and use requirements, properly limit that the exclusion to those taxpayers for whom it is reasonable to assume that the appreciation in the principal residence accrued over a relatively long time period and who have need of the realized appreciation to support their housing needs during retirement. To ignore these requirements simply because a principal residence was inherited would result in an unwarranted windfall to heirs who could not sat'sfy them independently.

Answer to Question 9

In a carryover basis system, a recipient of carryover basis property needs to know the basis of the property for purposes of determining gain or loss on a future disposition. Present law (section 6039A and section 6698) imposes upon an executor the duty to supply carryover basis information to the recipient of carryover basis property and imposes penalties for failure to comply with this reporting requirement unless the executor can show that the failure to comply was due to reasonable cause and not willful neglect.

Many tax professionals have suggested that a procedure be developed pursuant to which executors could achieve a final determination of basis, binding upon both the executor and the Internal Revenue Service, at the time of audit of the decedent's estate tax return. Those who have recommended this procedure believe it is essential to resolve basis uncertainties and simplify the long-term administration of carryover basis.

Treasury agrees with this suggestion. Section 2(b) of H.R. 4694 creates a procedure to enable the basis of any or all items of carryover basis property to be determined at the time a decedent's estate tax is audited. As a part of this procedure, an executor will be required to report the initial basis of each item of carryover basis property on the decedent's estate tax return. Thus, the Internal Revenue Service will have and retain this carryover basis information and will be in a position to supply the information to the recipients of carryover basis property if the information supplied by the executor is lost.

The requirement that an executor supply carryover basis information to a recipient is retained in H.R. 4694. However, the penalties for failure to supply information with respect to carryover basis property have been revised to take account of the new procedures regarding basis reporting and determination. Penalties would be imposed under H.R. 4694 only where the executor's failure is due to negligence or intentional disregard of rules and regulations.

Answer to Question 10

Income tax liability will arise in a carryover system when appreciated property is sold. That is a necessary and intended consequence of carryover basis. Moreover, it may also be necessary for an estate to sell additional property to raise funds to pay the income tax arising from the first sale. Indeed, some have expressed concern that this "mushrooming" income tax, arising fro a the end to

sell appreciated property to raise funds to pay death taxes, will result in the forced sale of farms and closely-held businesses.

Two provisions of H.R. 4694, taken together, eliminate this concern. First, section 7 of the bill combines into one section the two provisions of existing law which permit the deferred payment of estate tax attributable to closely-held businesses and farms. The new section contains the more generous provisions of each of the two existing provisions. Thus, in applicable cases, payment of estate tax attributable to a qualifying closely-held business or farm is deferred for five years and the balance may be paid in up to 10 annual installments commencing in the sixth year after death. These changes should, in most cases, eliminate forced sale of property to pay estate taxes.

In some cases, however, it may still be necessary to sell property. Absent specific relief, the sale of appreciated carryover basis property will result in income tax liability. Therefore, H.R. 4694 contains a special provision which allows the basis adjustment for estate tax to be allocated to property equal in value to the sum of death taxes and administration expenses. Thus, so long as successive heirs continue to own and operate the business or farm, no income tax liability will arise when property is sold to pay estate tax. Moreover, this provision provides some investment flexibility because there is no requirement that the sales proceeds actually be used to pay death taxes or administration expenses.

The net effect of these provisions is a more generous combination of liquidity relief than exists at present. I attach as Appendix A two examples illustrating their operation.

Answer to Question 11

The Treasury Department continues to oppose the "grandfathering" of all assets acquired prior to the effective date of the carryover provisions. When originally enacted, Congress made the policy decision to subject only appreciation occurring after December 31, 1976 to income tax. This decision recognized that it would be arbitrary and inequitable to have tax consequences turn solely on the date of acquisition of an asset.

We are aware of some difficulties that have been encountered in the determination of basis of assets acquired prior to the effective date of carryover basis. Items of tangible personal property and personal residences have proved particularly troublesome. Also, the statutory formula enacted by Congress in 1976 to determine the value of nonmarketable property held on December 31, 1976 has tangible personal property which was a capital asset in the hands of the decedent. caused difficulty because the computation required under that formula requires knowledge of the acquisition date and cost of property subject to the formula.

The proof of basis problems to which "grandfathering" is apparently addressed can be solved in a less drastic and more equitable manner. In my March 12 testimoney I set out a number of Treasury proposals designed to eliminate proof of basis problems for assets acquired prior to the effective date of carryover basis. These suggestions have been substantially adopted by Congressman Fisher in H.R. 4694.

Specifically, H.R. 4694 provides an increase in the tangible personal property exclusion from $10,000 to $25,000 and redefines excluded assets to include any tangible personal property which was a capital asset in the hands of the decedent.

The "fresh start" adjustment is also modified. While the fresh start adjustment for marketable securities is determined in the same manner as under present law, the fresh start adjustment for all property other than marketable securities (and certain other property having a readily ascertainable value on December 31, visions applicable to tangible personal property. Also, the fresh start adjust- 1976) is determined under a discount-back formula similar to the present provisions applicable to tangible personal property. Also, the fresh start adjustment will be available for purposes of determining both gain and loss.

The effect of these provisions is to eliminate proof of basis problems for most assets acquired prior to December 31, 1976. Historical cost will be relevant only if it exceeds fresh start value. In most cases, it will be possible readily to estimate whether historical cost exceeds fresh start value. Moreover, as noted in the explanation of H.R. 4694, reasonable methods of basis reconstruction will be

acceptable. This provision is intended to be administered liberally so as not to require executors to incur unnecessary expense attempting to document acquisition cost precisely.

H.R. 4694 directly addresses the proof of basis problem for assets acquired prior to the effective date of carryover basis in an equitable and administrable manner. It eliminates the need for grandfathering.

Answer to Question 12

In my March 12 testimony I stated, "there is no new tax imposed if step up is repealed." That statement is absolutely accurate. Under a carryover basis system the income tax on appreciation which occurred during a decedent's lifetime must be paid when inherited appreciated property is sold by an heir. This is not a new tax. It is simply the long overdue application of the present income tax system to appreciation which had been forgiven under step up.

Answer to Question 13

Inflation will increase receipts from the individual income tax by about $9 billion in 1979.

Answer to Question 14

The existing carryover basis provisions have been criticized because those provisions apply to the estates of decedents who are not subject to the estate tax system. This occurs because the present minimum basis of $60,000 effectively excludes only estates of that amount and less from carryover basis while, in 1981, the unified credit will exempt from the estate tax system most estates of $175,625 or less.

While it is true that virtually all decedents own some appreciated property, it is also appropriate to recognize that administrative considerations lead one toward some exemption level. The question then becomes what level is appropriate. Treasury believes it is appropriate to conform the carryover basis system to the exemption level of the estate tax system. Therefore, carryover basis would be inapplicable to those estates containing less than $175,000 of carryover basis property. However, a $175,000 minimum basis is available to those estates which are subject to carryover basis. The net effect, therefore, is to permit all estates a minimum basis of up to $175,000. As a result, all estates are treated equally.

Sincerely yours,

DONALD C. LUBICK,
Assistant Secretary (Tax Policy).

Enclosure.

TABLE 1.—*Unrealized capital gain in assets held at death by gross estates in excess of $60,000*

[1979 levels in billions of dollars]

Asset type	*Amount of capital gain*
Personal residence	3.1
Real estate	4.1
Securities	0.4
Noncorporate business assets	0.5
Corporate stock	8.3
Total	16.5

Office of the Secretary of the Treasury.
Office of Tax Analyst.

APPENDIX A

EXAMPLES ILLUSTRATING OPERATION OF THE LIQUIDITY RELIEF PROVISIONS OF H.R. 4694, THE CARRYOVER BASIS SIMPLIFICATION ACT OF 1979

The overall purpose of the liquidity relief provisions is to prevent the forced sale of closely-held businesses and farms which a decedent's heirs desire to continue to own and operate.

The provision permitting deferred payment of estate tax attributable to closely-held businesses and farms allows an adequate time period over which estate tax liability may be paid from earnings generated by the business. The follow-

ing examples illustrate that the alowance of a 15-year time period over which to pay the estate tax attributable to the closely-held business or farm will, in most cases, prove adequate.

Nonetheless, there may be situations where either this relief is insufficient, or, particularly in the case of closely-held stock, it is necessary or desirable to redeem some portion of the stock. As the examples illustrate, a sale or redemption may be made without income tax consequences if the executor elects to allocate a sufficient amount of the death tax basis adjustment to the property sold or redeemed. In effect, the sale of property to pay death taxes and administration expenses is accorded the same income tax treatment as occurred when the basis of property in the hands of an heir was "stepped up" to estate tax value. While there is less aggregate basis adjustment available for the retained portion of the closely-held business, this will not cause difficulty because, by hypothesis, the retained property will not be sold by the heir.

Example 1.—*X*, a widower, dies on December 31, 1990 with the following assets (all acquired after December 31, 1976) and liabilities. For purposes of illustration, administration expenses are ignored and it is assumed that the farm does not qualify for special use valuation.

Asset/Liability	Fair market value	Basis
Farm real property	$900,000	$200,000
Farm machinery	75,000	50,000
Cash	5,000	5,000
Life insurance	10,000	10,000
Stocks and bonds	20,000	12,000
Debts associated with farm	200,000	N/A

I. CALCULATION OF ESTATE TAX DUE

Gross estate:	
Farm real property	$900,000
Farm machinery	75,000
Cash	5,000
Life insurance	10,000
Stocks and bonds	20,000
Total	1,010,000
Less:	
Debts associated with farm	$200,000
Total	200,000
Taxable estate	810,000
Estate tax before unified credit	271,700
Unified credit	47,000
Estate tax payable	224,700

II. ESTATE TAX LIQUIDITY RELIEF-DEFERRED ESTATES TAX PAYMENT

The estate of *X* qualifies for the deferred estate tax payment privilege under proposed section 6166(a)(1)(A) because the value of the farm real property and machinery (net of debts) exceeds 65 percent of *X*'s adjusted gross estate. Thus, the estate of *X* may elect to pay the estate tax attributable to the farm real property and machinery in up to 10 annual installments commencing in the sixth year after *X*'s death at a 4 percent interest rate. The estate tax attributable to the farm real property and machinery is equal to the estate tax due *X*.

$$\frac{\text{closely-held business amount}}{\text{adjusted gross estate}} = \frac{\$214{,}991}{\$224{,}700} \times \frac{775{,}000}{810{,}000}$$

If the executor of the estate of *X* so elects, $9,709 will be payable at the time the estate tax return is due, interest of $8,600 will be payable annually for five years on the deferred estate tax of $214,991 and that deferred amount may be paid in 10 annual installments of $21,499 (plus interest) commencing in year 6.

This 15 year payout period, at a modest 4 percent interest rate, should itself permit the estate to pay the deferred estate tax from funds generated from the farm operation. However, should it be necessary or advisable to sell property additional liquidity relief is provided by proposed section 1023(f).

III. INCOME TAX LIQUIDITY RELIEF-ALLOCATION OF DEATH TAX BASIS ADJUSTMENT

Because X's estate qualifies for the deferred estate tax payment privilege, the executor of X's estate may elect to apportion the death tax adjustment to any carryover basis assets with an aggregate fair market value not in excess of $224,700.

The maximum amount of the death tax adjustment equals, in general, the highest applicable marginal estate tax rate times the net appreciation in all carryover basis assets included in the estate. In this example, the applicable marginal estate tax rate is 39 percent and the net appreciation in all carryover basis properties is $733,000. The aggregate death tax adjustment is $285,870.

If the executor of X's estate allocated $8,000 of the aggregate death tax adjustment to the $20,000 of stocks and bonds and $159,211 to farm real property worth $204,700, those assets could be sold without recognition of gain because the fair market value of each asset equalled basis. Moreover, under the facts in this example, the sale would not cause an acceleration of the deferred estate tax. Thus, the executor would have $224,700 in cash to invest while retaining the privilege of paying $214,991 in installments at 4 percent interest.

The balance of the death tax adjustment, $118,659, would be available for allocation by the executor to any other carryover basis assets, subject only to the limitation that the per asset adjustment could not exceed .39 times the appreciation in each asset.

Example 2.—Y, a widower, dies on December 31, 1990 with the following assets (all acquired after December 31, 1976). For purposes of illustration, administration expenses and debts are ignored.

Asset/Liability	Fair market value	Basis
Closely-held stock	$600,000	$200,000
Residence	250,000	80,000
Cash	25,000	25,000
Life insurance	50,000	50,000
Marketable stocks and bonds	75,000	40,000

I. CALCULATION OF ESTATE TAX DUE

Gross estate:	
Closely-held stock	$600,000
Residence	250,000
Cash	25,000
Life insurance	50,000
Marketable stocks and bonds	75,000
Total	1,000,000
Taxable estate	1,000,000
Estate tax before unified credit	345,800
Unified credit	47,000
Estate tax payable	298,800

II. ESTATE TAX LIQUIDITY RELIEF—DEFERRED ESTATE TAX PAYMENT

The estate of Y qualifies for the deferred estate tax payment privilege under proposed section 6166(a)(1)(B) and (C) because the value of the closely-held stock exceeds 35 percent of Y's gross estate and 50 percent of Y's taxable estate. Thus, the estate of Y may elect to pay the estate tax attributable to the closely-held stock in up to 10 annual installments commencing in the sixth year after Y's death at the statutory interest rate, currently 6 percent. The estate tax attributable to the closely-held stock is equal to the estate tax due X.

$$\frac{\text{closely-held business amount}}{\text{adjusted gross estate}} = \frac{\$298,800}{\$179,280} \times \frac{600,000}{1,000,000}$$

If the executor of the estate of *Y* so elects, $119,520 will be payable at the time the estate tax return is due, interest of $10,757 will be payable annually for five years on the deferred estate tax of $179,280 and that deferred amount may be paid in 10 annual installments of $17,928 (plus interest) commencing in year 6.

This 15 year payout period should itself permit the estate to pay the deferred estate tax from funds generated by the business. However, should it be necessary or advisable to sell property additional liquidity relief is provided by proposed section 1023(f).

III. INCOME TAX LIQUIDITY RELIEF—ALLOCATION OF DEATH TAX BASIS ADJUSTMENT

Because *Y*'s estate qualifies for the deferred estate tax payment privilege, the executor of *Y*'s estate may elect to apportion the death tax adjustment to any carryover basis assets with an aggregate fair market value not in excess of $298,000.

The maximum amount of the death tax adjustment equals, in general, the highest applicable marginal estate tax rates times the net appreciation in all carryover basis assets included in the estate. In this example, the applicable marginal estate tax rate is 39 percent and the net appreciation in all carryover basis properties is $605,000. The aggregate death tax adjustment is $235,950.

If the executor of *Y*'s estate allocated $35,000 of the aggregate death tax adjustment to the $75,000 of marketable stocks and bonds and $149,200 to closely-held stock worth $223,800, the marketable stocks and bonds could be sold and the closely-held business stock sold or redeemed without recognition of gain because the fair market value of each asset equalled basis and the redemption qualifies as a sale or exchange under section 303. Indeed, the executor could elect to allocate $199,200 of the death tax adjustment to closely-held stock worth $298,800 and have that amount redeemed under section 303 without income tax consequences. Moreover, under the facts in this example, the sale of this amount of closely-held stock would not cause an acceleration of the deferred estate tax. Thus, the executor would have $298,800 in cash proceeds from the sale of carryover basis assets and $75,000 in cash from *Y*'s savings and life insurance. Estate tax of $119,520 would be due with *Y*'s estate tax return, leaving the executor with $254,280 to invest while retaining the privilege of paying $179,280 in installments at 6 percent interest.

The balance of the death tax adjustment, $51,750 or $36,750 under the above alternatives, would be available for allocation by the executor to any other carryover basis assets, subject only to the limitation that the per asset adjustment could not exceed .39 times the appreciation in each asset.