ESTATE AND GIFT TAX PROBLEMS ARISING FROM THE TAX REFORM ACT OF 1976

HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

OF THE

COMMITTEE ON FINANCE UNITED STATES SENATE

NINETY-FIFTH CONGRESS

FIRST SESSION

JULY 25, 1977

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE
95-026 WASHINGTON : 1977

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S361-30

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ESTATE AND GIFT TAX PROBLEMS ARISING FROM THE TAX REFORM ACT OF 1976

MONDAY, JULY 25, 1977

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

The subcommittee met, pursuant to notice, at 9 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, Hansen, and Packwood.

Senator BYRD. The hour of 9 o'clock having arrived, the committee will come to order.

[The committee press release announcing this hearing follows:]

[Press release]

SUBCOMMITTEE OF TAXATION AND DEBT MANAGEMENT ANNOUNCES HEARINGS ON CERTAIN ESTATE AND GIFT TAX PROBLEMS ARISING FROM THE TAX REFORM ACT OF 1976

Subcommittee Chairman Harry F. Byrd, Jr. of Virginia today announced that a hearing will be held on July 25, 1977. The subject of the hearing is estate and gift tax problems arising from the Tax Reform Act of 1976, especially those affecting the average estate and estates containing interests in small or closely-held businesses.

The hearing will begin at 9:00 A.M. in Room 2221 Dirksen Senate Office Building.

The witnesses are as follows: Lewis M. Costello, Esquire; J. Thomas Eubank, Esquire; Joseph Kartiganer, Esquire; and Doris D. Blazek, Esquire.

In his announcement, Senator Byrd stated that the hearing is intended to bring to the attention of the Congress and the Administration some of the serious problems resulting from the estate and gift tax revisions poured into the Tax Reform Act of 1976.

"We want to bring to light a few of the most severe problems—the ones that can and should be acted upon."

He noted that these problems have come to the attention of the Finance Committee by letters from concerned taxpayers, not their attorneys or accountants, detailing adverse and arbitrary consequences of 1976 Act changes.

Senator Byrd emphasized that the hearing is not in connection with a particular piece of legislation, but is a fact-finding investigatory hearing.

"We want to look at some of these problems that we have heard about; then we can decide what kind of legislation ought to be drafted."

In particular, the Subcommittee will look at the problems in connection with the carryover basis rule—such as the problems of recordkeeping and executor administrative burden; problems having to do with the changes in the gift-in-contemplation-of-death rule; and a variety of problems affecting farmers and small businessmen.

"There is much concern about the consequences for the small businessman who has built up his company and now faces the effects of inflation and death taxes on his estate.

"Also, many farmers now find their land highly valued, yet have little liquid assets to pay estate taxes.

"The Committee and the Congress need facts now on which to base sound judgment as to needed changes in these areas of the tax laws."

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 must comply with the following rules:

(1) A copy of the statement must be filed by the close of business two days 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 statement must be typed on letter-size paper (not legal size) and at least *75 copies* must be submitted by the close of business the day before the witness is scheduled to testify.

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

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

Written testimony.—Senator Byrd stated that the Committee 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 September 9, 1977, to Michael Stern, Staff Director, Committee on Finance, Room 2227, Dirksen Senate Office Building, Washington, D.C. 20510.

Senator BYRD. In legislation enacted in 1976, Congress made extensive revisions in estate and gift tax provisions in the tax law.

These revisions arose from the concern of Congress over the heavy tax burden and high administrative costs placed upon estates of middle-income taxpayers. To meet these concerns, changes were made which raised the amount of property in an estate which is excluded from tax and which increased the level of the marital deduction for many taxpayers.

Although some aspects of the 1976 law have benefited taxpayers, there is a growing indication that the law has not fulfilled the goals which were anticipated, and Congress has received many reports from taxpayers about adverse consequences of the 1976 law.

Many small businessmen now foresee severe liquidity problems as their estates attempt to pay the estate taxes associated with their business, and the law may accelerate the trend toward mergers of small businesses into larger ones.

For all taxpayers, the changes have added an incredible degree of complexity to the tax law and increased the cost of administrative and professional services.

In this connection, I might say over the weekend I was with an official of one of the banks in Richmond, Va., and he told me that the paperwork alone in connection with this carryover basis provision would cost that particular bank $200,000 a year.

The purpose of these hearings today is to identify problems arising from the estate and gift tax provisions of the law and to develop possible solutions to these problems.

We are fortunate today to have a panel of four attorneys from all parts of the Nation who are highly knowledgeable about the practical problems associated with the 1976 law. I think that is what the Congress needs to know—how this law is working out in practice. Congress

too frequently tends to go by theory and becomes detached from the way matters work in practice.

Each of the panel members have lectured at seminars about the 1976 law and knows the thinking of professionals and of taxpayers who must deal with the law.

Each member of the panel will be addressing a group of issues and problem brought about by the new law. The subcommittee looks forward to the panel's presentation.

We are pleased to have with us today Mr. Lewis M. Costello, Mr. J. Thomas Eubank, Mr. Joseph Kartiganer, and Mrs. Doris Blazek.

Ladies and gentlemen, you may proceed as you wish. I understand Mr. Eubank will make the first presentation.

[The prepared statement of J. Thomas Eubank follows:]

STATEMENT OF J. THOMAS EUBANK, JR., ESQ.

Mr. EUBANK. Thank you, Mr. Chairman.

As you have indicated, each of us has been engaged in the private practice of the law. Each of us regularly represents taxpayers in the categories that you have indicated. We are in the trenches at the front, and we plan to talk about actual problems that Congress ought to consider.

I start by emphasizing that Congress should carefully reconsider many of the provisions of the 1976 act that affect the transmission of property at death. These hearings today are a step in the right direction, but only a step.

Incredible as it may seem, the new law was passed without public hearings on the bill. Shortly before the bill was introduced, a few people actually practicing in these tax areas were permitted to testify before the Ways and Means Committee; but they had to do so in a vacuum because they had no bill available to them.

Various hearings had been held on these subjects during the 1960's, but none of those at the 1976 hearings knew the subject matter of the bill or the form or language.

When the 1976 hearings were closed and before the transcripts were prepared, the bill was introduced. Obviously, the hearings, such as they were, meant nothing. There were no hearings on the actual bill, only executive markup sessions with no testimony.

This process is in sharp contrast to the development of the 1954 code, when there were full hearings after the bills were introduced and then hearings on revisions.

Conceived, developed, and borne in haste, the 1976 act was imposed upon the American citizens with no adequate development beforehand of the real and practical effects upon the citizens effects in many instances that can be described only as calamitous and surely unintended for broad segments of our citizens and indeed our society.

The leap in the dark has already occurred. Although we cannot repair all the injuries from that unfortunate leap, we can examine in the dawning light what we landed upon, bring more light to bear on the subject, and then mitigate and repair the injuries by careful and deliberate reconsideration. Congress has a prime duty to do that.

Many of the changes made have been advocated for years by some in academia. These ideas seem to have had a heavy influence upon the

staff of the Joint Committee on Taxation and others and in due course, upon the act itself.

Many of these ideas may have looked fine on the drawing boards, but: (*a*) they did not look fine to those who had the benefit of much experience at the practical, applied level; (*b*) they should have been tested extensively to determine their actual effects and ramifications, as new ideas are normally tested first in most other fields of endeavor; and (*c*) many citizens feel that inadequate consideration was given to many broad policy questions in the act concerning the continuance of our private sector economy as we know it and our ways of life.

Before I proceed with some examples, I should mention some of the public concerns about the transmission of property from one generation to another, for my examples need to be viewed in this broad context.

Most estates even of a modest size go through a process which we call probate. Ten or so years ago, the American Bar Association Section of Real Property, Probate and Trust Law, of which I am an officer, recognized that probate was in critical need of reform. It needed simplifying and streamlining to eliminate unneeded features that cause complexity, delay, and added expense.

That section was instrumental, with others, in developing the Uniform Probate Code, which is a guiding light for all efforts to simplify the transmission of property at death.

During this time, the public and many writers began to cry out against probate and to demand reform. My point here is that we had underway in 1976 a strong movement toward simplification of the processes for transmitting property at death—a movement demanded by the public.

Then came the 1976 act, which reversed the movement and forced properties at death through new processes with complexities almost beyond description. When the 1976 act was about to be passed, I met for a day with about 10 persons from throughout the Nation who are considered very knowledgeable about probate and taxes.

After discussing it, I asked at the end of the day how much the overall processes for transmitting wealth at death would be complicated. If the preact complexity was 1, what would the new complexity be, 1.1, 1.2, 1.5, 2 or what?

The lowest answer I got was 2. The highest was 8 for many situations. Doubling the complexity overnight.

First, take an estate of $60,000 or less. The new law has injured this estate. Under neither the old law nor the new law does it have to go through the estate tax process. But under the new law, it has to go through the new carryover basis process.

The decedent's basis in each asset must be determined, then the fresh adjustment must be made. The process is complex and may be expensive for an estate of that size.

Next, take an estate between $60,000 and $175,000. As to the estate tax process, the new law has benefited this estate by enabling it to bypass that process.

But the new law forces this estate through the new carryover basis process.

The process itself is going to be complex and expensive for an estate of that size.

In addition, the capital gains tax of the beneficiaries may be very substantial. It may be less than the old estate tax would have been, or about equal to it, or even more.

For example, say a parent dies and leaves to his child his only asset remaining after expenses, a farm worth $175,000 with an adjusted basis of $60,000. The gross estate tax under the old law would have been $25,200; and under the new law there is no such tax after 1980.

If the child sells the farm and realizes a $115,000 capital gain, that child's tax may well exceed the old $25,200 estate tax. The combined effect of the process expense and the capital gains tax will materially injure, rather than benefit, many such estates.

Now, take an estate over $175,000 that has to file an estate tax return. The new law has injured it greatly.

First, the estate tax process has been made more complex for it.

Second, it has to go through the new carryover basis process.

Third, it may have to go through another new process, the generation-skipping process. Even where no generation-skipping process was ever really intended, many medium estates are now forced through the new generation-skipping process, under customary wills when there is an unusual order of deaths and the technical requirements for the $250,000 exclusions have not been met.

Fourth, the probate process has been made much more complex and uncertain because of the conflicts that have been created among the beneficiaries, as to carryover basis, elections as to employee benefits, and other changes.

It is doubtful that Congress was ever given these crucial probate and fiduciary problems for consideration.

Fifth, the combined estate tax and capital gains tax will be surprisingly high for many medium estates. In that connection, somewhere and somehow, Congress needs to consider the inequity of imposing capital gains taxes upon those gains attributable to inflation, which, of course, are not true gains.

Small and medium estates are especially vulnerable here as to residences.

I liken these processes to the wringer of an old-style washing machine, which squeezes the fabric passing through, forcing out substance sometimes properly and sometimes improperly, but which in every case frays the fabric by causing delay, processing expense, and uncertainty, and which sometimes catches innocent fingers.

Now I want to give two illustrations of estates going through the carryover basis wringer. We should look for what the wringer has squeezed out as a new capital gains tax and for any damage the wringer has done to the fabric, in the form of delay, uncertainties, and expenses.

As I cast about for examples, I found them in my own backyard. May I suggest to all that it is truly an eye-opening experience for anyone to see the calculations that would have to be made upon his or her death.

About 10 years ago, I started buying stock in a particular mutual fund periodically. Now I have a little over $20,000 of value in this stock. This, of course, is a typical investment for millions of Americans.

I elected to have dividends reinvested, a common practice. The actual calculations are set forth in the appendix to these remarks.

To make the examples typical, I have assumed hypothetically in situation 1 that I have an estate of $525,000 and in situation 2 that I have a small estate of about $70,000. I have also had to assume my demise on a certain date in near future, which I assure you I hope is hypothetical.

Except for that and the value at that time, the mutual fund situations are real, concrete examples.

What do these calculations show?

In situation 1, the shares comprise 78 lots. Each lot is divided between Mrs. Eubank and a trust, and the shares in each lot have four different bases, two for gain and two for loss.

Thus, there are 312 bases.

These calculations took 17 hours by a capable and efficient individual who is both a CPA and a lawyer, accustomed to performing services of this kind. That time does not include any time necessary to research or learn the tax law, nor does it include hours needed for corrections and refinements.

At his normal billing rate of $70 per hour, the cost is $1,200. At the estate's marginal estate tax rate of 32 percent, this cost is borne as follows: By the Federal Government, $384; by the Eubank family, $816.

Under the law before the 1976 act, the basis in these shares would have been $26,690.45. Under the 1976 act, the total gain basis is $26,077.13.

The difference of $613.23 is what the new law is intended to tax as a capital gain that would not have been taxed under the old law.

If the Eubank family were to sell all these shares, the capital gains tax on that gain might be about $200.

Thus, in situation 1, the Federal Government has received $384 less in estate tax to get about $200 in capital gains tax, if and when the shares are sold. Moreover, it has inflicted upon the Eubank family a net cost of $816 for the extra professional expense.

In situation 2, the shares also comprise 78 lots. The shares in each lot have two different bases, one for gain and one for loss. Thus, there are 156 bases.

These calculations took 12 hours by that same person under the same conditions. At his normal billing rate of $70 per hour, the cost is $840.

At Mrs. Eubank's marginal income tax rate of, say, 20 percent, this cost is borne as follows: By the Federal Government, $168; Mrs. Eubank, $672.

Under the law before the 1976 act, the basis in these shares would have been $26,690.45. Under the 1976 act, the gain basis is $26,508.32.

The difference of $182.13 is what the new law is intended to tax as a capital gain that would not have been taxed under the old law.

If Mrs. Eubank were to sell these shares, the capital gains tax on that gain would not likely exceed $50.

Thus, in situation 2, the Federal Government has received about $168 less in income taxes to get about $50 in capital gains tax, if and when the shares are sold. Moreover, it has inflicted upon Mrs. Eubank a net cost of $672 for extra professional expense.

In situation 2 where no estate tax is due under the old or the new law, the new law has cost Mrs. Eubank $672 in expenses and $50 as a potential capital gains tax.

Senator BYRD. Your time has expired. We can get back to this in the question and answer period. It is a very interesting presentation.
Mr. Costello?

STATEMENT OF LEWIS M. COSTELLO, ESQ.

Mr. COSTELLO. I am Lewis M. Costello, an attorney in Winchester and Frederick County, Va. Although I am immediate past president of the board of governors of the section on taxation of the Virginia State Bar, that organization is an official arm of the State Supreme Court and a creature of statute. Therefore, I am not authorized to speak on behalf of that organization. I am speaking as an individual and a tax practitioner.

Both my practice and experience may be of some interest to the subcommittee, since I am not a theoretician.

For the most part, I represent clients in a basically agrarian and small business community. Much of my practice is in cooperation with other attorneys and CPA's. This essentially problem-solving practice extends over a broad area of the 7th Congressional District of Virginia and the panhandles of West Virginia and Maryland.

My background is as an economics major, lawyer and a certified public accountant. Primarily, I am engaged as an attorney in all phases of tax planning and the implementation of those plans for small businesses and farmers.

Presumably, I work with many of the people for whose benefit special provisions were inserted in the Tax Reform Act of 1976, hereafter, TRA 1976 and for whose benefit several provisions of the technical corrections bill of 1977 are included, hereafter TCB 1977.

It may come as a surprise to you to realize how the entire small business and farmer community has been set back by these two bills. The estate and gift tax portions of the TRA 1976 are virtually incomprehensible to the business community generally. The only thing certain is that it is the law of the Pharisees and not the philosophers. The philosophy is frankly inconsistent and confusing to the point of frustration. Personally, despite 15 years of practice, my background education and over 70 hours of continuing education in the past year, I am incompetent to explain the law or its logic.

As a result, I suggest to you that in the small business and farming section of this Nation there has arisen an annoyance with the practitioner—be he attorney, CPA, banker, insurance advisor or estate planner—a contempt for the congressional process, and a loathing for the Pharisaic Government in Washington unmatched in modern times, even by OSHA.

The single biggest problem is the complication from the carryover basis. The other speakers will cover this difficulty in detail. I attach to this presentation an article by Byrle M. Abbin entitled "Carryover Basis: Opening Pandora's Box."[1] As Mr. Abbin, a CPA points out, the complications will exist well into the 21st century.

My comment on this grievous bit of legislation is practical, not philosophical. Three questions my clients keep asking are:

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[1] See p. 81.

One, with regard to the taxation of the step up in basis at death—how large a "loophole" exists when an individual must die to get through?

The common man's conception of a loophole is a special tax section which gives unfair tax advantage to one who has advantages already. It is very difficult for the common man to understand that his death gives him such an unfair advantage.

Senator HANSEN. If Mr. Costello would let me interrupt for just a moment, I am reminded that Senator David Gabrell talked about a man who lived in the State of Georgia and who was sentenced to be hanged. A judge asked him if he had any words that he would like to say before the sentence was carried out.

He said, "Yes, Judge, this is going to be an awfully good lesson to me."

Mr. COSTELLO. The second question that my clients ask me is how long can my Government pursue me for bad recordkeeping and how do I know I have satisfied the Government?

In our law, the statute of limitations has always been a wonderful thing. It is a statute of repose. It puts to rest conflicts between people.

Your problems of proof, of duty, of penalty and et cetera are put to rest. And the tax law has recognized this for a long time in the statute of limitations on assessments and collections, as well as refunds, for both criminal and civil purposes.

I suggest, historically section 1014 did the same thing on the step-up in basis at death. Every generation, no matter how badly the records were kept during lifetime, if they paid the tax on what they owned at death, could begin over again and all past sins were forgiven. Certainly that has been killed here. And as Abbin points out, the sins of the father may well carry over here, well into the 21st century, until all assets now owned have been disposed of.

The third question that my clients keep asking, particularly when I send a bill, is, Does not anyone care about the complications involved, the executor's duties, the recordkeeping, the problems generated for years to come?

I earnestly submit that the American small businessmen and farmers, together with all Americans, ought not have such burdens placed upon their backs. They are entitled to a certainty, and a statute of limitations on basis, and to have their deaths regarded as more than the seizing of a loophole.

The elimination of carryover basis would solve most of the distressing problems I now intend to describe for you.

First of all, I feel that tax act to the small businessman and farmer was a cruel hoax. First, it emasculated prior relief provisions. I would almost be happy if we could get back to where we used to be. Section 303, the redemption of the small business corporation stock, in order to pay estate tax, used to take care of the whole problem. Everybody had lived on that business all of these years. It was logical that there is where the tax should come from.

303, as presently existing in the Code, does not allow for the redemption in order to pay the income taxes which result from the redemption and result from the carryover basis. Therefore, although you may be able to raise the estate tax, the income tax that you create by raising it, does not get that protection.

If you look at section 306, the so-called preferred stock that may be issued on common, it is very common in small business, when the father gets ready to step out, to issue preferred stock and, in effect, freeze his equity, then give or sell the common stocks so the children suffer their own good or ill fortune. You do not endanger the father, because he stays in a preferred position and, at death, you redeem the stock under the law and get your money out, and pay your tax.

Well, the accumulation problem cannot be ignored now in estate taxes. Section 531, the unreasonable accumulation privision may apply. Specifically, Congress has said to accumulate the money, to redeem the stock in the situation for 303 purposes is not an unreasonable accumulation.

Now, you cannot, under 303, redeem to pay the income taxes on the estate, so presumably the money that comes from the redemption to pay the estate tax and to pay the income tax after that is now subject again to 531 unreasonale accumulation tax.

In addition, a preferred stock with a carryover basis may or may not—the Code is unclear—still qualify for 303 redemption. For people who now hold nothing but preferred stock, having disposed of all of their common stock to the next generation to run the family business, this is the fear of uncertainty and an impediment indeed.

The technical corrections bill makes a horrible result even worse in that it purports to say specifically that the 306 stock, the preferred stock, will not be part of the 303 redemption stock, thereby guaranteeing what may be all ordinary income without regard to basis.

There is a bone in the technical corrections bill that would adjust that preferred stock basis by the high living the fresh start basis, only. If you read technically the language now in 306, the whole distribution, not just the excess over basis, is not just taxable income. It is all ordinary income.

We have a lot of small businesses that are caught in this box, and there is not any way out.

Just to get back to where we were would be a major step forward as far as the farmer and the small business is concerned. I suggest to you that there is rational reason that 306 stock should not be cured of its taint on the day of death. The purpose of 306 was to keep that individual from bailing out earnings. The purpose of 303 was to prevent a distribution with respect to the stock on an unqualified redemption from being ordinary income.

They were both intended to make distribution which would otherwise be ordinary income—not ordinary income, for the purpose of paying the estate tax. To now draw a distinction which did not even exist previously, you have taken away from us the ability to redeem this preferred stock. This does not appear to be philosophically logical internally in the bill.

A third thing has been done that has taken away from small businessmen and farmers—I never really heard much complaint about the administration of this section 303 before, which was a requirement of 35 percent of the gross estate or 50 percent of the taxable estate. We now have to meet a 50 percent of the gross estate requirement, which is an even higher requirement than ever before.

So what has happened is that my clients are forced to choose between possibly diversifying their assets, ostensibly trying to take care of the liquidity problem before thier deaths by trying to raise some money,

and thereby disqualifying themselves for the 303 redemption, not to mention the installment payments of 6166 and 6166A which are tax payments over 15 years and over the 10-year periods respectively.

They do not know when to get down. They sit on the fence. I am saying for practical purposes, estate planning has stopped since January 1 in my practice because nobody knows what to do.

The House Committee report said the lock-in was the reason that you wanted the carryover basis, to facilitate transfer. I suggest to you that the lock-in, which results from uncertainty, is far more severe and far more painful to my small business and farmer clients than was any lock-in because they were hanging on to get a stepped-up basis at the time of death.

Senator BYRD. For the record, could you give a brief explanation of the 50-percent requirement. Fifty percent of what—of the total estate?

Mr. COSTELLO. The 50-percent total requirement is gross estate less certain deductions for administrative expenses et cetera, under 2054, I think, and 2053. It now has to be 50 percent of the gross estate, as opposed to a former requirement of 35 percent of the gross or 50 percent of the taxable estate. You could qualify either way.

Incidentally, these are still the requirements under 6166A for the 10-year deferral of tax payment and you are in the interesting situation where the Government is saying, oh, no, you are not a small business who qualifies under 303. At the same time, the caption on your section 6166A you are deferring payments over 10 years, since this is a large interest in a closely-held business. The old requirements will continue in the 10-year installment payout of taxes, but the new higher requirements are only in 6166, the 10 years payments after 5 years of interest requirement.

The second thing is that all of these three things, (1) the 303 limitation, you cannot get your income taxes out. (2) the 306, the taint is not removed, and (3) the higher percentage limitations, are emasculations of prior relief. A man cannot understand how the bill was for his benefit. He is minus three points before we begin.

Then we move into an area where a false impression of new relief is given. I am afraid it is because Treasury does not really understand farmers and farming.

I do not have any clients who went into the farming business in the last 20 years and bought their own land and bought their own machinery and bought their own equipment and financed what you have to for tractors, et cetera without financing his farm. A 15-year payout is ludicrous unless you can finance under it, because I do not have farms that go 15 years without payouts.

Even the largest and strongest corporations which I represent find needs to finance within that period. That does not really help.

The second thing is the problem of minor beneficiaries and what is required of the executor.

In the court process in Virginia it is not that simple to get a permission on a minor beneficiary, to make that kind of an election. It is going to limit the use of this election.

Even if they are available, the so-called special use valuation provisions apparently do not handle the situation I run into all the time. A farmer usually has a lot of kids. If he has four or five children and

does not choose between them but leaves a provision in his will that the executor may sell the farm to any one of them, who will pay the fair value for it; then even though it is a qualified use before and a qualified heir, the sale by the estate of that farm does not fit under any exception, and consequently, all of the taxes are triggered. No special use valuation, and full estate tax, and income tax are triggered.

On a fairly common example, if he will pick and choose between his children and make them pay each other, that is fine. But that is a pressure on the family unit which ought not to exist.

The valuation trap is a major consideration. That is, if you take your special use valuation, as the law is presently written, and if you dispose of that land within the 15-year period, you spring the trap. That is, you not only have to go back and pay the deferred tax, you have to pay it on a higher valuation. You do not get an adjustment in the basis for the sprung trap because the time has passed for that.

You have really nailed the farmer and the small businessman.

I would suggest to you, you live close enough to Loudon, Fairfax, and Prince William Counties in Virginia to understand that farming there has disappeared. I lived in the richest dairy farming district on the east coast in Fairfax County when I grew up. You cannot let a cow eat that grass now because the taxes are so high.

If I made such an election 10 years ago in Fairfax, and was forced by the land taxes to tax-free trade that farm for a farm in Frederick County or West Virginia, I find no exception and my tax is triggered. This valuation trap is sprung on me, and I have no control over it at all.

Surely you did not mean to do that. First to emasculate what we had before. That Congress previously did. Then to give us an imaginary relief in three or four places, and in the process to vitiate a lot of reasonable, commercial arrangements.

There are a lot of buy-sell agreements in effect between closely held business owners. Now you just do not have an estate tax, you have an income tax. Consequently, any stockholder who dies, has his estate torn between crippling taxes in the short-term or a quick pay-out, or accidentally financing by long-term deferred payout a business in which he no longer has a voice. It is a small, closely held business that is very susceptible to bad management.

Insurance buyouts are going to be forced out of corporations because it would not make sense when there is no adjustment in the basis to be buying the business out at the corporate level.

My main concern in terminating is that you took something away from us and did not really give us anything in its place. For that reason, for the farmer and small businessman, the 1977 act has really turned out to be a hoax.

Senator BYRD. What you are saying, if I understand it, is that as far as the small farmers and small businessmen are concerned, each would be better off if the Congress would just forget what was done and simply go back to the old law?

Mr. COSTELLO. Absolutely. The carryover basis is the problem with almost everything I described to you. Yes, sir.

Senator BYRD. It is a very provocative and interesting presentation. It raises a number of questions which I would like to get to, especially the statute of limitations which you mentioned.

95-026—77——2

Mr. COSTELLO. Yes, there is a reference in my paper to that. I do not cover it specifically.

Senator BYRD. We can get back to that later in the question and answer period.

Mrs. Blazek?

STATEMENT OF DORIS D. BLAZEK, ESQ.

Ms. BLAZEK. My name is Doris Blazek. I am a practicing attorney in Washington, D.C. I am going to limit my remarks to the subject of carryover basis. It is the most important part of the 1976 Tax Reform Act in this area, not because the other sections do not have problems in them, but because this is the one that hits everybody.

The troubles created by carryover basis involve increased administrative problems and a failure to appreciate the economic burdens that carryover basis is going to give rise to.

One of the main difficulties of carryover basis is going to be establishing the basis of any given asset. It is simply a fact that people do not keep the kinds of records that they ought to keep in terms of being able to find out exactly what was paid for each asset they own. That is the kind of concept that is carryover basis. It involves calculations, asset by asset.

In essence, to carry it to the ludicrous, you have to determine what was actually paid for each dining room table, knife, fork, and spoon. With respect to one issue of stock, each separate lot that was bought.

It is an incredible burden.

That is unlike Mr. Eubank's records with respect to the mutual funds; he has his records. Most of the decedents that we will have to deal with will not have records. It will mean that in representing and doing the job of the executor you will have to go back through income tax returns and attempt a process of reconstruction. That kind of process is going to be charged for by transfer agents as they are inundated with requests for information.

You are going to have computer banks that are going to be in existence simply to provide evidence of basis, because that is what we are talking about—not simply somebody's recollection, but proof of basis.

You say, why is that any different than when the decedent sold during his lifetime? He had to have basis records then. What is the difference in the carryover basis concept?

What is different is what is missing in the decedent's special recollection about what transpired. You will find that even the decedent's widow and his children are really strangers to the decedent when it comes to these kinds of personal financial details. So, reconstructing the decedent's basis is a primary problem under carryover basis.

Household and personal effects present their own special problems. There is, in the Tax Reform Act, an exemption for $10,000 worth of household and personal effects. In essence, they are going to go under the old law. That is an exemption which is to be made by the executor. You will find in jurisdictions that require appraisals at fair market value for probate purposes—as is true basically in the Northeast—$10,000 does not cover the average, middle-class person.

All you have to do is look at the coverage for your own insurance policy. When it comes to household and tangible personal effects, you will find that most people are over the $10,000 limit. Once you are

over the limit, you have the problem of establishing basis. Who knows what you paid for your dining room table, and certainly even if you know what you paid for it, you do not have the records to prove it.

That is the kind of affirmative burden that carryover basis is placing on estates. You will have, with respect to household and personal effects, competing elections, because when there is no executor qualified, the executor is any recipient of property from the decedent, so you have two children who take this kind of property from the decedent. Each will say, I want my $10,000 under the exemption

You have the problem of adjustments in audit. You put in your appraisal of household and personal effects at $10,000. The IRS audits and says, you do not have $10,000, you have $12,000. How do you handle the election then?

There is really an array of problems in the area of household and personal effects which really have not been thought of by the decedent as a capital asset. It is incredible the kind of reaction you get from someone when you tell them that this is regarded as an asset and you are going to have to pay a gain on it on disposition.

You will have people say, under the tax law, yes, but most household effects depreciate. There is a special provision in the TRA that relates to depreciated household and personal effects. It does not get you out of the problem.

To get off first base, you have to show that you have a depreciated asset. In order to show that, you have to know the decedent's basis. It is not the kind of relief that some think it is.

There are the incredible calculations once you have established the decedent's basis. There are four possible adjustments that must be made and must be made on asset by asset.

Each of the adjustments turns on the preceding adjustment. One of the adjustments based on taxes paid is based on the average estate tax rate. That means in audit, if one asset that is subject to tax is changed with respect to its valuation, and therefore more estate taxes are due, the basis of every carryover basis asset subject to tax is changed. We have a problem then of not being able to resolve the basis of any asset until we have completed audit of the Federal estate tax return. That usually takes 15 months from the time of the decedent's death.

The calculations are going to have to be done many times. When an estate opens, we have to do the calculations in order to determine when assets are to be sold in order to meet the Federal estate tax due 9 months after death. After the return is filed, presumably at that point will be the reporting requirements. After audit and after adjustments, then the calculations are going to have to be made again. It is an incredible process and one that can probably be handled only by computers. When you get down to that kind of requirement, we wonder whether the general practitioners and the people who do not have access to large computer operations are going to be able to deal with this kind of calculation.

Senator BYRD. Just to clarify the record, you mentioned the dining room table. Let's take a specific example, and then you can indicate for the record how it would work.

Suppose a person bought a dining room table for $500 and it is valued at the time of death at $1,000. How is that item treated?

Ms. BLAZEK. It has two possible treatments. One treatment is that the executor will elect to include that within the $10,000 exemption. If it is one of the items included in the exemption, you get a step-up in basis so the value of that table for basis purposes is now $1,000.

If, on the other hand, there is a whole array of household furniture, that table is not excluded, and it becomes an item of carryover basis, you then have to take the $500 basis, put it through these four incredible calculations until you get an adjusted basis. If the table is then sold, there will be a capital gains tax assessed on the difference between the adjusted basis and the $1,000 value.

Senator BYRD. Suppose the total amount of household effects, furniture and household effects, would be established at the purchase price of $10,000 and the value at time of death was $30,000. Then you get a $10,000 exclusion?

Ms. BLAZEK. That is correct.

Senator BYRD. Then you pay a capital gains tax on $10,000?

Ms. BLAZEK. Yes; except presumably some portion of your original $10,000 basis will represent part of the $10,000 of property excluded. In other words, one-third of the original $10,000, if you do it on a pro rata basis. So, gain of $13,000 is approximately correct.

Senator BYRD. What happens is that you take the present fair market value of the furniture, and you pay a gains on the difference.

Ms. BLAZEK. That is correct, to the extent that it is not covered in the $10,000 exemption.

Senator BYRD. If Congress repeals the capital gains tax and throws capital gains into ordinary income, what would be the situation?

Ms. BLAZEK. The situation would be that much of ordinary income.

As Tom pointed out, there will be a number of basis for any particular asset, That is, again, because of the way these adjustments work. Some are adjustments only with respect to taxes paid.

The reporting requirements that are imposed by the act are affirmative obligations that carry with it a total penalty of some $7,500. You do not have to be a qualified executor to come under those reporting requiremens. The widow who gets $5,000 worth of joint stock from her husband is subject to these reporting requirements, even though there is no Federal estate tax return due. And there is a penalty imposed upon her if she fails to meet the reporting requirements. In most cases, the widow will not even know it is needed, yet the law hits her with a penalty.

I think, too, that the amount of the penalty—$7,500—means banks and a lot of people are refusing to serve as executors because they do not know that they are going to be able to comply with the reporting requirements. If they are faced with a $7,500 penalty, they will not get into that problem. The fees that are involved are not worth it.

Senator BYRD. The $7,500 penalty is for doing what?

Ms. BLAZEK. For failing to report to the Internal Revenue Service and failing to report to the beneficiary the adjusted basis of each asset of the decedent.

Senator BYRD. The adjusted basis of each asset?

Ms. BLAZEK. That is correct.

The designated executor in the beginning does not know if he will be able to establish the decedent's basis. He does not know whether or not the decedent kept the kind of records that are needed to meet the obligation, and therefore, he will simply refuse to serve.

That is going to hit the small- and middle-sized estates where the risk of incurring that kind of penalty simply does not outweigh the potential fee or benefit that can be derived from serving as executor.

I want to point out the economic burden of the law; that's one of the points that Tom made. I consider a widow with an estate of $160,000 which has applicable to it the minimum basis of $60,000. Before the act was changed, with the increase from $60,000 to $175,000 total of property that can pass free of tax, she paid $25.000 in estate taxes.

If she has a $760,000 estate with a minimum basis, there is $100,000 worth of gain in the estate. The amount of capital gains tax that will be incurred by her if she sells the family home and sells the few securities they had because she does not want to stay with the risk of the market, will be $25,000. Thus, for the widow with a $160,000 estate, she is in exactly the same tax position as she was before the Tax Reform Act, but with the increased cost of compliance.

Consider a college graduate in 1977 who establishes a business in Virginia that is successful and becomes worth $500,000. He dies leaving a widow and two small children. The widow has no interest or facility in running the business, so she sells the business. Under the old law, her total taxes on a $500,000 estate would be $57,000. Under the new law, with the preference tax, total taxes will be $198,000. That is an increase of $140,000 in total taxes; 40 percent of this $500,000 estate.

This is assuming it is a new business, started out in 1977.

Senator BYRD. In other words, the new law triples the amount of taxes?

Ms. BLAZEK. It does indeed.

Senator BYRD. Presumably the law was supposed to help people like that and reduce the taxes.

Ms. BLAZEK. That is the whole point. Carryover basis runs absolutely contrary to the policy that is implicit in the increased marital deduction and in the unified credit, which represents the increased exemption.

Taxpayers are going to be in a much worse situation. These people, meaning small estates and medium-sized estates, are going to be in a much worse situation under the 1976 Reform Act. Giving an increased marital deduction and increased exemption by the unified credit, simply falls upon deaf ears when the taxpayers find out what actually does happen to them.

The tax rates on the top dollar of appreciation, on even the medium-sized estates, when you add together the Federal estate tax, the Federal capital gains, the State inheritance tax, and the State income tax, can be approximately 62 percent. When you have a very large estate, total taxes on the top dollar of appreciation can exceed 90 percent. Taxpayers regard that as confiscatory. They say it is not really a tax on appreciation; it is not appreciation, it is inflation. It impedes equity investment because it reduces the incentive to invest in assets for appreciation and reduces the incentive to build and expand your own business.

Also, if the policy and purpose behind carryover basis is to place the taxpayer who sold prior death in the same position as the taxpayer who sold after death, that objective has not been achieved, because the income tax paid on the predeath sale is not subject to the Federal estate tax. So, we have practitioners talking about a new estate plan-

ning technique. It is called sales in contemplation of death, because sales affected prior to death may achieve ultimate tax savings.

Moreover, the post death situation is inherently unlike the predeath situation. It is unlike it because death causes the need to raise money to pay debts, administration expenses, and taxes. When you have to raise this money by the sale of assets, it means incurring capital gains tax. Therefore, you have a tax which is generated by a tax. The capital gains tax is generated because of the need to pay Federal estate tax, and you are hitting the taxpayers just at the time when they have lost the major wage earner or the head of the family business.

Really, written by tax theorists to make certain that not one dollar of appreciation escapes taxation; carryover basis is not practical in this operation or effect. It flies in the face of the call for simplification of the tax law.

Senator BYRD. Thank you.

I might say, as far as I can determine, this is the first time that this committee has had the benefit of information that is being brought up by the witnesses today. When this so-called tax reform act was before the committee in 1976, none of this detail came to the committee's attention and I just consulted with the Finance Committee staff and I understand that this carryover basis provision was put in in conference. It was not even considered by the Finance Committee itself. It was put in by a committee of conference, and I assume virtually no one in the Senate knew anything about this proposal.

Apparently, it is raising havoc with virtually all estates today. Thank you.

Mr. Kartiganer.

STATEMENT OF JOSEPH KARTIGANER, ESQ.

Mr. KARTIGANER. My name is Joseph Kartiganer. I am also a practicing attorney speaking as an individual, not for my own firm or any committee of which I am a member or which I have chaired in the past.

I have been designated as kind of a cleanup hitter on this panel which means that all the juicy topics have been taken by the people who have preceded me, but in an effort to raise the importance of the areas that I will discuss, I like to think that it is often the fleabites that are the most annoying and most often increase the disrespect for the tax law.

What we have in the tax law, particularly in the Tax Reform Act of 1976, is a new substantive law that must be applied to virtually all of the estates. The more annoyances you find in the tax law, the more annoyances you will build up among taxpayers and among the citizenry.

Estate and gift taxes and the related provisions such as carryover basis, affect virtually every estate in the country. The small estate will be exempted from estate gift tax by the new increase in exemption. Probably less than 10 percent of the decedents in the country will have to file estate and gift tax returns.

However, that small remaining percentage is an unusually large percentage of the small business, executive and entrepreneurial population of this country.

The carryover basis——

Senator PACKWOOD. Could you say that again? 10 percent of what?

Mr. KARTIGANER. I am not sure that the precise figures are available. Under the old law with the $60,000 exemption, it was said that only 7 percent of the decedents in the country had estates large enough to require a return. With the new law, that will be reduced markedly and then will build up again as inflation outweighs it. It will be 2 to 10 percent of estates which will have to file estate tax returns.

Senator PACKWOOD. If you raised, inflation would stay at 2 or 3 percent?

Mr. KARTIGANER. Probably so. It would still hit a large percentage of the small business and entrepreneurial popualtion of the country.

Senator PACKWOOD. I do not mean this to sound crass, but the 2, 3 and 5 percent are really true, but you say 90 percent are not being affected at all.

Mr. KARTIGANER. In estate and gift taxes, but there are many provisions in the carryover basis that will affect people starting from ground zero.

Senator PACKWOOD. Why is that?

Mr. KARTIGANER. Because carryover basis will affect everybody who owns, or aspires to the acquisition of, property.

Senator PACKWOOD. Among this 90 percent, it would have effect because they will figure what their basis is before they know whether or not they are subject to estate tax?

Mr. KARTIGANER. That may be mixing apples and oranges.

You will have, even with your $60,000 minimum basis, a tremendous proportion of the current population facing the carryover basis problem, the capital gains tax after death, which was never there before. That figure will grow, as inflation continues. That is not an exemption problem, not an estate and gift tax problem, but a carryover problem, a capital gains problem.

Senator PACKWOOD. I have to confess I do not understand any of it. I practiced law and never did any estate work. But if these statements are the basis for simplifying the law, I am not sure it will simplify it.

Mr. KARTIGANER. I can only apologize for my own statement.

Senator PACKWOOD. It would be very helpful to me if, in answering questions, you would answer it for somebody who understands nothing about the law, and explain how to simplify it.

Mr. KARTIGANER. I was going to start with explaining the problems to you before I got to simplification.

What I was saying is that the probate process, as, Mr. Eubank indicated affects lots of people. As the process becomes more complicated, as the tax law forces on that process more choices and creates more conflicts among beneficiaries and creates more conflicts between beneficiaries and fiduciaries and between beneficiaries and advisers to the decedent, the finger will be pointed more and more at the tax law and the Congress that passed it.

The reason for the problems arises because of a lack of practical input on how the process actually works, and I would like to point to a couple of relatively simple examples which I broadly characterize as how the tax law has created inducements to do the nonsensical; how it has created undue complexity which gives rise to mistakes, either because of a desire for perfection or because of unnecessary retroactivity; and in areas, particularly in carryover, where it has created

conflicts within the family—not necessarily conflicts with the taxing authorities, but conflicts within the family unit.

As a primary example of an inducement to do the nonsensical is the provision for qualified joint property. Joint property is the form in which some tremendous percentage—if I had to guess, I would have to say 90 percent—of the property of this country is held between husband and wife.

The tax law has increased the incentive to hold property jointly, despite the fact that every sophisticated tax practitioner says that jointly owned property clearly does not make sense. There are better ways of doing it.

The tax law, through its provisions, have given an incentive to do that which will work to the disadvantage of the taxpayer.

In the area of undue complexity, I point to the transitional rules in generation-skipping. I do not want to talk about generation-skipping too much, because generation-skipping generally hits a relatively small percentage of the population. But there can be serious generation-skipping problems in medium to small estates because of family circumstances—I can think in my own practice of the retarded grandchild who cannot be given property outright to qualify for the grandchild exclusion—and there will be unnecessary tax consequences because the transitional rules are complicated, as complicated as anything I have ever seen in the law affecting individual taxpayers as opposed to corporations, and were made retroactive.

You are going to see estates unnecessarily burdened with taxes.

Much more serious problems of retroactivity have already been discussed. In sections 303 and 306, plans that were made in good faith decades ago have now been upset and no longer work. How are they going to be unscrambled? Who is going to go through the records to find these plans, to seek out the clients and tell them that what they have planned for their family no longer makes sense, and to seek solutions—perhaps in renegotiating with third parties where conditions have changed? And who is going to pay for all of this?

Perfectionism also reaches into the technical corrections bill. There is a provision that has not been discussed which relates to the transfers of interests in closely held businesses. We are talking about the ability to move the ownership of these businesses over to other family members.

There is an amendment to section 2036, a proposed amendment, which would say that anybody who owns an interest in a closely held business cannot give away any interest in that business to anybody, family member or not, in trust or outright, unless he gives away the entire thing and keeps nothing, absolutely nothing. He cannot parcel out that interest.

Senator BYRD. That is not a part of the law?

Mr. KARTIGANER. Not a part of the law, but part of the technical corrections bill which is currently before the House Ways and Means Committee.

I point to that, not because I am afraid that it is going to pass, although there is a risk that it will go through.

Senator BYRD. You cannot tell whether it is going to pass or not.

Mr. KARTIGANER. There is a problem because a sophisticated practitioner, the one who has the time and energy to watch pending legis-

lation, has his hands tied. He is frozen in the advice that he can give to the owner of the small business. He cannot move.

The unsophisticated practitioner, or the sophisticated practitioner who does not have the time to study pending legislation, is blindly going ahead doing what he thinks is all right. The effective date of that amendment is June 22, 1976. It is retroactive for over a year, and it will be one hell of a job unscrambling the eggs that have been scrambled if that amendment passes, but that is the kind of thinking that I think is represented in the Tax Reform Act.

Addressing the major problem that I think is in my area, the discussion of the conflicts among beneficiaries. I like to think of a simple will that says $10,000 to my brother, $50,000 to my daughter, a maximum marital deduction amount to my wife, and the residual estate in trust for my wife and children. There is nothing unusual about that will. You see it in any medium to large-sized estate.

All of a sudden, carryover has created a potential for arguments among beneficiaries, dissension among families. The most obvious example of that is what did he mean by $10,000 to my brother? Did he means $10,000 in cash or did he mean $10,000 in stock?

There is a real economic difference between the two. Because of carryover, if you give the brother $10,000 in stock, you are not giving him $10,000, you are giving him $10,000 less a built-in capital gain tax liability.

With a small legacy, and I think that $10,000 is relatively small, that is probably not that much of a problem. Presumably, the intent was to give him $10,000 in cash. But does the answer remain the same if the legacy is larger? Does it mean the same when it is $50,000? Or in the $500,000 estate when it is $250,000 to the surviving spouse? And remember what the economic effect of the decision is. If you give that legatee cash, you are giving the legatee the amount that the decedent specified in the will, and the capital gains tax is being paid by the residual estate, another beneficiary.

You are now getting pushes and pulls between beneficiaries of the same estate, and, as any practicing lawyer in this field would tell you, the most horrible fights are the fights among family members when the head has died. All sorts of conflicts surface, and the tax law has now created a new potential for conflict, which is unnecessary, which results from a theoretical drive for perfection which does not take into account the practical needs of the population.

Assuming some prerogatives—as the last speaker, they told me I could do it, as a trade to leaving me with the loose ends—I would like to make a couple of suggestions.

Things can get a lot easier, even with carryover, if a practical approach is taken. I would like to see carryover repealed, because I do not think that the taxation of capital gains which accrued during a lifetime takes into account the need for simplification of the burden on the small estate or the already high level of taxation on the larger estate, but assuming some form of taxation of that gain is a political necessity, there are certain things that you can do, if you eliminate the desire to be technically perfect.

The most obvious thing that you can do, to eliminate a huge portion of the practical problems which have been discussed, is to grandfather all old assets, every asset which reflects a basis as of December 31,

1976—treat it as you did under the old law, forget about carryover with regard to that asset.

All you are losing there is the tax on the post-1976 appreciation on assets held by old people. The old people are not going to sell anyway because they want to get the fresh start which the law gives them. The young person is not going to hold on to an asset because sometime 40 years from now, when he dies, he is going to get a stepped-up basis for that asset.

If you give such a provision for carryover, you have eliminated all the records search problems on old assets. You have said, the past is behind us. You wipe the sale clean. From now on, you know what the rules are, and if you do not follow the rules, when you die 30 years from now, it is on your own head. But at least, what has gone before is passed.

You also eliminate the problems that Mr. Costello is concerned about, and I am concerned about, particularly the 303 and 306 problems with regard to old assets, because the old plans will still work and you have not imposed upon plans put together in good faith a brand new set of rules that make everything unfeasible.

The second thing I would do is to allow an optional averaging of basis to eliminate the problems that Mr. Eubank addressed where you have one block of mutual fund shares which he purchased at 78 different times, which gives rise for the need of 312 pieces of basic information. Allow people to say we will take those 78 lots of stock and put them altogether in one pack and average the basis among them so that people have a sensible set of records to keep, so that you are not imposing this recordkeeping burden that requires the mind of a computer to keep track of.

And finally, to address the problem that Ms. Blazek addressed, I would allow an estate tax adjustment, instead of at the theoretically perfect average estate tax rate, at the top rate. The reason for that is that the top rate rarely changes, and that means during administration a fiduciary will be able to take a look at the asset, he will be able to look at the adjustment that he has to make, be able to compute his tax, and be able to pay his tax without the fear that a change on audit will create a tax refund situation.

Senator BYRD. I am not clear as to what you are referring to when you say you would make it at the top rate? I am not clear on that point.

Mr. KARTIGANER. This refers to the estate tax adjustment. If you have an item which has appreciated, the law says that you can increase the basis of that asset by the estate tax attributable to the appreciation, but it does it at the average rate of tax, and Ms. Blazek indicated the problems inherent in that.

If you make a change in any item on the audit of the estate tax return, you are changing the overall tax. Therefore, you are changing the average rate of tax, because you have different numerators and different denominators.

On the other hand, you very rarely, only in a small percentage of the cases, change the top rate of tax because the brackets are large and it genearlly takes a very large change on audit to move an estate to a different tax bracket.

Therefore, what you are doing is you are increasing the certainty. You are saying that your computations will, in most cases, stand up

and you are diminishing the burden, both on the fiduciary and on the Treasurer.

Senator BYRD. The panel seems unanimous in its view in opposition to the carryover of basis under the present law. What alternatives does the panel suggest to the current carryover basis provision?

Mr. EUBANK. I might start off on that, Mr. Chairman, and then have comments from some of the others, if you wish.

There are a number of possibilities that are under consideration. We could go back to the old law or we could stay with the current form of carryover basis, or modified forms of it, as Joe just talked about.

Other possibilities are called the appreciation estate tax; and finally, there is the capital gains at death possibility, which is one that there has been quite a bit of talk about recently.

Senator BYRD. Explain your point in greater detail.

Mr. EUBANK. As I understand it, and very generally speaking, the capital gains at death possibility means that capital gains are triggered at death. In other words, every decedent's estate would be facing two possible taxes: The first is the capital gains tax, payable just as though he had sold the assets the moment before death; and the second, if the estate is large enough, is the estate tax that will be paid.

Senator BYRD. On the same assets?

Mr. EUBANK. Yes.

Mr. KARTIGANER. With a deduction for capital gains tax.

Mr. EUBANK. There would be a deduction. The size of his estate would be reduced by the amount of the capital gains tax that the estate would have to pay.

Senator BYRD. How is that different from the present law?

Mr. EUBANK. Under the present law, the capital gains tax is not payable at death. There is a carryover basis and the family faces the capital gains tax payment only in the future when they sell. But, of course, a lot of times it is necessary for the executor to sell some assets in order to raise money for taxes and to pay debts, and things of that sort. So the executor, under the current law, faces a capital gains tax payment shortly after the decedent's death, but only as to those assets being sold.

The other assets are distributed out to the beneficiaries of the estate with a carryover basis, and they face a capital gains tax.

Senator BYRD. At a future date?

Mr. EUBANK. Yes, sir.

Senator BYRD. Does not the law step up the basis to whatever the asset might be valued at on December 31, 1976?

Mr. EUBANK. That is correct.

Mr. COSTELLO. Theoretically.

Senator BYRD. What do you mean, theoretically?

Mr. COSTELLO. Only on marketable securities is that true. On any other assets, you play a gambling game. It depends on how high and low the value is at the time you die.

On a straight line extrapolation, based on the number of days held before December 31, 1976, to the total number of days held, you apportion that to a fresh start basis, and in a small business it is not too hard to imagine macrofluctuations in the value of that business, depending on the competition or otherwise which may very well, incidentally, disqualify percentage requirements from stock payouts and 303 exemp-

tions and your stepped-up basis as to what the value may have been December 31, 1976.

Mr. EUBANK. Perhaps we should add also that that fresh-start value adjustment to December 31, 1976, is temporary. It is only for odd assets held before then, and in due course that feature will pass out of existence as all assets become post-1976 acquired assets.

Ms. BLAZEK. That was the point of the $500,000 estate that I discussed with you, in terms of the raising of the total taxes paid on a $500,000 estate from $54,000 to $145,000, because it was all post-1976 appreciation, a business begun in 1977—in essence, what we are saying is that the young person coming out of college faces quite a different situation ultimately in terms of starting up a new business.

Senator BYRD. I see what you mean. The 1976 law is affecting young people starting out now.

Ms. BLAZEK. That is right, because it hits post-1976 appreciation.

Mr. KARTIGANER. If I may address the immediate question, this will impose a tax on assets that are appreciated in value, whether or not the asset has been sold or if there are ever any plans to sell it. If you are talking about the farmer or the small businessman who has built up a business and intends to pass it down from generation to generation, you are imposing a capital gains tax which under the old system, and even under the Tax Reform Act of 1976, would never pay a capital gains tax, because the gains tax has traditionally been imposed on the disposition of the asset.

The alternatives to carryover basis would all impose the tax upon the incidence of death. Any time there is a death, there would be a tax. I do not know what the rate would be. It has been discussed at various levels, but it would be a tax on the asset regardless of the fact that there was never an intention to sell the asset at any time.

Senator BYRD. I do not know this categorically, but my guess is that the administration will recommend and urge the elimination of the capital gains tax. If that is done, and it applies to estates, then the problem is further accentuated by a very great degree.

Mr. EUBANK. Yes, sir, it certainly would, and I might point out that there was a great deal of discussion here among the panelists ahead of time about some dangers in our pointing out difficulties with the current law on carryover basis. We were afraid that we might be misconstrued as opening the doors and encouraging the adoption of some of these other alternatives, like the capital gains tax at death or the appreciation estate tax.

Speaking for myself, I am not advocating that, and I am concerned that some of our comments might be taken as ammunition for some of those alternatives.

Mr. COSTELLO. That is my concern also. Again, with my practical fellow who does not understand how dying is getting through a loophole, when you say what is your alternative, the question arises is, why does there need to be an alternative?

If we stuck with the exemption that we had for so many years back, appreciation made the exemption meaningless and we face now a fixed income tax and a newly fixed estate tax rate. Experience would teach us in a period of a very few years we would then accelerate these mistakes to the astronomical tax brackets. Does it really matter, the way it is going to confiscate, your minimum bracket being 32 percent, when you get into a taxable estate?

You are gilding the lily to worry about an additional tax on top of that. For the administrative complexity, why does there have to be an alternative to the carryover basis situation, because as I understood it, we were looking for relief for the farmers and small businessmen and the former relief does not matter. If it can be done in a percentage of the tax, that is fine.

I, too, am concerned that we not be misconstrued to be saying that some of these other ideas sound like good ones.

Senator BYRD. In other words, as I understand it, each of you feels that most taxpayers and most estates would be better off to go back to what we had before rather than to continue with what was done in this field last year?

Mr. EUBANK. I do not think there was any doubt about it.

Ms. BLAZEK. There is no doubt about it.

Mr. KARTIGANER. We are unanimous on that.

Senator BYRD. Thank you.

Senator Hansen?

Senator HANSEN. Thank you, Mr. Chairman.

One aspect of our tax law that has direct correlations to estate planning is the capital gains tax. Where I come from, many ranchers and small businessmen sell their enterprises and use the proceeds for retirement income and frequently gift out some of the proceeds to lower their taxes.

Occasionally, during the last year, older folks who have sold out have written me telling virtual horror stories of the impact of the retroactive minimum tax on their tax planning. We all know the arguments against retroactive tax legislation. What I am wondering, however, is what changes you would make in the tax law to better protect these folks who have made a single sale of a capital asset held for virtually a lifetime?

Mr. COSTELLO. If I could answer, this is assuming you got stuck with carryover basis. The same answer that I would give for the small business sellout is the one I would give there. That would be to consider some special treatment for these plans, some single-sale fellow, whether it is a buy/sell agreement of a closely-held corporation, or something similar to the 10-year average that retirement plans were subjected to, or something in that range. Then you could apply the same, or some constructive percentage of that asset test or some size test if you wanted to. That would be the same solution if you kept the carryover basis that would be needed in the small business and farming.

Senator HANSEN. A proposal I made for a few years in which I have been joined by a number of other people was to have a sliding scale applied to capital gains. Oftentimes the small businessman and the small farmer and rancher who has held an asset for a substantial number of years and sells out loses a large part of the benefit of his asset with the way we "fixed things up" here last year. I use the word "fix-up" in the most pejorative sense, I might add. When the rancher goes through paying his taxes, he does not even come out even with the effect that inflation has had on costs. He cannot sell out and invest in something else, and he cannot pass on even what he started out with.

Would you make observations on that?

Mr. KARTIGANER. That is a much broader philosophical question than the technical problems in the tax reform act. Obviously an indexing approach would be of significant help to the small businessman or, for that matter, any taxpayer. If you are trying to evaluate the gain, you should evaluate it in the real world rather than in some absolute dollar terms, because the gain in most cases is really nonexistent, and if you add in the capital gains tax burden, you are making it less so. You are putting it in a negative category.

Senator HANSEN. I have heard suggestions that maybe another approach might be to roll over the value in one piece of property, or kind of property, and within a period of time put it in something else.

I know oftentimes older people, for various reasons, cannot continue operating the particular type of business they have been engaged in most of their lives. Here again, the effect of the various taxes that we have added on the sale of a property seems to make that particularly difficult.

Is that a possibility?

Mr. COSTELLO. I do not think that you can solve the problem for someone who already has his assets in cash equivalency, marketable securities without undercutting the whole income tax law. I would point out that you could conform the living and dead if the test of 303 exemptions were the old test of 35 percent of the gross and 50 percent of the net. You could apply that same thing to an income tax consequence and permit special capital gains rates for people who dispose of that closely held interest, farm or business, if they met the test requirements.

This might be a combination that would have some merit, and that might do away with the complaint that after death and before death, you have different treatments.

Senator HANSEN. There has been some reference to the provision we made in the law last year. We gained some support for a concept that would permit the passage of a farm or ranch if the present use were to be continued, with the basis determined by the value of its income-producing ability continuing in that same kind of an operation as contrasted with its best and highest use.

Senator Ribicoff was interested in the same concept being applied to a small business. We got a package put together and the Finance Committee did not put any limit on it.

There was a limit put on during the drafting of the bill by staff and it was put on at $1 million, but when it went to conference, the limit was reduced to $500,000 since the House had no similar provision.

I think Mr. Eubank spoke about the need for financing and the other problems that face the average operator, so for practical purposes, I do not think that $500,000 exemption really amounts to very much.

Would you comment?

Mr. EUBANK. I might start, Senator. There is a problem with the $500,000 limitation and there are lots of other problems in there. I have heard a lot of people talk about this section 2032A, who have analyzed it, and several messages come across from these people who have become experts on this.

The first is that it is extremely narrow in its application, not only because of the $500,000 but because of other things. Another is that

it is incredibly complex and difficult and uncertain as to exactly what it means; and our third problem is if a family elects to take advantage of it, dots all the "i's" and crosses all the "t's" and comes within the narrow confines of it, and then if something happens during the next 15 years that violates section 2032A—something involving management can be an inadvertent violation of that section—then that whole thing crumbles around them and the total tax is much greater than it would have been if they had never used the blasted section.

Senator HANSEN. I think you said that we would be better off to go back to what we had before we tried to improve things as we thought we were doing last year?

Mr. COSTELLO. Yes, sir. That is what I was describing in my paper.

I will say on farms, the number of farms that are trading in the range of $250,000 to $1 million within 100 miles of Washington has accelerated astronomically. I have been involved in at least four this year already.

In fact, one retired member of the Bureau of Standards paid $200 an acre for his land. After fighting 2 years in the process of Fairfax County zoning and two leasings in the Supreme Court of Appeals of Virginia and after a denial of a writ of certiorari to the U.S. Supreme Court, it took us 7 years to get it zoned, so we could do a tax-free swap for Georgia land. He is going to stay in Virginia and try to dispose of the other 100 acres of it.

In the meantime, by the leasing of Georgia land, he will no longer be a farmer because, as I read the provisions, because it takes 3 years, if our past experience is any example to get there. To replace it with a farming farm, you have to go over the $500,000 limit.

There is a man without outside income except for what he sold off the farm and his Government retirement.

Senator HANSEN. Mr. Chairman, you know, next to being in the apple business, the worse thing I can think of is being in the cattle business. Coming from the West, as I do, with the livestock prices being as terribly depressed as they are, many bankers have predicted 5 to 10 percent of all the ranchers in Wyoming this year may be forced to sell their outfits.

For those who have had a death in their family, invariably the whole outfit has to go on the auction block to try to settle the claims of the Government. That is the first mortgage, you know, Federal tax.

I just think we have created a terrible problem, a terrible dilemma, for the average citizen.

Mr. KARTIGANER. If I may make one comment here, this is an example of one of the problems in the legislative process. The farm relief bill started out as a very good idea, and if it had been left at where it was addressed, it probably would have worked out as a pretty good idea. But the theoretician became worried that this was going to create a new tax shelter. People with money were going to rush out and buy these farms because they were going to get a greater estate tax break.

I do not know whether people with money would, in fact, have done that. In an attempt to avoid that result, they have emasculated the relief provision and they have made it so complex and so difficult to comply with that it is no longer relief for those people for whom it was intended, and something is wrong with that process.

Mr. COSTELLO. Would this be an appropriate place to state that much concern has been expressed by practitioners in my area about the legis-

lative process that resulted in that 1976 bill? I have in my hand a letter from Congressman David Satterfield from the 3d District which, in effect, says that when Mr. Ullman brought his bill on the House floor and the House would not agree to review only two provisions, he took it back into committee because, as Congressman Satterfield said, "I and other Members were concerned that this rule would not permit the House to work its will and would have specifically prevented amendments to section 6 of the bill," and he is talking about the carryover.

[The following was subsequently supplied for the record:]

CONGRESS OF THE UNITED STATES,
HOUSE OF REPRESENTATIVES,
Washington, D.C., September 29, 1976.

Mr. LEWIS M. COSTELLO,
Chairman, Section on Taxation, Board of Governors, Virginia State Bar, Winchester, Va.

DEAR MR. COSTELLO: This is to acknowledge your letter of September 16, and the enclosed resolution concerning Estate and Gift Tax Reform.

Since the adoption of your resolution in July, several things have occurred with respect to the Estate and Gift Tax Reform measure. First, the bill cited in your resolution, H.R. 13966, was not reported by the Committee on Ways and Means. The Committee instead reported a "clean" bill, H.R. 14844.

The rule granted by the Rules Committee to govern action on the House floor with respect to H.R. 14844 was a modified closed rule, which would have permitted two amendments only. One of those amendments would terminate existing law, which defers estate taxes upon estates left in trust until their corpus vests in the ultimate beneficiary. The other would reinstate the "split-credit" provision, which had been deleted by the Ways and Means Committee.

I and other Members were concerned that this bill would not permit the House to work its will and specifically would have prevented amendments to delete or alter section 6 of the bill. As you know, under existing law the recipient of a decedent's estate, or portion thereof, acquires that property at the value it has as of the date of the decedent's death. Any subsequent transfer insofar as capital gains is concerned would be on the basis of that valuation. Section 6 of the bill (the "carry-over-basis" provision) would change that law so as to render the valuation of property the same as it was in the hands of the decedent prior to his death. Thus, the surviving successor in interest, upon transfer of the property, would have to pay capital gains not only upon its appreciated value while he had possession but whatever appreciation in value occurred while that property was in the hands of the previous decedent owner.

The matter came to the floor August 30, and the House voted to reject the modified closed rule and substitute and open rule, which would permit free amendment, in its place. At that point the Committee Chairman withdrew the measure from further consideration.

The matter emerged again, however, as a part of the Conference Report on the Tax Reform Act of 1976, which was passed by Congress and is awaiting the President's approval. As is so often the case with conference reports, when this one came to the floor specific votes on specific provisions were not permitted. Our only option was to vote the measure up or down. To further complicate matters, this conference report, which consisted of 646 pages, was not available until 1½ hours prior to the time the vote occurred. Consequently, there was not time to fully study the report to determine precisely what it contained. With measures of this magnitude I have made it my policy to vote against them unless I have a clear understanding of exactly what is involved.

I certainly agree with you and the members of the Section on Taxation that extreme caution should have been the rule of the day. While I feel that reform in the area of Estate and Gift taxes has long been needed, I am not convinced in my mind that what was passed will provide any measure of relief.

I am enclosing a copy of a summary of the Estate and Gift Tax provisions included in the Conference Report for your information.

With best wishes, I am
Sincerely yours,

DAVID E. SATTERFIELD III.

Mr. COSTELLO. The matter came back on the floor August 30 and the House voted to reject the modified closed rule. When it came back out of the conference, and he says:

To further complicate matters, this conference report, which consisted of 646 pages, was not available until 1½ hours prior to the time the vote occurred. Consequently, there was not time to fully study the report to determine previsely what it contained.

With measures of this magnitude, I have made it my policy to vote against them unless I have a clear understanding of exactly what is involved. I certainly agree with you and the members of the Section on Taxation that extreme caution should have been the rule of the day. While I feel reform in the area of Estate and Gift taxes has long been needed. I am not convinced in my mind that what was passed will provide any measure of relief.

The contempt I am running across in my practice for the congressional process—and I might be censored by other members of the panel for saying this, but I am going to say it—it seems to me that both the Senate and the House seemed to have abandoned the legislative process to the joint committee, and there was no House bill with equivalent measures because no bill had gone through the House at all, which is contrary to my understanding of the revenue bills originating in the House.

I think it raises some constitutional questions that perhaps ought to be looked at and concern with the legislative process is my concern, and I sincerely appreciate the opportunity to speak to this group today, because I think you are right. I think this is the only time the theory has been tested in a public hearing.

Senator BYRD. As one legislator, I agree with what you said about the Congress.

Senator HANSEN. Make it two.

Senator BYRD. Senator Packwood?

Senator PACKWOOD. I recall very specifically how we got into this estate-gift tax problem. I sat in the hearings of this committee, argued on the floor, and was a member of the conference. At the time that we passed these estate tax provisions, I was fully aware that not only did we not know what was in them, but if we did know what was in them, we did not know the effect that they had.

I will tell you this. Your problem is not with the legislative process per se but with the tax reformers. It is sort of a golden conclusion that they want to reach and it makes no difference to them what the law is. They will change the law to reach that conclusion, and you know the philosophy I am talking about, the loopholes, the great Treasury raid, the $78 billion in tax expenditures that exist for 5 to 10 percent of the population is what the reform is about, I think.

In the estate and gift tax area, one is to allow the spouse—usually a widow, not always—to live her life in comfort, not opulence, with money to educate her children and send them on their way. Beyond that, that is about it. After that, the reformers think you should not have any more money and they want a very high, progressive rate of taxation on whatever is left beyond that amount.

Two, they are willing to concede that family-run businesses ought to be passed on—I emphasize the word "run," not "own." There is something inherently good in passing on a small farm, a stationery

store, from father to son or father to daughter if he can. That is about all they want to allow.

Unless you change the election policy, that is what you are going to get. Within those confines, how should we prospectively draw the law so that those goals are achieved equitably?

Mr. EUBANK. Let me make one comment in answer to that. I think the others will have some other ideas.

Until recently, I had no idea of the complexity of the carryover basis and the other alternatives like appreciation estate tax and capital gains at death. I got to thinking of the evolution of the law we had before, and I came to realize that the past Congresses who have faced this must have had a great deal more wisdom than I ever gave them credit for, because I think perhaps they spotted those difficulties and they avoid them by setting the estate tax rates at a very healthy, high rate—it got up to 77 percent—and they felt that that was high enough to justify a new basis at death so as to avoid this whole can of worms.

If we are talking about prospects, some consideration should be given to this.

Senator PACKWOOD. If that was the intent of the past Congress, I think you give them credit for more wisdom than I do. I do not think they ever thought to themselves that carryover would be so difficult that we will make it very hard for it to come into effect.

Have you read—I am curious—any statements of Senator Kennedy and his supporters on the floor of his tax reform bill and the millions that are escaping and passing from generation to generation unjustifiably untaxed?

Mr. EUBANK. Yes; I have heard of a recent one where he is still talking about changes, apparently without recognition of the new law's effect, to avoid appreciation escaping taxation.

Senator PACKWOOD. That is the philosophy we are facing. That is probably predominant philosophy of the Senate. That is not going to change, short of election changes.

With that philosophy rampant, is there a way that the estate and gift tax law can be fairly accommodated to meet those goals?

I do not necessarily agree with the goals set, but to reach the goals that reform is about. Let's speak prospectively; you are right, retroactively we should change the law, put the rules back where they were. Prospectively, realizing what the reform is going to do, it is going to very heavily tax any estate beyond any $500,000, $600,000, $700,000 and just not do anything at best than the widow has a decent house and can get her children through college and that is it. After that, you are on your own, and the Government will take the rest.

Mr. COSTELLO. I would like to say that perhaps Senator Kennedy understands this better than most of the panel members as to the millions of dollars that are escaping taxation from transfer from generation to generation, and that accounts for his speaking out on the subject, perhaps. But I would understand your question to say, assuming you cannot do away with carryover basis, what would you do to accomplish what we are concerned about.

Senator PACKWOOD. Maybe we can do away with carryover basis. I am saying if you come up with some system that in some way allows a fair portion to escape the reformer's wrath of being taxed at value at death if that value exceeds $500,000, $600,000, $700,000, they are go-

ing to find some way to do it, and if they think carryover is the way to do it, they will go about it that way.

Mr. COSTELLO. At the risk of giving aid on the other side of the question, one way would be simply curing this 306 taint on closely-held businesses. You could live with carryover, perhaps, if you cured that taint on death and said so, and you permitted 303 redemptions.

Senator PACKWOOD. Explain that so I understand it.

Mr. COSTELLO. Preferred stock which was issued on common, specifically by regulation and by statute was cured of its tainted status under the old law.

Senator PACKWOOD. I understand that. What do you mean, preferred stock issued on common?

Mr. COSTELLO. In the recapitalization of a business, it was not uncommon—let us say you had a $1 million business and you had $100,000 of common stock, to freeze the equity you might issue $700,000 of preferred stock and then sell to the next generation the rest of the common. The issuance of the preferred on the common was not a taxable distribution.

At death, the taint on that stock was cured.

Senator PACKWOOD. Who held the preferred stock?

Mr. COSTELLO. The originator of the business.

Senator PACKWOOD. You are assuming here a privately held small corporation, $100,000 in common stock, this is held by the owner——

Mr. COSTELLO. Right.

Senator PACKWOOD. What does he do with it?

Mr. COSTELLO. He issues preferred stock.

Senator PACKWOOD. Who buys it?

Mr. COSTELLO. He issues it to himself, then he disposes of all the common stock ownership of the corporation to the family, to pass the family business on. He sell it or gives it to them for nothing. At death, under the old law, the taint was cured, then that was a way you could bail out earnings of a corporation by selling off the common stock and letting them redeem the preferred, 306 backed that.

It was so-called tainted stock, because whatever you did, it resulted in ordinary income. By holding it under the prior law till the date of death, it got a stepped up basis to the fair market value of that date, so the redemption or disposition of it with other common stock that may have been retained to be redeemed under 303 did not have any taint. You did not get ordinary income treatment upon the disposition of that asset. There would be no reason in closely held business, again assuming percentage requirements were met, that 306 stock could not, clearly, statutorily, have the taint removed on that kind of stock and permit the redemption—not only enough to pay estate taxes, but to pay income taxes that are triggered under the new law.

Also, at present under the new law, you cannot do that. The accumulation of the money to redeem could be jumped by some bright Treasury agent under the unreasonable accumulation section. You are fighting three rounds in there. If you had to live with what you had, at least those three things ought to be done. The percentage requirements back to the old requirements under 303. I know of no studies that show abuse existed with the 35-percent gross estate and 50-percent net estate requirements.

It may come as a surprise that few of my clients ever wanted special treatment. They want to pay the tax; they want to get it off their mind. You are actually going now to make people make elections to pay 10-year taxes where they could have redeemed under 303 and paid them to the Government at one time, because they cannot afford the income tax consequences without qualification for a 303 redemption.

If you could redeem, under 303 for both the estate tax and income tax that would result—and it was not ordinary income; it could be done on capital gain without unreasonable accumulation—these are things that would help any farmer and businessman.

I hope I have been responsive to the question.

Ms. BLAZEK. I would like to make a few comments on what might be done to meet the reformers' concept within the concept of carryover basis, if need be.

One of them is, as you suggest, to recognize the need of the spouse to have assets on which to live and to finish raising the children, therefore increase what is now called the minimum basis. It is currently $60,000. Take it up to some place where it really makes sense, at least to the point of the exemption of $120,000 or $170,000. Indeed, I think it would not be inconsistent with the reformers' concept to take it where the true middle-class wage earner is at this day, with all of the other assets of $500,000. Get the people you really want, which are the large estates. Let everybody under $500,000 out of it.

Senator PACKWOOD. The reformers are not wedded to the carryover concept. What they are wedded to is taxing certain estates above a certain size.

If there is a better way to do that than the carryover basis, they would accept that.

Ms. BLAZEK. I think frankly that absent repeal, given the context to meet the reformers, if it has to be done, rather than the additional estate tax, rather than capital gains at death, we favor carryover basis concepts that work. Part of what is needed is an increased exemption; take out the assets which really are not capital assets, such as personal effects, and hopefully, the residences. It could be a much more workable statute.

Mr. EUBANK. If the reformers are going to have their day and carry one way or the other, it does not have to be this particular kind of carryover basis we have now. We call this one we have today an item-by-item carryover basis, and it is the item-by-item business that makes it particularly unworkable.

There are other forms of carryover basis. It could be improved; and if it were improved and if it were coupled with an allowance for inflationary increases that are not truly capital gains, we would be a long way down the road, and we would have a capital gains tax on true appreciation, so as to satisfy the goals of those who want that.

Senator PACKWOOD. I do not agree with the philosophy, even with a minimum philosophy. They are overlooking other problems, capital formation generally, and second, to the family-run, as apart from the family-owned business, just because the business is big enough and has 400 or 500 employees owned by the family, too big for one person to run, they have the option of selling it out because you cannot afford when you die to do anything but do that—that is not a healthy trend in this country. I think maybe you bring the reformers that far.

If the answer from those who represent very large estates in the estate and gift tax brackets, and we are going to find some way to pass on $15 and $20 million estates, the second generation relatively on a scale that is not going to work, we would end up with a terrible mishmash.

Mr. EUBANK. None of us is advocating that.

Mr. KARTIGANER. On the other hand, there are limits beyond which I do not think taxation should be pushed. To take your example of a 400- or 500-employee business—I would guess that the value of that estate is somewhere around $5,000,000—I have run some computation recently for a client of mine with a $5 million situation. I said, what would happen if you increased the value of that $5 million to $6 million? How much of it will your family keep? And the answer that my arithmetic came up with was under 3 percent.

That is the combined estate and capital gains impact on that increase. The tax on the increment from $5 to $6 million was 97.1 percent.

Senator PACKWOOD. You also understand that that is what the reformers have in mind?

Mr. KARTIGANER. I understand that. It also means that my client, or the person you are concerned with, the 400- or 500-employee businessman is out of his head if he stays in it, because it is all work and no gain, so what happens? He sells out and he reinvests in municipals. He does a lot better to keep it in tax-free income and in municipals than in keeping his money at risk when the Government is going to step in any take it away from his family.

Senator PACKWOOD. Thank you.

Senator BYRD. Thank you.

I think you are quite right, and I think that Senator Packwood emphasizes rightly the important aspect of this hearing. When Congress enacted tax laws which may force the small businesses and small farms to sell out or merge with large businesses, a more adequate record is necessary than was present for the 1976 law.

This country has too many large businesses today and I think the great problem in our country is that we have a combination of big government, big labor, and big business. Yet the tax laws are forcing more and more small people to sell out to the big people.

It seems that what we want to do, what reform is, is to go in the other direction. I do not call the act we passed last year a tax reform act. I call it a so-called tax reform act.

The 1976 act sets up effective dates by which certain changes in the estate trust area are made retroactive. Do you see problems caused by these effective dates?

Mr. KARTIGANER. Senator, it is a horror. What has happened is that they have taken the philosophy of the tax law which was designed for General Motors and Exxon and IBM—where you have lawyers who are up on Capitol Hill watching every development and they want to make sure that any time they adopt any change that they do it with immediate effect, for fear that the big, giant corporations with the sophisticated lawyers are going to rush out and take advantage—and moved it over into a tax law that affects individuals, and it does not make sense.

The 1969 act is a great example of that. They made it with virtually immediate effect, and you are still passing a law in every session extend-

ing the effective date because individuals cannot comply that quickly and they do not restructure their affairs in order to take advantage of loopholes that are disappearing. And you have a rapidly growing gap between the needs of these individual clients and the competence of their counselors. You are making it more complex, you are making it more dangerous. And when you make it retroactive, you are making it unfair.

Ms. BLAZEK. There are two provisions in the act that acted retroactively to the detriment of the taxpayer and consternation of lawyers trying to cope. One was in the area of generation-skipping taxes in which the TRA in essence grandfathered, or said the tax would not be applicable in respect to trust or skips that are in addition, or come into effect with respect, to a will in existence on April 30.

We had clients coming to us wanting to make a change, even a minor change, in an existing will that contained a standard residuary trust that had a skip in it. The person already had two codicils, so, rather than do a third codicil, we did a new will. In May we wrote a new will for a client, and that taxpayer is hit with a generation-skipping tax, even though the basic scheme in the will was not changed.

There was no way that that taxpayer—indeed, we as practitioners—could have known the tax effect when we made those changes.

A second area was an attempt to reach those taxpayers that were transferring appreciated property into trust. In essence, the TRA said, if you put stock in a trust and sell it within 2 years of the transfer to the trust, the trust is going to pay a tax as though it were in the donor's tax bracket.

That provision had an effective date, I think, at the end of June. It was perfectly possible after June and before the act came out, for people to create a trust, put the stock in and sell it. They were hit with a capital gains tax that they did not know they had to pay. There was no way they could plan.

Mr. KARTIGANER. We should also come back to carryover basis. Carryover goes back and picks up deals that were done 20 years ago where, for example, two partners who set up a business entered into a buy-sell agreement to determine what happens when one of them dies. That agreement has been knocked completely out.

The reason it does not work is that carryover was adopted without a grandfather provision. Fresh start does not help, it does not cure the problem. What you have are all sorts of practical problems in making those arrangements work, and retroactivity is a problem.

Mr. COSTELLO. All of a sudden, you have taken a businessman who, in good faith 2 years ago, negotiated a buy-sell agreement with a fellow businessman. As a result—he now has a bad heart. He is in a box. If a younger fellow will not agree to rescind or amend that agreement, he is nailed.

At least on the effective date, you have a date you can go back to.

To make a point on the effective date, I have the Commerce Clearinghouse publication here. It is interesting that the bill is presaged by 11 pages of effective dates. I suggest to you that no practitioner can comprehensively explain to a client the need for 11 pages of separate dates on single legislation. I certainly cannot cope with it.

[The following was subsequently supplied for the record:]

EFFECTIVE DATES

This CCH-prepared table presents the effective date for the amended and added law provisions of the Tax Reform Act of 1976. Entries are listed by Act section order.

TAX REFORM ACT OF 1976

Act provision subject	Act section	Effective date	Code section
Amortization of real property construction period interest and taxes.	201	Nonresidential real property, construction begun after 1975; residential property, tax years beginning after 1977; low-income housing, tax years beginning after 1981.	New 189.
TAX SHELTERS			
Recapture of depreciation on real property	202	Tax years, ending after 1975	1250 (a) (d).
Amortization of low-income housing	203	Expenditures paid or incurred after 1975 and before 1978.	167(k).
Limitation on deductions to amount at risk.	204(a)	Tax years beginning after 1975	New 465(a).
Amounts considered at risk	204(a)	do	New 465(b).
Activities to which applicable	204(a)	do	New 465(c).
Definition of loss	204(a)	do	New 465(d).
Special rule for film production	204(c)	Depreciation, property in production under a binding contract on Sept. 11, 1975; production or distribution, property in production before Sept. 11, 1975. Exception where principal photography began before 1976. Transitional rule for leasing.	New 465(c).
Gain from disposition of interest in oil or gas property.	205	Property disposed of after 1975 in tax years ending after 1975.	751(c), 1254(a).
Farm loss recapture rules	206(a)	Transfer occurring after 1975	1251(b).
Limitations on deduction for farm syndicates.	207(a)	Tax years beginning after 1975	New 464(a).
Orchard and vineyard expenses	207(b)	Planted after 1975 in tax years beginning after 1975.	New 464(b).
Accounting for agribusiness	207(c)	Tax years beginning after 1976	New 447.
Prepaid interest	208	Amounts paid after 1975 in tax years beginning after 1975, but not to amounts paid before 1977 under binding contracts existing on Sept. 16, 1975.	New 461(g).
Limitation on interest of nonbusiness deduction.	209	Tax years beginning after 1975; not applicable to indebtedness incurred or contracted before Sept. 11, 1975, for a specified term.	163(d).
Amortization of production costs of films, books, records.	210	Expenditures paid or incurred after 1975 if principal production begins after 1975.	New 280.
Produced film rents defined	211	Tax years ending on or after Dec. 31, 1975.	543(a).
Sports franchises	212	Sales or exchanges of franshises after 1975 in tax years ending after 1975.	New 1056.
Partnership 1st-year depreciation	213(a)	Partnership tax years beginning after 1975.	179(d).
Partnership organization and syndication fees.	213(b)	Partnership tax years beginning after 1976.	New 709.
Partner's distributive share	213(d)	Partnership tax years beginning after 1975.	704(b).
Deductible losses of limited partners	213(e)	Liabilities incurred after 1976	704(d).
Hobby losses; waiver of statute of limitations.	214	Tax years beginning after 1969, unless deficiency assessment period has expired.	183(e)(4).
MINIMUM AND MAXIMUM TAX			
Minimum tax	301	Tax years beginning after 1975	56, 57.
Maximum tax	302(a)	Tax years beginning after 1976	1348.
EXTENSION OF INDIVIDUAL RATE REDUCTIONS			
General tax credit	401(a)	Tax years ending after 1975 and before 1978.	Sec. 3(b) of Revenue Adjustment Act of 1975.
Standard deduction	401(b)	do	141(c); 6012(a).
Earned income credit	401(c)	Tax years beginning after 1975 and before 1977.	43(a) and (b).
Withholding requirements	401(d)	Wages paid after Sept. 14, 1976	3402 (a) and (m).
Earned income credit disregarded for federal programs.	402	Tax years ending after 1975	Sec. 2(d) of Revenue Adjustment Act of 1975.

TAX REFORM ACT OF 1976—Continued

Act provision subject	Act section	Effective date	Code section
INDIVIDUAL TAX SIMPLIFICATION			
Tables for taxable income under $20,000	501(a)	Tax years beginning after 1975	3.
Alimony deduction	502(a)	Tax years beginning after 1976	62.
Retirement income credit	503(a)	Tax years beginning after 1975	37.
Child care expense credit	504(a)	do	New 44A.
Sick pay, disability pensions exclusion	505(a)	do	105(d).
Military disability pensions	505(b)	do	New 104(b).
Disability income, terrorist attack	505(c)	do	104(a).
Moving expenses	506(a)	Tax years beginning after 1976	217(b), (c), (g).
BUSINESS RELATED INDIVIDUAL PROVISIONS			
Business use of home, rental of vacation homes.	601(a)	Tax years beginning after 1975	New 280.
Attending foreign conventions	602(a)	Conventions, seminars and similar meetings taking place after 1976.	New 274(h).
Qualified stock options	603(a)	Tax years ending after 1975	83(e), 422 (b), (c), 424(c).
State legislators' travel expenses	604	Election to be made at date to be prescribed by Treasury.	162(a).
Nonbusiness guarantees of bad debts	605	Taxable years beginning after 1975 for guarantees made after 1975.	166(f) repealed.
ACCUMULATION TRUSTS			
Taxing distributions	701(a)	Distributions made in tax years beginning after 1975.	667.
Income accumulated for child under 21	701(b)	do	665(b).
Distributions not in excess of income	701(c)	do	665(b).
Repeal of capital gain throwback	701(d)	do	669 repealed.
Property transferred to trust at less than fair market value.	701(e)	Transfers made after May 21, 1976	New 644.
CAPITAL FORMATION			
Limitation on used property	801	Tax years beginning after 1975	Sec. 301(c), Tax Reduction Act of 1975; 46, 48.
Extension of investment tax credit	802(a)	do	46(a).
Unused credit carryback and carryover	802(b)	do	46(b).
Employee stock ownership plans	803(a)	do	46(f).
Special rules	803(b)	do	46(f).
Plan requirements for credit	803(c)	Tax years beginning after 1974	Sec. 301(d), Tax Reduction Act of 1975.
Elective additional half percent credit	803(d)	Tax years beginning after 1976	Sec. 301 of Tax Reduction Act of 1975.
Limitations on contributions	803(f)	Tax years beginning after 1975	415(c).
Waiver of penalty for underpayment of estimated tax.	803(g)	Tax years beginning after 1974	415(c).
ESOP retroactive regulation	803(h)	On enactment	
Commission on expanded stock ownership.	803(i)	On enactment	ERISA 3022(a).
Investment credit for films	804(a)	Taxable years beginning after 1974	New 48(k).
Overestimation of useful life	804(b)	do	47(a).
Alternative computation for past periods	804(c)	Any film placed in service in a tax year beginning before 1975.	46(c).
Entitlement to credit	804(d)	do	48(k).
Investment credit for ships	805	Tax years beginning after 1975	New 46(g).
Net operating loss	806(a)	For losses incurred in tax years ending after 1975.	172(b).
Regulated transportation companies	806 (b), (c)	do	172(b).
Insurance companies	806(d)	For losses incurred in tax years ending after 1975.	812(b).
Limitations on carryover	806(e)	For tax years beginning after June 30, 1978.	382.
Small fishing vessel construction reserves	807	On enactment	Sec. 607, Merchant Marine Act.
SMALL BUSINESS PROVISIONS			
Surtax exemption rate extended	901(a)	Dec. 23, 1975	11(a)(b)(c)(d).
Mutual insurance companies	901(b)	Tax years ending after 1974	821(a).
Tax-option corporation shareholders	902(a)	Tax years beginning after 1976	1371 (a), (e).
Tax-option corporation distributions	902(b)	Tax years beginning after 1975	New 1377(d).
Husband and wife stock	902(c)	do	1371 (c), (f).

TAX REFORM ACT OF 1976—Continued

Act provision subject	Act section	Effective date	Code section
FOREIGN INCOME			
Income earned abroad by U.S. citizens	1011(a)	Tax years beginning after 1975	911(c).
Additional limitations	1011(b)	do	911.
Credit with standard deduction	1011(c)	do	36.
Nonresident aliens married to U.S. citizens.	1012(a)	Tax years ending on or after Dec. 31, 1975.	6013.
Community income	1012(b)	Tax years beginning after 1976	New 879.
Estimated tax return due date	1012(c)	do	Do.
Foreign trusts with U.S. beneficiaries	1013(a)	Tax years ending after 1975 as to trusts created and transfers of property made after May 21, 1974.	New 679.
Grantor treated as owner	1013(b)	do	678(b).
Capital gains and losses of foreign trusts	1013(c)	Tax years beginning after 1975	643(a).
Returns of foreign trusts	1013(d)	Tax years ending after 1975 as to trusts created and transfers of property made after May 21, 1974.	6048.
Interest charge on accumulation distributions by foreign trusts.	1014(a)	Tax years beginning after 1976	667(a).
Computation of interest	1014(b)	do	New 668.
Excise tax on foreign transfers to avoid U.S. tax.	1015(a)	Transfers after Oct. 2, 1975	1491.
Nontaxable transfers	1015(b)	do	1491.
Election to treat as taxable exchange	1015(c)	do	New 1057.
Investment by foreign controlled corporations.	1021(a)	Tax years of foreign corporations beginning after 1975 and of U.S. investors which overlap.	956(b).
Constructive ownership of stock	1021(b)	do	958(b).
Repeal of exclusion of earnings of less developed country corporations.	1022	Tax years beginning after 1975	1248(d).
Exclusion from personal holding company income of foreign insurers.	1023	Tax years of foreign corporations beginning after 1975 and of U.S. investors which overlap.	954(c).
Shipping profits of foreign corporations	1024	do	954(b).
Foreign tax credit limitation	1031	Tax years beginning after 1975	904.
Recapture of foreign losses other than government debts.	1032	Losses sustained in tax years beginning after 1975.	New 904(f).
Less developed country corporate dividends.	1033	Distributions out of current income, received by a domestic corporation after 1977; distributions from accumulated profits for tax years after 1975.	902.
Treatment of capital gains for foreign tax credit purposes.	1034	Tax years beginning after 1975	904(b).
Foreign oil and gas extraction income	1035(a)	Tax years ending after 1976	907(a).
Foreign extraction income earned by individuals.	1035(b)	Tax years ending after 1974	907(b).
Tax credit for production-sharing contracts.	1035(c)	Tax years beginning after June 29, 1976	901.
Carryback and carryover of disallowed credits.	1035(d)	Taxes paid or accrued in tax years ending after date of enactment.	907 (c), (f).
Underwriting income	1036(a)	Tax years beginning after 1976	861(a).
Treatment as foreign source income	1036(b)	do	862(a).
3d-tier foreign tax credit	1037	As to earnings and profits of foreign corporations included in gross income of domestic corporations in tax years beginning after 1976.	960(a).
Interest on bank deposits	1041	Interest paid after 1976	861(c).
Foreign corporations' transfers of property from the United States.	1042(a)	Exchanges beginning after Oct. 9, 1975. See also sec. 868.	367.
Earnings and profits of subsidiaries of foreign corporations.	1042(b)	Exchanges beginning after Oct. 9, 1975	1248(c).
Gain from sales or exchanges of stock in foreign corporations.	1042(c)	do	New 1248(f).
Declaratory judgment procedure	1042(d)	Pleadings filed with the Tax Court after enactment with respect to exchanges beginning after Oct. 9, 1975.	New 7477.
Contiguous country branches of domestic life insurers.	1043	Tax years beginning after 1975	New 819A.
Transitional rule for bond losses of foreign banks.	1044	Tax years beginning after July 11, 1969	582(c).
Tax treatment of corporations operating in Puerto Rico and U.S. possessions.	1051(a)	Tax years beginning after 1975	33.
Puerto Rico and possession tax credit	1051(b)	do	New 936.
Income from U.S. possessions	1051(c)	do	931.
DISC corporation dividends	1051(d)	do	901(d).
Taxable income credit	1051(e)	do	904(b).
Dividends received deduction	1051(f)	do	243(b).

TAX REFORM ACT OF 1976—Continued

Act provision subject	Act section	Effective date	Code section
FOREIGN INCOME—Continued			
Consolidated returns	1051(g)	do	1504(b).
Western Hemisphere Trade Corporations.	1052(a)	Tax years beginning after 1975 and before 1980.	New 922(b).
China Trade Act Corporations	1053(a)	Tax years beginning after 1975	941.
Dividends to residents for Formosa and Hong Kong.	1053(b)	do	943.
Denial of credit to boycotters and kick-backers.	1061(a)	Payments or participation 30 days after enactment.	New 908.
Denial of deferral	1062	do	952(a).
Denial of DISC benefits	1063	do	995(b).
Boycott and bribe reports	1064	do	New 999.
Foreign bribes	1065(a)	Payments 30 days after enactment	952(a).
No reduction of foreign earnings or profits.	1065(b)	do	964(a).
Reports by the Secretary	1067	Annually	
DOMESTIC INTERNATIONAL SALES CORPORATIONS			
Definitions	1101(a)	Tax years beginning after 1975	New 995 (e), (f), (g)
Property excluded from export property.	1101(b)	Transactions after Mar. 18, 1975, in tax years ending after that date.	993(c).
Producer's loans	1101(c)	Tax years ending after Mar. 18, 1975	993(d).
Recapture of accumulated DISC income on stock disposition.	1101(d)	Tax years beginning after 1975	751(c); 995(c).
Allocating distributions	1101(e)	do	996(a).
Mining exclusion	1101(f)	Dispositions after Mar. 17, 1975, but before Mar. 18, 1980.	Tax Reduction Act of 1975, sec. 603(b).
ADMINISTRATIVE PROVISIONS			
Determinations open to public	1201(a)	Nov. 1, 1976	New 6110.
Pending requests	1201(b)	As soon as practicable after July 1, 1976.	Do.
Letters made public	1201(d)	Applications filed after Oct. 31, 1976	Do.
Confidentiality of returns	1202(a)	Jan. 1, 1977	6103.
Statistical publications	1202(b)	do	6108.
Inspection by local officers	1202(c)	do	4103.
Penalty for unauthorized disclosure	1202(d)	do	7213.
Civil damages	1202(e)	do	New 7217.
Processing of returns	1202(f)	do	7513.
Privacy Act applicability	1202(g)	do	New 7852(e).
Tax return preparers	1293	Documents prepared after 1976	New 6060, 6107, 6994–6996, 7407.
Jeopardy assessments review	1294(a)	Notice after 1976	New 7409.
Termination assessments	1204(b)	do	6851.
Sale of seized property	1204(c)	do	6863(c).
Third party summons	1205(a)	Summons issued after 1976	New 7609.
Assessments in case of errors	1206(a)	Returns filed after 1976	6213(b).
Errors defined	1206(b)	do	New 6213(f).
State tax withholding on armed forces personnel who are residents of a State.	1207(a)	Wages withheld 120 days after request for agreement.	5516(a), 5517(a).
Reserve forces	1207(b)	120 days after enactment	New 5517(d).
Federal employees	1207(c)	do	5517(a).
Gambling winnings	1207(d)	Winnings received after 90 days from enactment.	New 3402(q).
Commercial fishermen	1207(e)	Generally, services performed after 1971 in tax years ending after that date; reporting requirements, calendar years after 1971.	1402(c); 3121(b); 3401(a); 6050A.
State lottery wagering tax exemption	1208(a)	Bets placed after Mar. 10, 1964	4402.
Coin-operated devices	1208(b)	After Mar. 10, 1964	4462(b).
Minimum exemption from levy	1209	Levies after 1976	6331, 6334(a), (d).
Joint committee refund cases	1210(a)	Reports submitted after enactment	6405(a).
Tentative refunds	1210(b)	do	6405(c).
Audit	1210(c)	Jan. 1, 1977	8023(a).
Social Security account numbers	1211	On enactment	6109; Social Security Act, 208(g).
Deferral of interest on IRS errors	1212	Tax years ending after enactment	6404.
TAX-EXEMPT ORGANIZATIONS			
Transition rules for disposition of private foundation property.	1301	Dispositions after enactment in tax years ending after that date.	Tax Reform Act of 1969; 101(b).
New private foundation set-asides	1302	Tax years beginning after 1974	4942(g).
Minimum distribution amount	1303	Tax years beginning after 1975	4942(e).
Extension of time to amend charitable remainder trust.	1304(a)	Decedents dying after 1969	2055(e).
Refund claim period	1304(b)	do	2055(e).
Unrelated business income of trade shows, state fairs, etc.	1305	Tax years beginning after enactment for conventions and trade shows, after 1962 for public entertainment activities.	New 513(d).

TAX REFORM ACT OF 1976—Continued

Act provision subject	Act section	Effective date	Code section
TAX EXEMPT ORGANIZATIONS—Cont.			
Declaratory judgments on status	1306	Pleadings filed in Federal courts 6 mo after enactment with respect to determinations made after 1976.	New 7428.
Lobbying by public charities	1307(a)	Tax years beginning after 1976	New 501(h).
Taxes on excess lobbying expenditures	1307(b)	do	New ch. 41.
Disallowance of deduction for lobbying	1307(c)	do	170(f).
Liens for taxes	1308	Tax years ending after 1969	514(c).
Self-dealing transition rules for private foundations.	1309	Dispositions made after enactment	Tax Reform Act of 1969, 101.
Imputed interest, private operating foundations.	1310(a)	Tax years ending after enactment	4942(j).
Hospital services	1311	All tax years to which the 1954 Code applies.	New 513(e).
Clinical services of cooperative hospitals	1312	Tax years ending after 1976	501(e).
Exemption of amateur athletic organizations.	1313	Day after enactment	170(c), 501(c).
CAPITAL GAINS AND LOSSES			
Ordinary income offset	1401	Tax years beginning after 1976	1211(b).
Capital gain holding period	1402(a)	Tax years beginning in 1977	1222.
Capital loss, regulated investment companies.	1403	Loss years ending after 1969	1212(a).
Sale of residence by elderly	1404	Tax years beginning after 1976	121(b).
PENSION AND INSURANCE TAXATION			
Retirement savings for married individuals.	1501(a)	do	New 220(a).
Limitations on pension contributions	1502(a)	Limitations, years beginning after 1975; minimum, tax years beginning after 1975.	415(c).
IRAs for Reserves and National Guard	1503	Tax years beginning after 1975	219(c).
Annuity plan investments	1504	do	403(b).
Segregated asset accounts	1505	do	801(g).
Study of salary reduction pension plans	1506	On enactment	Employee Retirement Income Security Act, sec. 2006.
Insurers' consolidated returns	1507	Tax years beginning after 1980; transitional rule for carryover to pretaxable years.	821, 1504(c).
Guaranteed renewable life insurance	1508	Tax years beginning after 1957	809(d).
Study of IRA's	1509	On enactment	
Tax status of PBGC	1510	Sept. 2, 1974	ERISA, sec. 4002(g).
Level premium plans for owner-employees.	1511	Years beginning after 1975	415(c).
Lump-sum distributions from qualified plans.	1512	Distributions after 1975 in tax years beginning after 1975.	402(e).
REAL ESTATE INVESTMENT TRUSTS			
Deficiency dividend deduction	1601	Determinations after date of enactment.	316(b), 381(c), 857(b); New 859, 6697.
Income tests not disqualifying	1602	Generally, tax years beginning after date of enactment.	856(c), 857(b).
Property held for sale to customers	1603	Tax years beginning after enactment	856(a), 857(b).
Changes in income requirement	1604(a)	do	856(c).
Apportionment of income	1604(b)	do	856(d).
Commitment fees	1604(c)	do	856(c).
Mortgages held less than 4 yr	1604(d)	do	856(c).
Options to purchase realty	1604(e)	do	856(c).
Incorporation	1604(f)	do	856(a).
Interest	1604(g)	Loans made after May 27, 1976	New 856(f).
Dividends	1604(h)	Tax years beginning after enactment	858(a).
Annual accounting period	1604(i)	do	New 860.
Distribution requirements	1604(j)	do	857(a).
Termination or revocation of election	1064(k)	do	New 856(g).
Excise tax	1605	do	New 4891.
Allowance of loss carryover	1606(a)	do	857(b).
Years to which loss may be carried	1606(b)	Tax years ending after enatcment; transitional rule for loss carrybacks for years ending before 1976.	172(b).
Determination of amount	1606(c)	Tax years ending after enactment	172(d).
Alternative tax on capital gains	1607	Tax years beginning after enactment; transitional rule for loss carrybacks.	857(b).

TAX REFORM ACT OF 1976—Continued

Act provision subject	Act section	Effective date	Code section
RAILROAD AND AIRLINE PROVISIONS			
Railroad ties	1701(a)	Tax years beginning in 1977	263(g).
Investment credit, railroads	1701(b)	Tax years ending after 1976 and before 1983.	46(a).
Amortization of pre-1969 boring and grading equipment.	1702	Original use before 1969	New 185 (d), (e).
Investment credit, airlines	1703	Tax years ending after calendar 1975 and before calendar 1983.	46(a).
REPEAL OF OBSOLETE AND RARELY USED PROVISIONS			
Deadwood provisions—repeal and modification.	1901-52	90 days after enactment	See Sec. 51.
ESTATE AND GIFT TAXES			
Unified rate schedule	2001(a)	Decedents dying after 1976	2201, new 2010, 2035.
Changes in gift tax	2001(b)	Gifts made after 1976	2502(a), new 2505.
Estate tax imposed	2001(c)	Decedents dying after 1976	2011, 2101.
Marital deduction increase, estate tax	2002(a)	do	2056(c).
Marital deduction increase, gift tax	2002(b)	Gifts made after 1976	2523(a).
Fractional interest of spouse	2002(c)	Joint interests created after 1976	New 2040(b), 2515(c).
Valuation of farm property	2003(a)	Decedents dying after 1976	New 2032A.
Special lien	2003(b)	do	New 6234B.
Extension of time, estate tax	2004(a)	do	New 6166.
4 percent interest rate	2004(b)	do	New 6601(j).
Reasonable cause	2004(c)	do	6161(a).
Special lien	2004(d)	do	New 6234A.
Sale of stock to pay death taxes	2004(e)	do	303(b).
Carryover basis	2005(a)	do	New 1023.
Nonrecognition of gain	2005(b)	do	New 1040.
Limitation on increase in basis	2005(c)	Gifts made after 1976	1015(d).
Information requirement	2005(d)	Decedents dying after 1976	New 6039A, 6694,
Generation-skipping transfers	2006	Transfers made after Apr. 30, 1976	New ch. 13.
Orphans' exclusion	2007	Decedents dying after 1976	New 2057.
Administrative changes	2008(a)	Decedents dying, gifts made, after 1976	New 7517.
Special rule for gift returns	2008(b)	Gifts made after 1976	6075(b).
Public index of tax liens	2008(c)	Liens filed before enactment, 270th day later; filed later, filed 120th day later.	6323(f).
Decedents retained voting rights	2009(a)	Transfers after June 22, 1976	2036(a).
Disclaimers	2009(b)	Transfers made after 1976	New 2518, 2045.
Retirement benefits	2009(c)	Decedents dying after 1976	2039(e), 2517(a).
Expenses of estate	2009(d)	Tax years ending after enactment	642(g).
MISCELLANEOUS PROVISIONS			
Exempt housing associations	2101	Tax years beginning after 1973	New 528(a).
Disaster payments	2102	Payments received after 1973 in tax years ending thereafter.	451(d).
1972 disaster losses	2103(a)	To be set by regulations	
Debts owed by political parties	2104	Tax years after 1975	271(c).
Tax-exempt bonds for student loans	2105(a)	Obligations issued on or after enactment date.	103(a).
Personal holding company income defined.	2106	Tax years beginning after 1976	543(a).
Work incentive program expenses	2107	On enactment	50A(a), (c), 50B (a), (e), (g).
Light-duty truck parts excise repeal	2108	Parts sold after enactment	6416(b).
Articles resold after modification	2109	Resales on or after enactment date	4063.
Franchise transfers	2110	Transfers after 1976 in taxable years ending later.	751(c).
Tip reporting by employers	2111(a)	Jan. 1, 1976	6041(a).
Pollution control investment credit	2112	Tax years beginning after 1975	48(a).
Fishermen organizations	2113	Tax years ending after 1975	New 501(g).
Innocent spouse rule	2114	Applications filed within 1st calendar year after enactment.	Public Law 91-679, 3.
Percentage depletion limitations	2115(a)	Tax years ending after 1974	613(a)(d).
Transfers of oil and gas property	2115(b)	Tax years ending after 1974	613A(c).
State election to participate in Federal-state tax collection program.	2116(a)	Jan. 1 more than 1 yr after 1 State has elected to participate.	6361(a), 6362(b); Federal-State Tax Collection Act of 1972, sec. 204(b).
Student loan cancellations	2117(a)	Discharge of debts incurred before 1979.	61.
Student loan defined	2117(b)	do	170(b)(1).
Gain or loss on simultaneous liquidation of parent and subsidiary.	2118	Plans adopted after 1975	337.
Publishers' prepublication expenses	2119	On enactment	61.
Utility construction contributions	2120	Contributions made after Jan. 31, 1976	118.

TAX REFORM ACT OF 1976—Continued

Act provision subject	Act section	Effective date	Code section
MISCELLANEOUS PROVISIONS—Cont.			
State taxes on electricity	2121	After June 30, 1974	15 U.S.C. 381.
Architectural barriers for the handicapped.	2122	Tax years beginning after 1976 and before 1980.	New 190.
High income taxpayer report	2123	On enactment	
Preservation of historic structures	2124(a)	Additions to capital made after June 14, 1976, and before June 1, 1981.	New 191.
Demolition of historic structures	2124(b)	Demolition begun after June 30, 1976, and before 1981.	New 280B.
Depreciation of improvements	2124(c)	Basis attributable to construction after 1975 and before 1981.	167.
Substantially rehabilitated property	2124(d)	Additions to capital made after June 30, 1976, and before July 1, 1981.	167.
Transfers of partial interests for conservation.	2124(e)	Contributions made after June 13, 1976, and before June 14, 1977.	170(f).
Supplemental security income	2125	On enactment	Social Security Act, 1612(a).
Carryover loss for Cuban expropriations	2126	do	172(b).
MISCELLANEOUS AMENDMENTS			
Outdoor advertising displays	2127	Tax years beginning after 1970	1033(g).
Tax on large cigars	2128(a)	1st month more than 90 days after enactment.	5701(a); new 5702(m); 5741.
Gain from sales of depreciable property between related parties.	2129	Sales or exchanges made or contracted for after enactment.	1239.
Education programs for armed forces	2130	Amounts received in calendar 1976–79 for those receiving training in 1976.	Public Law 93–483, 4(c).
Swap stock funds	2131(a)	See sec. 905–908	368(a).
Partnership contributions	2131(b)	do	721.
Common trust funds	2131(d)	do	584(e)
Use of trust as exchange fund	2131(e)	do	683.
Contributions of government publications	2132	On enactment	1221.
Tax incentives study	2133	Final report Sept. 30, 1977	
Prepaid legal expenses	2134	Tax years beginning after 1976 and ending before 1982.	120.
Charitable contributions of inventory	2135	Contributions made after enactment in tax years ending after that date.	170(e).
Grantors of options	2136	Options granted after Sept. 1, 1976	1234.
Exempt interest dividends of regulated investment companies.	2137(a)	Tax years beginning after 1975	852(a).
Dividends paid deduction	2137(b)	do	852(b).
Exempt interest dividends	2137(c)	do	852(b).
Disallowance of deductions	2137(e)	do	265.

Mr. EUBANK. We see this problem on buy-sells all the time. Let's say there are two business owners and they agreed some time ago that on the death of the first, the other would buy him out; and they agreed on a fair price of about $300,000. Each business owner had to agree to that price and ask, will this be enough for my wife and children; and he reached the decision that it will be enough.

The new tax law comes along and he dies and he is bought out for $300,000; but his family has to pay a capital gains tax on that, and they do not net $300,000 from the business.

The new tax law has changed that bargain. He can go to the other partner and say, now please amend this. The other one may not be willing to because of the reasons Lew just mentioned. He may see he has a bargain, and he may be a hard-nosed bargainer and just not agree to the change.

Senator BYRD. I gather that one or more of you have looked into the proposed technical amendments that have been considered by the Ways and Means Committee.

What concerns me about the proposed technical amendments is that we will find ourselves worse than we are now.

Mr. COSTELLO. In preferred stock particularly, because the proposal in the technical corrections bill is moving exactly opposite to all the

prior law, specifically to say that preferred stock will not be redeemable and will suffer ordinary income tax consequences, which is exactly opposite to Congress stated law and the Treasury regulations in effect.

Senator BYRD. If it does that in that particular field, there may be dozens of examples where the average taxpayer, the average citizen, the average small businessman, the average small farmer may be in an even worse position than he would be if we had left the thing alone.

This is the problem with these new tax laws. People always come out worse off than before.

Mr. KARTIGANER. I see three major areas or problems in the technical amendments, three significant adverse effects on the small individual.

One is the proposed change to 303 and 306 that Mr. Costello just addressed. The other is the so-called anti-Byrum amendment. Byrum was a case in the Supreme Court of the United States, *Byrum* v. *United States*. It caused consternation in the Treasury.

They enacted an amendment to change the results of that case. It became known as the anti-Byrum amendment. It was technically defective. Everybody recognizes that, and the technical corrections bill seeks to make a change in that amendment.

The change again levels the elephant gun against a relatively small problem and the net effect of the amendment would be that nobody, no client of mine, certainly, will make any transfer of any interest in a closely held business to anyone unless he disposes of the entire business. He could not give any portion of his stockholding to his son or to a third party, and it does not matter whether he gives it outright or in trust. He cannot dispose of it.

Mr. EUBANK. It comes back in his estate?

Mr. KARTIGANER. It will come back into his estate, even though he has transferred it, even though he has lived 3 years, even though he has paid a gift tax on the transfer.

It is a very serious problem. I think everyone I have spoken to has stopped, we have frozen, because the amendment is retroactive to June 22, 1976.

Senator BYRD. That has not been adopted yet.

Mr. KARTIGANER. I thought the thrust of your question was, what is coming through.

Senator BYRD. Yes.

Mr. KARTIGANER. The third one is the amendment of the contemplation of death rule which has a proposed provision that any transfer within any one year to an individual which would require the filing of a gift tax return would automatically be brought back in.

That means if an individual gives $3,000 of IBM stock to his son, he can look at the newspaper and find a precise value for that stock. He is safe.

If he gives $3,000 of stock in his own business—and everybody knows how difficult it is to value stock in a closely held business—and the agent is successful in arguing that the stock was not worth $3,000 but worth $3,001, the $1 change in value will bring the entire transfer back in. So a $1 change in value creates a tremendous differential in tax impact.

It is an invitation to litigation. It means if you give $3,000 in cash to your son and he is an adult and you take him out for dinner, and

you did not have an obligation to support him so it is technically a gift, you are now creating an increase in the estate tax liability.

It is a dangerous provision.

Mr. EUBANK. I call this the necktie provision in the technical corrections bill. If there is a $3,000 gift, the agent is going to go out and look for a Christmas gift, say a necktie, that raises the total gifts for the year to over $3,000 and brings all the gifts back into the donor's estate.

Mr. COSTELLO. We cannot believe that Congress intended this ludicrous results and we really need somebody to say so. The constituents, I am sure, are saying so in some way, but surely Congress did not intend it.

Senator BYRD. I do not think that that was the intent of Congress at all. I do not think that what has happened in the estate field was the intent of Congress, as I understood the discussion by the Committee of Finance in this room when it was being marked up.

As a matter of fact, most of the matters we have discussed today did not even come up in the markup sessions or in the discussions on the tax bill of 1976. This is why I think that it is very important to have the views of people like yourselves who deal with this day after day and who know just how individual citizens are being effected by it. We need discussions like this and have the problems brought out in the open so that at least the Members of the Congress will know about it.

Whether they will act wisely on it is something else. At least they would have the opportunity to know about it.

Senator Hansen?

Senator HANSEN. Let me say this. I think that this is an extremely worthwhile hearing this morning. I share completely the view that has been expressed by many. I certainly did not know the monstrosity that we were creating, although I did harbor some fears that we might very well be doing that.

I recall, when we considered the effective date in the bill of 1976, if I remember correctly, we had 4½ printed pages of effective dates. I think I can say, without fear of contradiction, that not one member of either the Senate Finance Committee or the House Ways and Means Committee could have identified those specific provisions in the Code that would be affected by those effective dates.

I have heard repeatedly what the effect has been on our making retroactive changes in the tax law, the imposition of the minimum tax, on planning that people had done in good faith, going along, operating in consultation with their tax attorneys and accountants. This seems to be an act of a reasonable person, only we have changed the rules of the game and made them retroactive to an earlier date.

With specific reference to the energy industry, oil and gas particularly, I know a number of independent operators who found that they could not have pursued a more unwise course of action than they were following at the time, because they were going along with what the law said. We changed the rules as far as that goes, and we have since made some adjustments and moved the effective date of some of those laws that dealt with depletion, intangible drilling costs, and the tax preference items that we had included in the law so as to obviate some of the damage.

But I think that we have really created a veritable briar patch for people who were trying to do a reasonably good job.

I do know this. As I receive mail from my constituents, they are made painfully aware of what we have done and what we are doing and they would certainly hope that, before we take any further action that we ponder for some period of time the observations that you have made here, because I think that we could add further injustice upon the American people.

There is one other thing, Mr. Chairman, that disturbs me too. Members of the panel have pointed out how difficult it is, how the amount of time that is consumed by professional people, accountants and tax lawyers, in trying to figure out what we have done.

It is a pretty easy thing for someone to conclude that it is becoming so difficult to operate a business these days, why worry, why bother about it.

Is it not a better way to have money invested in something and put it in tax-exempt municipals?

I think that realistically it is fair to say that more and more people are going out of business these days, with OSHA, with all of the reports, the paperwork that we put on business, and with the complicated tax laws that we are adding to everyday, for people to say, why bother at all? It is better to be employed, it is better to go to work for someone than to try to run a business. For example, we have had a couple of ERA bills—economic development bills. I voted against both of them because they did not seem to make much sense.

They were intended to put people to work. Actually, I think they are going to miss the mark. I can see the money that is scattered around the United States. My little home county in Wyoming would have received about $6 million.

We happen to live in a resort area. We do not have very many people living there permanently. A part of the young people who are there like to play in the summertime and work in the wintertime, and as a consequence, they are unemployed part of the year.

There is another group that likes to work in the summer and play in the winter. As a consequence, according to the rules of the legislation passed, we would have gotten about $6 million.

Well, EDA has said now that they are not quite sure that these rules are as wisely thought out as they thought they were. They called upon Members of Congress to recommed changes.

I have voted against the bills, as I said. I did not think I was competent to make any changes. I did not want to try to add my ineptitude to a law that I thought was poorly devised in the first place, and if anybody should be able to determine where the money should be spent in Wyoming, it should be the State officials and the local citizens.

You cannot hire anybody for love or money in Jackson's Hole today. We have more jobs than there are workers, and yet EDA was going to dump off a $6 million expenditure in there, just to get money spent. It did not matter how the hell you spent it, just get it spent, so people are going to be put to work.

I am definitely worried that this tax maze that is made more complicated day by day will have the effect of driving people out of small business activity that you spoke about.

In the long run, that is not going to help anybody. It is going to make it more difficult trying to find a job, because I have to believe that the jobs worth a damn are jobs in private industry. I do not mean to depreciate a lot of fine Government workers, but the ultimate success of this country has to be based, I think, on private business activity. It cannot be based on an expanded governmental role and a decreasing private role.

I would hope very much we would heed the observations that you all made here this morning and see that others, too, are made aware of what has been the practical effects of these changes in tax law.

If we do not, we're going to be in a worse situation than we are in now.

Senator BYRD. I concur with your remarks.

I just have one additional question. It is prompted by the reference that has been made to preferred stock. I do not understand this situation.

Has there been a change in the way that preferred stock is handled as a result of the 1976 tax law, or are you speaking now of the proposed technical amendments?

Mr. COSTELLO. Both.

Senator BYRD. I wonder if you could do this, if you could say what the situation was prior to 1976, what it is under the 1976 law, and what it might be under the proposed technical amendments?

Mr. COSTELLO. Prior to 1976 when preferred stock was issued with regard to common during the lifetime of the person to whom it was issued, the owner of the business, if he disposed of that stock or redeemed it in the corporation, the result was ordinary income. It was to keep him from issuing preferred stock to himself and selling it to somebody else for a capital gains rate, and that person redeeming it back from the corporation, thereby converting accumulated earnings and profits on what would have had to have been a dividend, if he had been paid it in cash, to a capital gain.

Tht is the so-called preferred stock bail-out or hot stock or tainted stock or however you want to talk about it. However, under both the code and regulations prior to the Reform Act, death cured any taint on that stock. Its basis got stepped up just as the common stock got stepped up, and the two together specifically under the provisions of section 303 could be used in the redemption in order to get the money out to pay the estate taxes.

So that requirements were that to be a closely held business qualifying, it had to be 35 percent of the gross estate, or 50 percent of the taxable estate composed of this kind of stock.

All right, under the 1976 Reform Act and carryover basis, you no longer had a step up basis in 306 stock. There was an adjusted basis.

You have the percentage increased to 50 percent of the gross estate, less specific exemptions or deductions, that would have to be used to qualify for exemption and no longer is the automatic curing of the taint on the death of the decedent evident.

Articles have been written saying it does or does not get cured on the death of the decedent. This is true whether or not you are combining it with 303. Under the Treasury's view, if you took all of the preferred and all of common and redeemed it pro rata, you would still

have ordinary income problems with the preferred. If you did it separately, you would have ordinary income problems with the preferred, and there are two sections of the code cited in my statement that are in opposition.

Well, to do us a big favor and to clarify it, the technical corrections act would say, ha-ha, heads we win, tails you lose. It says that absolutely the taint is not cured and it will be ordinary income when you do it.

This is right over the top of the enterprises that have taken steps—and I have at least four in my practice that are directly affected by this, and some of the major industries in my area are affected by this.

It was accidental. It reverts back so that the correction is moving in precisely the wrong direction. Even the Treasury in its regulations—and I cited that in here previously—agreed that death curied any taint, and there ought not be any taint, because both the provisions, 303 and 306, said that where ordinarily you would have had ordinary income on the redemption of the stock, or where you are keeping most of it on the 306 stock, we are going to have no gain because you would be able to redeem it to get the money out to pay the tax.

Presumably, since both of those distributions, whether on common or preferred, would be on ordinary income, there is no philosophical reason that it should not cure the taint.

This is an area you not only failed to give us any relief, you took away a lot of what we had already.

Senator HANSEN. Mr. Chairman, if I may ask one further question, I think that there was testimony to the effect that it would be a dangerous thing to give away any part of a business, even though you paid gift taxes. I am just thinking about agriculture. I know it has been a common thing in the West, and I suspect in the East as well, for parents to give some land to members of their family.

Do I understand the situation now to be that a gift of some land that might have been made as far as tax treatment purposes go again become part of that estate?

Mr. EUBANK. We were talking there about this proposed amendment in the Technical Corrections Act to section 2036.

It would apply only in the case of closely-held stock.

Mr. KARTIGANER. It would have to be incorporated.

Mr. EUBANK. The problem we were mentioning would not apply to a gift of land, but if the land were in a corporate form, then it would.

Senator Hansen, you were mentioning a minute ago the maze and the briar patch. I feel maybe I should add one brief comment about the maze and the briar patch that I handed out in the appendix in my remarks. I got to looking at the mathematical calculations, and there are many, many pages of them. I did not review them in detail in one situation until last night. I am afraid if somebody goes through these calculations step by step, they are going to find an error. I think I spotted one, and I apologize for that.

As far as I can tell, it does not affect the overall totals very much at all, and they are still good examples. But the fact that an experienced CPA-lawyer made a mistake and had difficulties in situation 2, which is the small estate of $70,000, does, if anything, prove my point about complexity and difficulty.

There is an error on page 9 or 10 that affects the factor and carries forward. Overall, the totals are approximately correct.

Mr. COSTELLO. In answer to your question, I do not think it has been completely covered—in answer to your question about giving out land, yes. Slices of land can be deeded off in smaller than $3,000 increments, but the correction that you are talking about, anything that came to $3,005 worth of land—presumably you are not going to go through all of these shenanigans unless you are going to get $5,000 or $10,000 of the land—will come back in under this technical corrections bill at the time of death.

Any gift over the amount will be valued at its fair market value if death occurs in 3 years, to the estate, regardless of the value that was given away, and after 3 years, it will be valued at the value placed on it for gift tax purposes and will be brought back into the estate; yes.

Senator HANSEN. If a person were to give a gift of land in excess of $3,000 and then died within 3 years after the time of the gift, the gift is presumably made in contemplation of death, even if it has a value that is agreed upon by the IRS, it will still come back in the estate.

Mr. COSTELLO. Interestingly enough, it does not gather a stepped-up basis, consequently the valuation that is brought back into the estate does not give the recipient any relief on the income taxes.

I am advised by one of the panel members that I may have overstepped my bounds.

Mr. KARTIGANER. I think that is an illustration of what we are dealing with, we who are talking are presumably experts and we are all making mistakes, and we cannot cope.

One who just goes out on the lecture circuit and looks at the faces and sees the lawyers who are going to these continuing legal education panels to try to cope, all he sees on their faces is panic, absolute panic. People are saying we do not know how to deal with it, and the result of things such as you are suggesting now is going to be disregard of the law. It is going to be either intention or unintentional. In most cases, it will be unintentional, because the lawyer or other adviser is not going to be able to handle it. However, in many cases—unfortunately too many—the voluntary taxation assessment system we have in this country is going to break down.

Senator HANSEN. Did I understand you to say that the situation you have just described would obtain if these technical amendments are passed, or is that the law now.

Mr. COSTELLO. I was describing the law as it already has been passed.

Senator HANSEN. In 1976?

Mr. COSTELLO. In 1976, yes, sir.

Senator HANSEN. I would venture, Mr. Chairman, that not 1 taxpayer out of 100 has any idea what many of the provisions at law are.

Senator BYRD. I am not sure that there is one Senator.

Senator HANSEN. I know one who does not.

Senator BYRD. Are you saying under the present law that if an individual gives away certain property, or stocks, or whatever it might be and pays the gift tax on that, that that then still comes back into the estate.

Mr. EUBANK. Yes, sir, it does. That is a part of the unified transfer system. That is, it comes back into the estate in a special way. The gift tax value is brought back in and is added to the taxable estate at death for a total, and then the estate tax is calculated on that. And then there is a subtraction for the gift tax that has been paid.

That is all very complicated, but the way I think of it is this: If I pay no gift tax when I make the gift, or a relatively low gift tax when I make the gift, then at my death the Treasury comes back in for another whack which is equal to the difference between the estate tax and the gift tax.

Let me give you this example. Say I die and my estate is in the 32-percent bracket and I have made a gift and have paid a 10-percent gift tax. The Treasury comes back in for the difference of 22 percent at my death.

Mr. COSTELLO. The reason the gifts have been stopped in this area, Senator, I would like to draw a circle around it here.

If you injudiciously pick an asset that is not appreciated, that actually depreciated, it is brought back into your estate after 3 years or outside that period. It is brought in at the value you declared it for gift tax purposes, and the tax is to be assessed at the value, without regard to its actual value at that time, as we understand the law. Nothing is going to be done to correct that. The reason you do not dare make any gift is that you have to be certifying that you have a 24-carat gold appreciating asset to your client, or he is going to come back after you with an ax.

As an example in my statement shows, if you assume a fellow is 60, you have to assume he has 6, 8, 10 percent appreciation and all the multiplications. You cannot do it.

Mr. EUBANK. This result we have been describing is a result of the unified transfer system that is now built into the 1976 act. We have not even talked about that this morning.

We are able to live with that. That is not a major problem, compared to the others.

Mr. KARTIGANER. I have seen some very funny results. I cannot understand any policy or reason underlying the legal structure that would justify penalizing somebody for giving money to his spouse. Under unification, there was a big bonus given allowing $100,000 to be transferred by an individual to his or her spouse without any gift tax, but the arithmetic works out that as soon as you get over that $100,000 and you give more to your spouse, which is presumably something that should be encouraged in the law, you are paying a significant tax penalty

This is something that does not appear from the face of the law. This is a part of the complexity that I am concerned about and the complication that I am concerned about that is a result of unification, and the net effect is that people are being told, do not give money to your wife. I cannot understand that to be sound, congressional policy, but that is the effect of unification.

Senator BYRD. The staff asked if you would explain that further, because the staff is not clear as to what you are saying.

Mr. KARTIGANER. Let's take some simple numbers. Let's take a person with $1 million in cash—get rid of carryover and all of the rest. He has $1 million in cash. Assuming he makes a transfer of $400,000 to his wife, he gets a marital deduction on that transfer of $200,000.

He pays a gift tax on $200,000 of the transfer, but his wife now has $400,000.

When he dies, he has $600,000 left, putting aside the gift tax that he paid. Brought back into his estate will be the so-called adjusted taxable gift, the unification concept, of $200,000, the amount that he gave over and above the marital deduction.

That means his tax bracket will be as if he had $800,000 of taxable assets, but he only has $600,000 left. So his marital deduction when he gives the property to his wife, is only $300,000. That means he has a total marital deduction on the transfer of $200,000 when he made it during his lifetime and $300,000 at death, the $500,000 total being exactly the same as the marital deduction he would have had if he had given nothing to his wife during his lifetime.

Look at the wife's situation. She has received $400,000 during his lifetime, plus $300,000 at death. She now has $700,000 to be taxed when she dies, as opposed to the $500,000 which she would have had taxed when she died, had he given her nothing during his lifetime.

The arithmetic works inextricably to say that it does not make sense—unless you have Mr. Costello's 24-carat gold appreciating asset—to give a spouse more than $100,000. That just does not make sense, and that is the kind of thing that I think would have been picked up if somebody would have said, let's see how this works in practice.

What are people going to start telling their clients? What they are going to be telling them is that a law has been passed that works against inter-spousal transfers.

Mr. EUBANK. I never understood why we have to pass tax laws so quickly. When we were building our cruise missiles, we did not build them directly from the blueprints or drawing boards without a lot of extensive testing. In the tax law, that is exactly what we do. We go right from the drawingboards into enacting laws with effective dates that, in effect in some cases, are retroactive.

Senator BYRD. Unfortunately, that is what we do with new Government programs also. I have often thought that what we ought to do before we go into a major program is to have a pilot project first, test it out for a year or two, and see how it works.

What you are saying is that you would apply that principle also to the tax laws. I think that has some merit to it.

Thank you, all of you, very much. I think it was very helpful and very enlightening.

[The prepared statements of the preceding panel follow:]

STATEMENT OF J. THOMAS EUBANK, JR.[1]

The four panelists today have been asked to discuss actual problems being encountered by taxpayers under the estate and gift tax and carryover basis rules of the Tax Reform Act of 1976. We have been asked to emphasize those affecting the average estate and those containing interests in small or closely-held businesses. Each of us is engaged in the private practice of law and regularly represents such taxpayers. We are in the trenches at the front, and we plan to talk about actual problems that Congress ought to consider.

I start by emphasizing that Congress should carefully reconsider many of the provisions of the 1976 Act that affect the transmission of property at death. These hearings today are a step in the right direction, but only a step.

[1] These remarks are by Mr. Eubank individually and not as a representation of any organization. Mr. Eubank is engaged in the private practice of law at 3000 One Shell Plaza, Houston, Tex. 77002.

Incredible as it may seem, the new law was passed without public hearings on the bill. Shortly before the bill was introduced, a few people actually practicing in these tax areas were permitted to testify before the Ways and Means Committee; but they had to do so in a vacuum because they had no bill available to them. Various hearings had been held on these subjects during the 1960's; but none of those at the 1976 hearings knew the subject matter of the bill or the form or language. When the 1976 hearings were closed and before the transcripts were prepared, the bill was introduced. Obviously, the hearings, such as they were, meant nothing. There were no hearings on the actual bill, only executive mark-up sessions with no testimony. This process is in sharp contrast to the development of the 1954 Code, when there were full hearings after the bills were introduced and then hearings on revisions.

Conceived, developed, and borne in haste, the 1976 Act was imposed upon the American citizens with no adequate development beforehand of the real and practical effects upon the citizens—effects in many instances that can be described only as calamitous and surely unintended for broad segments of our citizens and indeed our society.

The leap in the dark has already occurred. Although we cannot repair all the injuries from that unfortunate leap, we can examine in the dawning light what we landed upon, bring more light to bear on the subject, and then mitigate and repair the injuries by careful and deliberate reconsideration. Congress has a prime duty to do that.

Many of the changes made have been advocated for years by some in academia. These ideas seem to have had a heavy influence upon the staff of the Joint Committee on Taxation and others and in due course upon the Act itself. Many of these ideas may have looked fine on the drawing boards, but:

(*a*) they did not look fine to those who had the benefit of much experience at the practical, applied level;

(*b*) they should have been tested extensively to determine their actual effects and ramifications, as new ideas are normally tested first in most other fields of endeavor; and

(*c*) many citizens feel that inadequate consideration was given to many broad policy questions in the Act concerning the continuance of our private sector economy as we know it and our ways of life.

Before I proceed with some examples, I should mention some of the public concerns about the transmission of property from one generation to another, for my examples need to be viewed in this broad context. Most estates even of a modest size go through a process which we call probate. Ten or so years ago, the American Bar Association Section of Real Property, Probate, and Trust Law, of which I am an officer, recognized that probate was in critical need of reform. It needed simplifying and streamlining to eliminate unneeded features that cause complexity, delay, and added expense. That Section was instrumental, with others, in developing the Uniform Probate Code, which is a guiding light for all efforts to simplify the transmission of property at death. During this time, the public and many writers began to cry out against probate and to demand reform. My point here is that we had underway in 1976 a strong movement toward simplification of the processes for transmitting property at death—a movement demanded by the public.

Then came the 1976 Act, which reversed the movement and forced properties at death through new processes with complexities almost beyond description. When the 1976 Act was about to be passed, I met for a day with about ten persons from throughout the nation who are considered very knowledgeable about probate and taxes. After discussing it, I asked at the end of the day how much the overall processes for transmitting wealth at death would be complicated. If the pre-Act complexity was 1.0, what would the new complexity be, 1.1, 1.2, 1.5, 2.0, or what? The lowest answer I got was 2.0. The highest was 8.0 for many situations. Doubling the complexity overnight!

First take an estate of $60,000 or less. The new law has injured this estate. Under neither the old law nor the new law does it have to go through the estate tax process. But under the new law, it has to go through the new carryover basis process. The decedent's basis in each asset must be determined; then the fresh start adjustment must be made; then the $60,000 minimum basis adjustment must be made. The process is complex and may be expensive for an estate of that size.

Next take an estate between $60,000 and $175,000. As to the estate tax process, the new law has benefitted this estate by enabling it to by-pass that process. But the new law forces this estate through the new carryover basis process. The

process itself is going to be complex and expensive for an estate of that size. In addition, the capital gains tax of the beneficiaries may be very substantial. It may be less than the old estate tax would have been, or about equal to it, or even more. For example, say a parent dies and leaves to his child his only asset remaining after expenses, a farm worth $175,000 with an adjusted basis of $60,000. The gross estate tax under the old law would have been $25,200; and under the new law there is no such tax after 1980. If the child sells the farm and realizes a $115,000 capital gain, that child's tax may well exceed the old $25,200 estate tax. The combined effect of the process expense and the capital gains tax will materially injure, rather than benefit, many such estates.

Now take an estate over $175,000 that has to file an estate tax return. The new law has injured it greatly. First, he estate tax process has been made more complex for it. Second, it has to go through the new carryover basis process. Third, it may have to go through another new process, the generation-skipping process. Even where no generation-skipping was ever really intended, many medium estates are now forced through the new generation-skipping process, under customary wills when there is an unusual order of deaths and the technical requirements for the $250,000 exclusions have not been met. Fourth, the probate process has been made much more complex and uncertain because of the conflicts that have been created among the beneficiaries, as to carryover basis, elections as to employee benefits, and other changes. It is doubtful that Congress was ever given these crucial probate and fiduciary problems for consideration. Fifth, the combined estate tax and capital gains tax will be surprisingly high for many medium estates. In that connection, somewhere and somehow, Congress needs to consider the inequity of imposing capital gains taxes upon those gains attributable to inflation, which, of course, are not true gains. Small and medium estates are especially vulnerable here as to residences.

I liken these processes to the wringer of an old-style washing machine, which squeezes the fabric passing through, forcing out substance sometimes properly and sometimes improperly, but which in every case frays the fabric by causing delay, processing expense, and uncertainty, and which sometimes catches innocent fingers.

Now I want to give two illustrations of estates going through the carryover basis wringer. We should look for what he wringer has squeezed out as a new capital gains tax and for any damage the wringer has done to the fabric, in the form of delay, uncertainties, and expenses.

As I cast about for examples, I found them in my own backyard. May I suggest to all that it is truly an eye-opening experience for anyone to see the calculations that would have to be made upon his or her death. About ten years ago, I started buying stock in a particular mutual fund periodically. Now, I have a little over $20,000 of value in this stock. This, of course, is a typical investment for many millions of Americans. I elected to have dividends reinvested, a common practice. The actual calculations are set forth in the Appendix to these remarks. To make the examples typical, I have assumed hypothetically in Situation 1 that I have an estate of $525,000 and in Situation 2 that I have a small estate of about $70,000. I have also had to assume my demise on a certain date in near future, which I assure you I hope is very hypothetical. Except for that and the value at that time, the mutual fund situations are real, concrete examples.

What do these calculations show?

In Situation 1, the shares comprise 78 lots. Each lot is divided between Mrs. Eubank and a trust, and the shares in each lot have four different bases, two for gain and two for loss. Thus, there are 312 bases. The totals are as follows:

	For gain	For loss
Mrs. Eubank's shares	$12,322.26	$11,999.61
The trust's shares	13,754.87	13,460.35
Total	26,077.13	25,459.96

These calculations took 17 hours, by a capable and efficient individual who is both a CPA and a lawyer, accustomed to performing services of this kind. That time does not include any time necessary to research or learn the tax law, nor does it include hours needed for corrections and refinement. At his normal billing rate of $70 per hour, the cost is $1,200. At the estate's marginal estate tax rate of 32%, this cost is borne as follows:

By the Federal Government	$384
By the Eubank family	816
Total	1,200

Under the law before the 1976 Act, the basis in these shares would have been $26,960.45. Under the 1976 Act, the total gain basis is $26,077.13. The difference of $613.32 is what the new law is intended to tax as a capital gain that would not have been taxed under the old law. If the Eubank family/were to sell all these shares, the capital gains tax on that gain might be about $200.

Thus, in Situation 1, the Federal Government has received $384 less in estate tax to get about $200 in capital gains tax, if and when the shares are sold. Moreover, it has inflicted upon the Eubank family a net cost of $816 for the extra professional expense.

In Situation 2, the shares also comprise 78 lots. The shares in each lot have two different bases, one for gain and one for loss. Thus, there are 156 bases. The totals are as follows:

Mrs. Eubank's shares:	
For gain	$26,712.44
For loss	27,133.85

These calculations took 12 hours by that same person under the same conditions. At his normal billing rate of $70 per hour, the cost is $840.

At Mrs. Eubank's marginal income tax rate of, say, $20%, this cost is borne as follows:

By the Federal Government	$168
By Mrs. Eubank	672
Total	840

Under the law before the 1976 Act, the basis in these shares would have been $26,690.45. Because the total gain basis under the 1976 Act, $26,712.44, happens in this case to be about twenty dollars higher than what it would have been under the old law, the new law may or may not cost Mrs. Eubank a capital gains tax, depending on what she sells. But, it has inflicted upon Mrs. Eubank a net cost of $672 for extra professional expense to determine this complicated result. Also, the federal government has received about $168 less in income taxes because of that extra professional expense.

Keep in mind that these calculations, about fifteen pages for each situation, are only one asset (except that in Situation 2 it is necessary also to calculate the basis of the residence to determine the $60,000 minimum basis for all assets involved). The calculations for other assets may be much simpler or even more difficult. An interest in a closely-held corporation or partnership or an interest in a farm or ranch with improvements continually being made and depreciated can involve great complexity also.

It is easy to imagine the dismay, and reaction, when a widow realizes she has to pay for and cope with calculations like these. The anger will be vented in offices such as mine, and I do not think Congress will be immune either. Although I cannot speak for all lawyers and accountants, who presumably will get those fees, I am convinced that lawyers and accountants relish neither this new work nor those new fees from the 1976 Act. It is not professionally enjoyable to wrestle with such problems that should not exist. I believe, contrary to certain suggestions in the press, that lawyers and accountants as a whole favor simplification.

It is true that the exenses indicated above may be reduced by using a computer properly programmed. The recalculations resulting from estate tax audit changes will especially be easier with those computers. Nevertheless, the expenses will remain substantial, and many of the taxpayers facing the carryover basis process will not have access to those computers without employing certain banks, accounting firms, or law firms which have them.

Focus on some other problems the carryover basis creates in Situation 1. Until the estate tax has been finally settled, each asset will have a "suspended basis," because any estate tax adjustment will affect the basis of every asset in the estate. This means that any income tax return filed during this period of two or three years or more involving a sale of those shares will be wrong if any adjustment is made to the estate tax. Moreover, there are likely to be critical fiduciary law and tax law problems in connection with the selection of properties with differing bases for the marital deduction gift and other gifts.

How much more complex can the tax laws become before the voluntary self-assessment system bogs down, and before the tax laws go beyond the realm of reasonable compliance and enforcement? Have some of these new tax laws gone beyond that realm? I answer that carryover basis in its present form has without a doubt gone beyond that realm—that it is too complex for taxpayers to comply with and too complex for the government to enforce. It opens the door for disregard of the law and enhances the services of tax advisors who improperly might counsel that it be disregarded.

These criticisms, I fear, may be misconstrued as encouraging the adoption of other alternatives, such as the capital gains tax at death or the appreciation estate tax. These alternatives have serious problems also, which I do not discuss here but which might be discussed later in these hearings.

I am not an expert on the legislative history of our tax laws, but I have always thought that perhaps Congress in the past realized these insolvable problems connected with basis at death and opted for estate tax rates high enough to justify a new basis at death, in the interest of simplicity and workability. Admittedly, while this approach may be fair for taxpayers as a whole, it may not be fair in individual cases. But complexity itself creates inequity.

I understand that Congress is receiving many complaints about the contemplation of death law. This is not surprising, because the old law was a thorn to taxpayers, as well as to the Internal Revenue Service, and the new law has problems too. What is surprising, at least to me, is that a much simpler approach was not taken in the new law. Under that approach, subsections (a) and (b) of section 2035 would be repealed, so that that section would consist only of the subsection (c) provision about gift taxes on gifts during the last three years of life. The substance of the repealed portions would be picked up automatically by the unified transfer provisions of section 2001 relating to adjusted taxable gifts. This would solve the knotty $3000 problem by disregarding both appreciation and depreciation in value between the date of the gift and the date of death. The only material problem regarding appreciation, from the government's point of view, involves gifts of life insurance by the insured near the end of life. A provision on that could be included with the other provisions on life insurance in section 2042, so as to include in a decedent's gross estate any insurance on his life if he had any incident of ownership within three years before his death.

Then, the law would be that there is no difference as to the treatment of gifts, regardless of whether made before or during the three-year period, except as to insurance and the gift tax amount on gifts within the last three years of life.

In these remarks, I have emphasized the complexity and expense of carryover basis. Other panelists will emphasize other problems with carryover basis, as well as a second area of our greatest concern, which involves family-owned and other closely-held business, including farms and ranches.

Appendix A

Remarks of J. Thomas Eubank, Jr., Constituting—Actual Calculations of the Carryover Basis of Stock in A Single Mutual Fund Required Under the Tax Reform Act of 1976, Together With Statements of Costs

Description of the Estate

All of the facts used regarding the mutual fund stock are real, except for the value of $9.50 per share on the decedent's date of death. See Tab 3 for the actual account statements. Mr. Eubank, the hypothetical decedent, emphasizes that all other facts are intended to be hypothetical, especially the date of his death.

Situation 1 is designed to illustrate an estate with an estate tax, both before and after 1976 TRA. The gross estate has an estate tax value of $525,000. It includes 2,809 shares of the mutual fund stock having a value of $26,690. Mr. Eubank leaves his surviving wife a maximum marital deduction gift of $250,000. The balance, after taxes and expenses, he leaves in trust for his wife and children.

Situation 2 is designed to illustrate a small estate with no estate tax, before and after the 1976 TRA. The gross estate has an estate tax value of $70,690, consisting of the same mutual fund stock ($26,690), a residence ($40,000),

household goods and personal effects ($3,000), and cash ($1,000). Mr. Eubank leaves his entire estate to his surviving wife.

The mutual fund investment is, of course, highly typical for medium and small estates. The periodic investments and dividend reinvestment features are also typical. This situation is neither the simplest nor the most complicated of similar common situations.

For example, if the investments had been monthly rather than every other month and if the mutual fund had paid dividends quarterly rather than annually, the length of the calculations would have more than doubled.

This example is not limited to mutual funds. Any shareholder of many listed common stocks can now elect dividend reinvestment, and he or she typically has acquired the shares in various lots. This example does not illustrate all of the serious problems arising from carryover of basis. It illustrates only one very typical general problem.

SUMMARY OF RESULTS IN SITUATION 1

The shares comprise 78 lots. Each lot is divided between Mrs. Eubank and the trust, and the shares in each lot have four different bases, two for gain and two for loss. Thus, there are 312 bases. The totals are as follows:

	For gain	For loss
Mrs. Eubank's shares	$12,322.26	$11,999.61
The trust's shares	13,754.87	13,460.35
Total	26,077.13	25,459.96

These calculations took 17 hours, by a capable and efficient individual who is both a CPA and a lawyer, accustomed to performing services of this kind. That time does not include any time necessary to research or learn the tax law, nor does it include hours needed for corrections and refinement. At his normal billing rate of $70 per hour, the cost is $1,200. At the estate's marginal estate tax rate of 32 percent, this cost is borne as follows:

By the Federal Government	$384
By the Eubank family	816
Total	1,200

Under the law before the 1976 TRA, the basis in these shares would have been $26,690.45. Under the 1976 TRA, the total gain basis is $26,077.13. The difference of $613.32 is what the new law is intended to tax as a capital gain that would not have been taxed under the old law. If the Eubank family were to sell all these shares, the capital gains tax on that gain would likely be about $200.

Thus, in this example, the Federal government has received $384 less in estate tax to get about $200 in capital gains tax, if and when the shares are sold. Moreover, it has inflicted upon the Eubank family a net cost of $816 for the extra professional expense.

SUMMARY OF RESULTS IN SITUATION 2

The shares comprise 78 lots. The shares in each lot have two different bases, one for gain and one for loss. Thus, there are 156 bases. The totals are as follows:

Mrs. Eubank's shares:

For gain	$26,712.44
For loss	27,183.85

These calculations took 12 hours, by a capable and efficient individual who is both a CPA and a lawyer, accustomed to performing services of this kind. That time does not include any time necessary to research or learn the tax law, nor does it include hours needed for corrections and refinement. At his normal billing rate of $70 per hour, the cost would be $840.

At Mrs. Eubank's marginal income tax rate of, say, 20%, this cost would be borne as follows:

By the Federal Government	$168
By Mrs. Eubank	672
Total	840

Under the law before the 1976 Act, the basis in these shares would have been $26,690.45. Because the total gain basis under the 1976 Act, $26,712.44, happens in this case to be about twenty dollars higher than what it would have been under the old law, the new law may or may not cost Mrs. Eubank a capital gains tax, depending on what she sells. But, it has inflicted upon Mrs. Eubank a net cost of $672 for extra professional expense to determine this complicated result. Also, the federal government has received about $168 less in income taxes because of that extra professional expense.

SITUATION 1

Calculation of Decedent's Federal Estate Tax and State Inheritance Tax

Gross estate	$525,000
Less: Debts and expenses	25,000
Marital deduction	250,000
Subtotal	275,000
Taxable estate	250,000
Adjusted taxable gifts	0
Total	250,000
Tentative tax	70,800
Less: Gift taxes paid	
Unified credit	30,000
Credit for State death taxes	30,000
Net estate tax payable	36,880
Estate tax	36,880
Inheritance tax	3,920
Total taxes	40,800

AVERAGE TAX RATE—TOTAL TAXES

GROSS ESTATE—MARITAL DEDUCTION

$$\frac{\$40,800}{\$525,000-\$250,000}=\frac{\$40,800}{\$275,000}=.1484$$

RATE OF ASSETS PASSING TO SPOUSE

$$\frac{\$250,000}{\$525,000}=.4762$$

CALCULATION OF DECEDENT'S BASIS, ROWE PRICE NEW HORIZONS FUND, INC.

Lot No.	Date of purchase	Number of shares	Number of shares after adjustments	Cost basis
1	Sept. 14, 1967	19	57	$481.08
2	Oct. 2, 1967	7.73	23.19	200.00
3	Dec. 1, 1967	7.378	22.134	200.00
4	(1)	1.992	5.776	53.89
5	Feb. 1, 1968	7.888	23.664	200.00
6	Apr. 1, 1968	8.116	24.348	200.00
7	Nov. 2, 1968	186.000	558.000	5,903.64
8	June 3, 1968	6.626	19.878	200.00
9	Aug. 1, 1968	7.054	21.162	200.00
10	Oct. 1, 1968	6.329	18.987	200.00
11	Dec. 2, 1968	5.895	17.685	200.00
12	Dec. 3, 1969	6.575	19.725	200.00
13	(1)	14.991	44.973	454.09
14	(1)	1.569	4.707	47.52
15	Apr. 1, 1969	6.978	20.934	200.00
16	June 1, 1969	6.715	20.145	200.00
17	Aug. 1, 1969	7.766	23.298	200.00
18	Aug. 15, 1969	114.000	342.000	2,979.96
19	Oct. 1, 1969	7.340	22.02	200.00
20	Dec. 1, 1969	6.894	20.682	200.00
Subtotal		436.836	1,310.508	12,720.18
21	Feb. 2, 1970	7.650	22.95	200.00
22	(1)	20.061	60.183	524.20
23	(1)	3.511	10.533	91.74
24	Apr. 1, 1970	7.769	23.307	200.00
25	June 1, 1970	10.091	30.273	200.00
26	Aug. 10, 1970	10.686	32.058	200.00
27	Aug. 24, 1970	10.142	30.426	200.00
28	Oct. 9, 1970	8.708	26.124	200.00
29	Dec. 14, 1970	8.400	25.200	200.00
30	Feb. 5, 1971	7.772	23.316	200.00
31	(1)	9.282	27.846	240.97
32	(1)	3.229	9.687	83.82
33	Apr. 12, 1971	6.844	20.532	200.00
34	June 7, 1971	6.656	19.68	200.00
35	Aug. 9, 1971	7.057	21.171	200.00
36	Oct. 4, 1971	6.081	18.243	200.00
37	Dec. 5, 1971	6.028	18.084	200.00
38	(1)	1.620	4.860	63.45
39	(1)	9.130	27.390	357.62
40	Feb. 7, 1972	5.031	5.193	200.00
Subtotal		491.483	1,777.752	16,881.98
41	Apr. 3, 1972	4.637	13.911	200.00
42	June 5, 1972	4.397	13.191	200.00
43	Aug. 9, 1972	4.510	13.530	200.00
44	Oct. 4, 1972	4.904	14.712	200.00
45	Dec. 6, 1972	4.590	13.770	200.00
46	(1)	33.167	99.501	1,278.59
47	(1)	2.007	6.021	77.38
48	Feb. 14, 1973	5.265	15.795	200.00
49	Apr. 2, 1973	6.227	18.681	200.00
50	Apr. 30, 1973	1,324.576	(2)	(2)
51	June 4, 1973	22.548	22.548	200.00
52	Aug. 6, 1973	19.608	19.608	200.00
53	Oct. 5, 1973	18.484	18.484	200.00
54	Dec. 6, 1973	25.284	25.284	200.00
55	(1)	14.691	14.691	112.97
56	(1)	8.302	8.302	63.84
57	Apr. 4, 1974	26.667	26.667	200.00
58	June 5, 1974	28.289	28.289	200.00
59	Aug. 26, 1974	39.293	39.293	200.00
60	Oct. 3, 1974	44.150	44.150	200.00
Subtotal		2,234.180	2,234.180	21,414.76
61	Dec. 4, 1974	40.816	40.816	200.00
62	(1)	42.348	42.348	207.93
63	Feb. 3, 1975	36.166	36.166	200.00
64	Apr. 1, 1975	30.960	30.960	200.00
65	May 30, 1975	27.510	27.510	200.00
66	July 31, 1975	28.169	28.169	200.00
67	Oct. 6, 1975	31.008	31.008	200.00
68	Dec. 1, 1975	28.986	28.986	200.00
69	(1)	26.964	26.964	185.51

See footnotes at end of table.

CALCULATION OF DECEDENT'S BASIS, ROWE PRICE NEW HORIZONS FUND, INC.—Continued

Lot No.	Date of purchase	Number of shares	Number of shares after adjustments	Cost basis
70	Feb. 2, 1976	26.991	26.991	200.00
71	Apr. 1, 1976	26.490	26.490	200.00
72	June 3, 1976	28.329	28.329	200.00
73	Aug. 6, 1976	28.169	28.169	200.00
74	Oct. 5, 1976	28.944	28.944	200.00
75	Dec. 6, 1976	27.933	27.933	200.00
76	(1)	26.901	26.901	190.46
77	Feb. 8, 1977	28.860	28.860	200.00
78	Apr. 5, 1977	29.895	29.895	200.00
79	June 6, 1977	28.944	28.944	200.00
Total		2,808.563	2,808.563	25,198.66

[1] Dividend.
[2] New shares apportioned to prior lots.

CALCULATION OF CARRYOVER BASIS, ROWE PRICE NEW HORIZONS FUND, INC.

Lot No.	Decedent's basis	Value on Dec. 31, 1976	Value for estate tax	Basis after fresh start	
				For gain	For loss
1	$481.08	$417.24	$541.50	$481.08	$481.08
2	200.00	169.74	220.32	200.00	200.00
3	200.00	162.03	210.27	200.00	200.00
4	53.89	43.74	56.76	53.89	53.89
5	200.00	173.22	224.82	200.00	200.00
6	200.00	178.23	231.30	200.00	200.00
7	5,903.64	4,084.56	5,301.00	5,903.64	5,903.64
8	200.00	145.50	188.85	200.00	200.00
9	200.00	154.92	201.03	200.00	200.00
10	200.00	138.99	180.39	200.00	200.00
11	200.00	129.45	168.00	200.00	200.00
12	200.00	144.39	187.38	200.00	200.00
13	454.09	329.19	427.23	454.09	454.09
14	47.52	34.47	44.73	47.52	47.52
15	200.00	153.24	198.87	200.00	200.00
16	200.00	147.45	191.37	200.00	200.00
17	200.00	170.55	221.34	200.00	200.00
18	2,979.96	2,503.44	3,249.00	2,979.96	2,979.96
19	200.00	161.19	209.19	200.00	200.00
20	200.00	151.38	196.47	200.00	200.00
Subtotal	12,720.18	9,592.92	12,449.82	12,720.18	12,720.18
21	200.00	168.00	218.04	200.00	200.00
22	524.20	440.55	571.74	524.20	524.20
23	91.74	77.10	100.05	91.74	91.74
24	200.00	170.61	221.43	200.00	200.00
25	200.00	221.61	287.58	221.61	200.00
26	200.00	234.66	304.56	234.66	200.00
27	200.00	222.72	289.05	222.72	200.00
28	200.00	191.22	248.19	200.00	200.00
29	200.00	184.47	239.40	200.00	200.00
30	200.00	170.67	221.49	200.00	200.00
31	240.97	203.82	264.54	240.97	240.97
32	83.82	70.92	92.04	83.82	83.82
33	200.00	150.30	195.06	200.00	200.00
34	200.00	146.16	189.69	200.00	200.00
35	200.00	154.98	201.12	200.00	200.00
36	200.00	133.53	173.31	200.00	200.00
37	200.00	132.39	171.81	200.00	200.00
38	63.45	35.58	46.17	63.45	63.45
39	357.62	200.49	260.22	357.62	357.62
40	200.00	110.49	143.37	200.00	200.00
Subtotal	16,881.98	12,983.19	16,888.68	16,960.97	16,881.98

CALCULATION OF CARRYOVER BASIS, ROWE PRICE NEW HORIZONS FUND, INC.—Continued

Lot No.	Decedent's basis	Value on Dec. 31, 1976	Value for estate tax	Basis after fresh start	
				For gain	For loss
41	200.00	101.82	132.15	200.00	200.00
42	200.00	96.57	125.31	200.00	200.00
43	200.00	99.03	128.55	200.00	200.00
44	200.00	107.70	139.77	200.00	200.00
45	200.00	100.80	130.83	200.00	200.00
46	1,278.59	728.34	945.27	1,278.59	1,278.59
47	77.38	44.07	57.21	77.38	77.38
48	200.00	115.62	150.06	200.00	200.00
49	200.00	136.74	177.48	200.00	200.00
50	0	0	0	0	0
51	200.00	165.05	214.21	200.00	200.00
52	200.00	143.53	186.28	200.00	200.00
53	200.00	135.30	175.60	200.00	200.00
54	200.00	185.08	240.20	200.00	200.00
55	112.97	107.54	139.56	112.97	112.97
56	63.84	60.77	78.87	63.84	63.84
57	200.00	195.20	253.34	200.00	200.00
58	200.00	207.08	268.75	207.08	200.00
59	200.00	287.62	373.28	287.62	200.00
60	200.00	323.18	419.43	323.18	200.00
Subtotal	21,414.76	16,344.21	21,224.76	21,711.63	21,414.76
61	200.00	298.77	387.75	298.77	200.00
62	207.93	309.99	402.31	309.99	207.93
63	200.00	264.74	343.58	264.74	200.00
64	200.00	226.23	294.12	226.63	200.00
65	200.00	201.37	261.35	201.37	200.00
66	200.00	206.20	267.61	206.20	200.00
67	200.00	226.98	294.58	226.98	200.00
68	200.00	212.18	275.37	212.18	200.00
69	185.51	197.38	256.18	197.38	185.51
70	200.00	197.57	256.41	200.00	200.00
71	200.00	193.91	251.66	200.00	200.00
72	200.00	207.37	269.13	207.37	200.00
73	200.00	206.20	276.61	206.20	200.00
74	200.00	211.87	274.97	211.87	200.00
75	200.00	204.47	265.36	204.47	200.00
76	190.46	196.92	255.56	190.46	190.46
77	200.00	211.26	274.17	200.00	200.00
78	200.00	211.83	284.00	200.00	200.00
79	200.00	211.87	274.97	200.90	200.00
Total	25,198.66	20,547.72	26,690.45	25,876.24	25,198.66

Lot No.	Appreciation from—		Estate tax adjustment		Adjusted basis	
	Basis for gain	Basis for loss	For gain	For loss	For gain	For loss
1	$60.42	$60.42	$8.97	$8.97	$490.05	$490.05
2	20.32	20.32	3.02	3.02	203.02	203.02
3	10.27	10.27	1.52	1.52	201.52	201.52
4	2.87	2.87	.43	.43	54.32	54.32
5	24.82	24.82	3.68	3.68	203.68	203.68
6	31.30	31.30	4.64	4.64	204.64	204.64
7	0	0	0	0	5,903.64	5,903.64
8	0	0	0	0	200.00	200.00
9	1.03	1.03	.15	.15	200.15	200.15
10	0	0	0	0	200.00	200.00
11	0	0	0	0	200.00	200.00
12	0	0	0	0	200.00	200.00
13	0	0	0	0	454.09	454.09
14	0	0	0	0	47.52	47.52
15	0	0	0	0	200.00	200.00
16	0	0	0	0	200.00	200.00
17	21.34	21.34	3.17	3.17	203.17	203.17
18	269.04	269.04	39.93	39.93	3,019.89	3,019.89
19	9.19	9.19	1.36	1.36	201.36	201.36
20	0	0	0	0	200.00	200.00
Subtotal	450.60	450.60	66.87	66.87	12,787.05	12,787.05

CALCULATION OF CARRYOVER BASIS, ROWE PRICE NEW HORIZONS FUND, INC.—Continued

Lot No.	Appreciation from—		Estate tax adjustment		Adjusted basis	
	Basis for gain	Basis for loss	For gain	For loss	For gain	For loss
21	18.04	18.04	2.68	2.68	202.68	202.68
22	47.54	47.54	7.05	7.05	531.25	531.25
23	8.31	8.31	1.23	1.23	92.97	92.97
24	21.43	21.43	3.18	3.18	203.18	203.18
25	65.97	87.57	9.79	13.00	231.40	213.00
26	69.90	104.55	10.37	15.52	245.03	215.52
27	66.33	89.04	9.54	13.21	232.56	213.21
28	48.19	48.19	7.15	7.15	207.15	207.15
29	39.40	39.40	5.85	5.85	205.85	205.85
30	21.49	21.49	3.19	3.19	203.19	203.19
31	23.57	23.57	3.50	3.50	244.47	244.47
32	8.22	8.22	1.22	1.22	85.04	84.95
33	0	0	0	0	200.00	200.00
34	0	0	0	0	200.00	200.00
35	1.12	1.12	.17	.17	200.17	200.17
36	0	0	0	0	200.00	200.00
37	0	0	0	0	200.00	200.00
38	0	0	0	0	63.45	63.45
39	0	0	0	0	357.62	357.62
40	0	0	0	0	200.00	200.00
Subtotal	890.11	968.87	132.09	143.82	17,073.606	17,025.80
41	0	0	0	0	200.00	200.00
42	0	0	0	0	200.00	200.00
43	0	0	0	0	200.00	200.00
44	0	0	0	0	200.00	200.00
45	0	0	0	0	200.00	200.00
46	0	0	0	0	1,278.59	1,278.59
47	0	0	0	0	77.38	77.38
48	0	0	0	0	200.00	200.00
49	0	0	0	0	200.00	200.00
50	0	0	0	0	0	0
51	14.21	14.21	2.11	2.11	202.11	202.11
52	0	0	0	0	200.00	200.00
53	0	0	0	0	200.00	200.00
54	40.20	40.20	5.97	5.97	205.97	205.97
55	26.59	26.59	3.95	3.95	116.92	116.92
56	15.03	15.03	2.23	2.23	66.07	66.07
57	53.34	53.34	7.92	7.92	207.92	207.92
58	61.67	68.75	9.15	10.20	216.23	210.20
59	85.66	173.28	12.71	25.71	300.33	225.71
60	96.25	219.43	14.28	32.56	337.46	232.56
Subtotal	1,283.06	1,579.70	190.41	234.47	21,902.04	21,649.23
61	88.98	187.75	13.20	27.86	311.97	227.86
62	92.32	194.38	13.70	28.85	323.69	236.78
63	78.84	143.58	11.70	21.31	276.44	221.31
64	67.49	194.12	10.02	28.81	236.65	228.81
65	59.96	61.35	8.90	9.10	210.27	209.10
66	61.41	67.61	9.11	10.03	215.31	210.03
67	67.60	94.58	10.03	14.04	237.01	214.04
68	63.19	75.37	9.38	11.18	221.56	211.18
69	58.80	70.67	8.73	10.49	206.11	196.00
70	56.41	56.41	8.37	8.37	208.37	208.37
71	51.66	51.66	7.67	7.67	207.67	207.67
72	61.76	69.13	9.17	10.26	216.54	210.26
73	70.41	76.61	10.45	11.37	216.65	211.37
74	63.10	74.97	9.36	11.13	221.23	211.13
75	60.89	65.36	9.04	9.70	213.51	209.70
76	65.10	65.10	9.66	9.66	200.12	200.12
77	74.17	74.17	11.01	11.01	211.01	211.01
78	84.00	84.00	12.47	12.47	212.47	212.47
79	74.97	74.97	11.13	11.13	211.13	211.13
Total	2,584.12	3,361.49	383.51	498.91	26,259.75	25,697.57

DISTRIBUTION OF SHARES

Lot No.	Number of shares	Shares to spouse	Basis for gain	Basis for loss	Remaining shares	Basis for gain	Basis for loss
1	57	27.1434	$229.09	$229.09	29.8566	$256.69	$256.69
2	23.19	11.0431	95.24	95.24	12.1469	106.34	106.34
3	22.134	10.5402	95.24	95.24	11.5938	105.56	105.56
4	5.976	2.8458	25.66	25.66	3.1302	28.45	28.45
5	23.664	11.2688	95.24	95.24	12.3952	106.69	106.69
6	24.348	11.5945	95.24	95.24	12.7535	107.19	107.19
7	558.000	265.7196	2,811.31	2,811.31	292.2804	3,092.33	3,092.33
8	19.878	9.4659	95.24	95.24	10.4121	104.76	104.76
9	21.162	10.0773	95.24	95.24	11.0847	104.84	104.84
10	18.987	9.0416	95.24	95.24	9.9454	104.76	104.76
11	17.685	8.4216	95.24	95.24	9.2634	104.76	104.76
12	19.725	9.3930	95.24	95.24	10.3320	104.76	104.76
13	44.973	21.4161	216.24	216.24	23.5569	237.85	237.85
14	4.707	2.2415	22.63	22.63	2.4655	24.89	24.89
15	20.934	9.9688	95.24	95.24	10.9652	104.76	104.76
16	20.145	9.5930	95.24	95.24	10.5520	104.76	104.76
17	23.298	11.0945	95.24	95.24	12.2035	106.42	106.42
18	342.000	162.8604	1,419.06	1,419.26	179.1396	1,581.82	1,581.82
19	22.02	10.4859	95.24	95.24	11.5341	105.47	105.47
20	20.682	9.8488	95.24	95.24	10.8332	104.76	104.76
Subtotal	1,310.508	624.0638	6,057.35	6,657.35	686.4442	6,697.86	6,697.86
21	22.95	10.9288	95.24	95.24	12.0212	106.16	106.16
22	60.183	28.6591	249.62	249.62	31.5239	278.27	278.27
23	10.533	5.0158	43.69	43.69	5.5172	48.70	48.70
24	23.307	11.0988	95.24	95.24	12.2082	106.43	106.43
25	30.273	14.4160	105.53	95.24	15.8570	121.21	111.57
26	32.058	15.2660	111.75	95.24	16.7920	128.35	112.89
27	30.426	14.4889	106.06	95.24	15.9371	121.81	111.68
28	26.124	12.4402	95.24	95.24	13.6838	108.51	108.51
29	25.200	12.0002	95.24	95.24	13.1998	107.82	107.82
30	23.316	11.1031	95.24	95.24	12.2129	106.43	106.43
31	27.846	13.2603	114.75	114.75	14.5857	128.05	128.05
32	9.687	4.6129	39.92	39.92	5.0741	44.54	44.50
33	20.532	9.7773	95.24	95.24	10.7547	104.76	104.76
34	19.968	9.5088	95.24	95.24	10.4592	104.76	104.76
35	21.171	10.0816	95.24	95.24	11.0894	104.85	104.85
36	18.243	8.6873	95.24	95.24	9.5557	104.76	104.76
37	18.084	8.6116	95.24	95.24	9.4724	104.76	104.76
38	4.860	2.3143	30.21	30.21	2.5457	33.24	33.24
39	27.390	13.0431	170.30	170.30	14.3469	187.32	187.32
40	15.093	7.1873	95.24	95.24	7.9057	104.76	104.76
Subtotal	1,777.752	846.5655	8,076.82	8,039.20	931.1868	8,953.35	8,918.08
41	13.911	6.6244	95.24	95.24	7.2866	104.76	104.76
42	13.191	6.2816	95.24	95.24	6.9094	104.76	104.76
43	13.530	6.44[illegible]	95.24	95.24	7.0870	104.76	104.76
44	14.712	7.0059	95.24	95.24	7.7061	104.76	104.76
45	13.770	6.5573	95.24	95.24	7.2127	104.76	104.76
46	99.501	47.3824	608.86	608.86	52.1186	669.73	669.73
47	6.021	2.8672	36.85	36.85	3.1538	40.53	40.53
48	15.795	7.5216	95.24	95.24	8.2734	104.76	104.76
49	18.681	8.8959	95.24	95.24	9.7851	104.76	104.76
50	0	0	0	0	0	0	0
51	22.548	10.7374	95.24	95.24	11.8106	105.87	105.87
52	19.608	9.3373	95.24	95.24	10.2707	104.76	104.76
53	18.484	8.8021	95.24	95.24	9.6819	104.76	104.76
54	25.284	12.0402	95.24	95.24	13.2438	107.89	107.89
55	14.691	6.9959	53.80	53.80	7.6951	61.24	61.24
56	8.302	3.9534	30.40	30.40	4.3486	34.61	34.61
57	26.667	12.6988	95.24	95.24	13.9682	108.91	108.91
58	28.289	13.4712	98.61	95.24	14.8178	113.26	110.10
59	39.293	18.7113	136.96	95.24	20.5817	157.31	118.23
60	44.150	21.0242	153.90	94.24	23.1258	176.76	121.81
Subtotal	2,234.180	1,063.9166	10,339.08	10,197.71	1,170.2637	11,472.30	11,339.84
61	40.816	19.4366	142.27	95.24	21.3794	163.41	119.35
62	42.348	20.1661	147.62	99.02	22.1819	169.55	124.03
63	36.166	17.2222	126.07	95.24	18.9438	144.80	115.92
64	30.960	14.7432	107.92	95.24	16.2168	123.96	119.85
65	27.510	13.1003	95.89	95.24	14.4097	110.14	109.53
66	28.169	13.4141	18.19	95.24	14.7549	112.78	110.01
67	31.008	14.7660	108.09	95.24	16.2420	124.15	112.11
68	28.986	13.8631	101.04	95.24	15.1829	116.05	110.62

DISTRIBUTION OF SHARES—Continued

Lot No.	Number of shares	Shares to spouse	Basis for gain	Basis for loss	Remaining shares	Basis for gain	Basis for loss
69	26.964	12.8403	93.99	88.34	14.1237	107.96	102.66
70	26.991	12.8531	95.24	95.24	14.1379	109.14	109.14
71	26.490	12.6145	95.24	95.24	13.8755	108.78	108.78
72	28.329	13.4903	98.75	95.24	14.8387	113.42	110.13
73	28.169	13.4141	98.19	95.24	14.7549	113.48	110.72
74	28.944	13.7831	100.88	95.24	15.1609	115.88	110.59
75	27.933	13.3017	97.37	95.24	14.6313	111.84	109.84
76	26.901	12.8103	90.70	90.70	14.0907	104.82	104.82
77	28.860	13.7431	95.24	95.24	15.1139	110.53	110.53
78	29.895	14.2360	95.24	95.24	15.6590	111.29	111.29
79	28.944	13.7831	95.24	95.24	15.1609	110.59	110.59
Total	2,808.563	1,337.4378	12,[illegible]22.26	11,999.61	1,471.1255	13,754.87	13,460.35

SITUATION 2

CALCULATION OF DECEDENT'S BASIS ROWE PRICE NEW HORIZON'S FUND, INC.

Lot No.	Date of purchase	Number of shares	Number of shares after adjustments	Cost basis
1	Sept. 14, 1967	19	57	$481.08
2	Nov. 2, 1967	7.73	23.19	200.00
3	Dec. 1, 1967	7.378	22.134	200.00
4	(1)	1.992	5.976	53.89
5	Feb. 1, 1968	7.888	23.664	200.00
6	Apr. 1, 1968	8.116	24.348	5,903.64
7	Dec. 2, 1968	186.000	558.000	5,903.64
8	June 3, 1968	6.626	19.878	200.00
9	Aug. 1, 1968	7.054	21.162	200.00
10	Oct. 1, 1968	6.329	18.987	200.00
11	Dec. 2, 1968	5.895	17.685	200.00
12	Dec. 3, 1969	6.575	19.725	200.00
13	(1)	14.991	44.973	454.09
14	(1)	1.569	4.707	47.52
15	Apr. 1, 1969	6.978	20.934	200.00
16	June 1, 1969	6.715	20.145	200.00
17	Aug. 1, 1969	7.766	23.298	200.00
18	Aug. 15, 1969	114.000	342.000	2,979.96
19	Oct. 1, 1969	7.340	22.02	200.00
20	Dec. 1, 1969	6.894	20.682	200.00
Subtotal		436.836	1,310.508	12,720.18
21[2]	Feb. 2, 1970	7.650	22.95	200.00
22	(1)	20.061	60.183	524.20
23	(1)	3.511	10.533	91.74
24	Apr. 1, 1970	7.769	23.307	200.00
25	June 1, 1970	10.091	30.273	200.00
26	Aug. 10, 1970	10.686	32.058	200.00
27	Aug. 24, 1970	10.142	30.426	200.00
28	Oct. 9, 1970	8.708	26.124	200.00
29	Dec. 14, 1970	8.400	25.200	200.00
30	Feb. 5, 1971	7.772	23.316	200.00
31	(1)	9,282	27,846	240.97
32	(1)	3,229	9,687	83.82
33	Apr. 12, 1971	6,844	20.532	200.00
34	June 7, 1971	6.656	19,968	200.00
35	Aug. 9, 1971	7.057	21.171	200.00
36	Oct. 4, 1971	6.081	18.243	200.00
37	Dec. 3, 1971	6.028	18.084	200.00
38	(1)	1.620	4.860	63.45
39	(1)	9.130	27.390	357.62
40	Feb. 7, 1972	5,031	15.095	200.00
Subtotal		592.584	1,777.752	16,881.98

See footnotes at end of table.

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SITUATION 2—Continued

CALCULATION OF DECEDENT'S BASIS ROWE PRICE NEW HORIZONS FUND, INC.—Continued

Lot No.	Date of purchase	Number of shares	Number of shares after adjustment's	Cost basis
41	Apr. 3, 1972	4.637	13.911	200.00
42	June 5, 1972	4.397	13.191	200.00
43	Aug. 9, 1972	4.510	13.530	200.00
44	Oct. 4, 1972	4.904	14.712	200.00
45	Dec. 6, 1972	4.590	13.770	200.00
46	(1)	33.167	99.501	1,278.59
47	(1)	2.007	6.021	77.38
48	Feb. 14, 1973	5.265	15.795	200.00
49	Apr. 2, 1973	6.227	18.681	200.00
50	Apr. 30, 1973	1,324.576	(2)	(2)
51	June 4, 1973	22.548	22.548	200.00
52	Aug. 6, 1973	19.608	19.608	200.00
53	Oct. 5, 1973	18.484	18.484	200.00
54	Dec. 6, 1973	25.284	25.284	200.00
55	(1)	14.691	14.691	112.97
56	(1)	8.302	8.302	63.84
57	Apr. 4, 1974	26.667	26.667	200.00
58	June 5, 1974	28.289	28.289	200.00
59	Aug. 26, 1974	39.293	39.293	200.00
60	Oct. 3, 1974	44.150	44.150	200.00
Subtotal		2,234.180	2,234.180	21,414.76
61	Dec. 4, 1974	40.816	40.816	200.00
62	(1)	42,348	42.348	207.93
63	Feb. 3, 1975	36.166	36.166	200.00
64	Apr. 1, 1975	30.960	30.960	200.00
65	May 30, 1975	27,510	27.510	200.00
66	July 31, 1975	28.169	28.169	200.00
67	Oct. 6, 1975	31.008	31.008	200.00
68	Dec. 1, 1975	28.986	28.986	200.00
69	(1)	26.964	26.964	185.51
70	Feb. 2, 1976	26.991	26.991	200.00
71	Apr. 1, 1976	26.490	26.490	200.00
72	June 3, 1976	28.329	28.329	200.00
73	Aug. 6, 1976	28.169	28.169	200.00
74	Oct. 5, 1976	28.944	28.944	200.00
75	Dec. 6, 1976	27.933	27.933	200.00
76	(1)	26.901	26.901	190.46
77	Feb. 8, 1977	28.860	28.860	200.00
78	Apr. 5, 1977	29.895	29.895	200.00
79	June 6, 1977	28.944	28.944	200.00
Total		2,808.563	2,808.563	25,198.66

[1] Dividend.
[2] New shares apportioned to prior lots.

CALCULATION OF CARRYOVER BASIS—ROWE PRICE NEW HORIZONS FUND, INC.

Lot No.	Decedent's basis	Value on Dec. 31, 1976	Value for estate tax	Basis after fresh start	
				For gain	For loss
1	481.08	417.24	541.50	481.08	481.08
2	200.00	168.74	220.32	200.00	200.00
3	200.00	162.03	210.27	200.00	200.00
4	53.89	43.74	56.76	53.89	53.89
5	200.00	173.22	224.82	200.00	200.00
6	200.00	178.23	231.30	200 00	200.00
7	5,903.64	4,084.56	5,301.00	5,903.64	5,903.64
8	200.00	145.50	188.85	200.00	200.00
9	200.00	154.92	201.03	200.00	200.00
10	200.00	138.99	180.39	200.00	200.00
11	200.00	129.45	168.00	200.00	200.00
12	200.00	144.39	187.38	200.00	200.00
13	454.09	329.19	427.23	454.09	454.09
14	47.52	34.47	44.73	47.52	47.52
15	200.00	153.24	198.87	200.00	200.00
16	200.00	147.45	191.37	200.00	200.00
17	200.00	170.55	221.34	200.00	200.00
18	2,979.96	2,503.44	3,249.00	2,979.96	2,979.96
19	200.00	161.19	209.19	200 00	200.00
20	200.00	151.38	196.47	200.00	200.00
Subtotal	12,720.18	9,592.92	12,449.82	12,720.18	12,720.18

CALCULATION OF CARRYOVER BASIS—ROWE PRICE NEW HORIZONS FUND, INC.—Continued

Lot No.	Decedent's basis	Value on Dec. 31, 1976	Value for estate tax	Basis after fresh start	
				For gain	For loss
21	200.00	168.00	218.04	200.00	200.00
22	524.20	440.55	571.74	524.20	524.20
23	91.74	77.10	100.05	91.74	91.74
24	200.00	170.61	221.43	200.00	200.00
25	200.00	221.61	287.58	221.61	200.00
26	200.00	234 66	304.56	234.66	200.00
27	200.00	222.72	289.05	222.72	200.00
28	200.00	191.22	248.19	200.00	200.00
29	200.00	184.47	239.40	200.00	200.00
30	200.00	170.67	221.49	200.00	200.00
31	240.97	203.82	264.54	240.97	240.97
32	83.82	70.92	92.04	83.82	83.82
33	200.00	150.30	195.06	200.00	200.00
34	200.00	146.16	189.69	200.00	200.00
35	200.00	154.98	201.12	200.00	200.00
36	200.00	133.53	173.31	200.00	200.00
37	200.00	132.39	171.81	200.00	200.00
38	63.45	35.58	46.17	63.45	63.45
39	357.62	200.49	260.22	357.62	357.62
40	200.00	110.49	143.37	200.00	200.00
Subtotal	16,881.98	12,983.19	16,888.68	16,960.97	16,881.98
41	200.00	101.82	132.15	200.00	200.00
42	200.00	96.57	125.31	200.00	200.00
43	200.00	99.03	128.55	200.00	200.00
44	200.00	107.70	139.77	200.00	200.00
45	200.00	100.80	130.83	200.00	200.00
46	1,278.59	728.34	945.27	1,278.59	1,278.59
47	77.38	44.07	57.21	77.38	77.38
48	200.00	115.62	150.06	200.00	200.00
49	200.00	136.74	177.48	200.00	200.00
50	0	0	0	0	0
51	200.00	165.05	214.21	200.00	200.00
52	200.00	143.53	186.28	200.00	200.00
53	200.00	135.30	175.60	200.00	200.00
54	200.00	185.08	240.20	200.00	200.00
55	112.97	107.54	139.56	112.97	112.97
56	63.84	60.77	78.87	63.84	63.84
57	200.00	195.20	253.34	200.00	200.00
58	200.00	207.08	268.75	207.08	200.00
59	200.00	287.62	373.28	287.62	200.00
60	200.00	323.18	419.43	323.18	200.00
Subtotal	21,414.76	16,344.21	21,224.76	21,711.63	21,414.76
61	200.00	298.77	387.75	298.77	200.00
62	207.93	309.99	402.31	309.99	207.93
63	200.00	264.74	343.58	264.74	200.00
64	200.00	226.23	294.12	226.63	200.00
65	200.00	201.37	261.35	201.37	200.00
66	200.00	206.20	267.61	206.20	200.00
67	200.00	226.98	294.58	226.98	200.00
68	200.00	212.18	275.37	212.18	200.00
69	185.51	197.38	256.18	197.38	185.51
70	200.00	197.57	256.41	200.00	200.00
71	200.00	193.91	251.66	200.00	200.00
72	200.00	207.37	269.13	207.37	200.00
73	200.00	206.20	276.61	206.20	200.00
74	200.00	211.87	274.97	211.87	200.00
75	200.00	204.47	265.36	204.47	200.00
76	190.46	196.92	255.56	190.46	190.46
77	200.00	211.26	274.17	200.00	200.00
78	200.00	211.83	284.00	200.00	200.00
79	200.00	211.87	274.97	200.00	200.00
Total	25,198.66	20,547.72	26,690.45	25,876.24	25,198.66

Calculation of Fresh Start Adjustment to Residence

Fair market value	$40,000
Decedent's basis	20,000
Appreciation	20,000
Number of days in holding period:	
1974	19
1975	365
1976	366
1977	365
1978	365
1979	273
Total	1,753
Number of days in holding period prior to December 31, 1976:	
1974	19
1975	365
1976	366
Total	750
Apportionment of appreciation:	
750 over 1,753 times $20,000	$8,556
Decedent's basis	20,000
Fresh start adjustment	8,556
Fresh start basis	28,556

CALCULATION OF TOTAL BASIS AFTER FRESH START ADJUSTMENT AND REMAINING APPRECIATION

Item	Estate tax value	Fresh start basis for gain	Remaining appreciation
Residence	$40,000.00	$28,556.00	$11,444.00
Mutual fund	26,690.45	25,876.24	2,564.18
Cash	1,000.00	1,000.00	0
Total	67,690.45	55,432.24	14,008.18
	Estate tax value	Fresh start basis for loss	Remaining appreciation
Residence	$40,000.00	$20,000.00	$20,000.00
Mutual fund	26,690.45	25,198.66	3,261.72
Cash	1,000.00	1,000.00	0
Total	67,690.45	46,198.66	23,261.72

Note.—The remaining appreciation for the mutual fund does not equal the differences between the estate tax value of the mutual fund and the fresh start bases because not all of the lots of the mutual fund are appreciated carryover basis properties.

Carryover basis of residence for gain:	
Fresh start basis	$28,556.00
Minimum basis adjustment: $60,000 minus $55,432.24 over $14,008.18 times $11,444	3,731.89
Adjusted carryover basis for gain	32,287.89
Carryover basis of residence for loss:	
Fresh start basis for loss	20,000.00
Minimum basis adjustment: $60,000 minus $46,198.66 over $23,261.72 times $20,000	11,866.00
Adjusted carryover basis for loss	31,866.00

Minimum basis adjustment factors for mutual fund:

Adjustment factor for gain: $60,000 minus $55,432.24 over $14,008.18 .... 0.3261

Adjustment factor for loss: $60,000 minus $46,198.66 over $23,261.72 .... 0.5933

CALCULATION OF MINIMUM BASIS ADJUSTMENT TO MUTUAL FUND

Lot No.	Appreciation from gain basis	Adjustment (0.3261)	Carryover basis for gain	Appreciation from loss basis	Adjustment (0.5933)	Carryover basis for loss
1	$60.42	$19.70	$500.78	$60.42	$35.85	$516.93
2	20.32	6.63	206.63	20.32	12.06	212.06
3	10.27	3.35	203.35	10.27	6.09	206.09
4	2.87	.94	54.83	2.87	1.70	55.59
5	24.82	8.09	208.09	24.82	14.73	214.73
6	31.30	10.21	210.21	31.30	18.57	218.57
7	0	0	5,903.64	0	0	5,903.64
8	0	0	200.00	0	0	200.00
9	1.03	.34	200.34	1.03	.61	200.61
10	0	0	200.00	0	0	200.00
11	0	0	200.00	0	0	200.00
12	0	0	200.00	0	0	200.00
13	0	0	454.09	0	0	459.09
14	0	0	47.52	0	0	47.52
15	0	0	200.00	0	0	200.00
16	0	0	200.00	0	0	200.00
17	21.34	6.96	206.96	21.34	12.66	212.66
18	269.04	87.73	3,067.69	269.04	159.62	3,139.58
19	9.19	3.00	203.00	9.19	5.45	205.45
20	0	0	200.00	0	0	200.00
21	18.04	5.88	205.88	18.04	10.70	210.70
22	47.54	15.50	539.70	47.54	28.21	552.41
23	8.31	2.71	94.45	8.31	4.93	96.67
24	21.43	6.99	206.99	21.43	12.71	212.71
25	65.97	21.51	243.12	87.58	51.96	251.96
26	69.90	22.79	257.45	104.56	62.04	262.04
27	66.33	21.63	244.35	89.05	52.83	252.83
28	48.19	15.71	215.71	48.19	28.59	228.59
29	39.40	12.85	212.85	39.40	23.38	223.38
30	21.49	7.01	207.01	21.49	12.75	212.75
31	23.57	7.69	248.66	23.57	13.98	254.95
32	8.22	2.68	86.50	8.22	4.88	88.70
33	0	0	200.00	0	0	200.00
34	0	0	200.00	0	0	200.00
35	1.12	.37	200.37	1.12	.66	200.66
36	0	0	200.00	0	0	200.00
37	0	0	200.00	0	0	200.00
38	0	0	63.45	0	0	63.45
39	0	0	357.62	0	0	357.62
40	0	0	200.00	0	0	200.00
41	0	0	200.00	0	0	200.00
42	0	0	200.00	0	0	200.00
43	0	0	200.00	0	0	200.00
44	0	0	200.00	0	0	200.00
45	0	0	200.00	0	0	200.00
46	0	0	1,278.59	0	0	1,278.59
47	0	0	77.38	0	0	77.38
48	0	0	200.00	0	0	200.00
49	0	0	200.00	0	0	200.00
50	0	0	0	0	0	0
51	14.21	4.63	204.63	14.2	8.43	208.43
52	0	0	200.00	0	0	200.00
53	0	0	200.00	0	0	200.00
54	40.20	13.11	213.11	40.20	23.85	223.85
55	26.59	8.67	121.64	26.59	15.78	128.75
56	15.03	4.90	68.74	15.03	8.92	72.76
57	53.34	17.39	217.39	53.34	31.65	231.65
58	61.67	20.11	227.19	68.75	40.79	240.79
59	85.66	27.93	315.55	173.28	102.81	302.81
60	96.25	31.39	354.57	219.43	130.19	330.19

CALCULATION OF MINIMUM BASIS ADJUSTMENT TO MUTUAL FUND—Continued

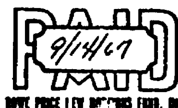
Lot No.	Appreciation from gain basis	Adjustment (0.3261)	Carryover basis for gain	Appreciation from loss basis	Adjustment (0.5933)	Carryover basis for loss
61	88.98	29.02	327.79	187.75	111.39	311.39
62	92.32	30.11	340.10	194.38	115.33	323.26
63	78.84	25.71	290.45	143.58	85.19	285.19
64	67.49	22.01	248.64	94.12	55.84	255.84
65	40.02	13.05	214.42	61.35	36.40	236.40
66	61.41	20.03	226.23	67.61	40.11	240.11
67	67.60	22.04	249.02	94.58	56.11	256.11
68	63.19	20.61	232.79	75.37	44.72	244.72
69	58.80	19.17	216.55	70.67	41.93	227.44
70	56.41	18.40	218.40	56.41	33.47	233.47
71	51.66	16.85	216.85	51.66	30.65	230.65
72	61.76	20.14	227.51	69.13	41.01	241.01
73	70.41	22.96	229.16	76.61	45.45	245.45
74	63.10	20.58	232.45	74.97	44.48	244.48
75	60.89	19.86	224.33	65.36	38.78	238.78
76	65.10	21.23	211.69	65.10	38.62	229.08
77	74.17	24.19	224.19	74.17	44.01	244.01
78	84.00	27.39	227.39	84.00	49.84	249.84
79	74.97	24.45	224.45	74.97	44.48	244.48
Total	2,564.18	836.20	26,712.44	3,261.72	1,935.19	27,133.85

ROWE PRICE NEW HORIZONS FUND, INC.
ONE CHARLES CENTER
BALTIMORE, MARYLAND 21201
TELEPHONE 539-1992
AREA CODE 301

Certificate(s) will be registered as follows:

433-36-2840

J. Thomas Eubank, Jr.
1600 Esperson Building
Houston, Texas 77002



We are pleased to accept the following subscription to the Capital Stock of the

ROWE PRICE NEW HORIZONS FUND, INC.

INVOICE NO.	DATE ACCEPTED MO. DAY YR.	NUMBER OF SHARES	OFFERING PRICE/SHARE	TOTAL COST	AMOUNT PAID	BALANCE DUE FUND OR REFUND (-)
22892	9 14 67	19	25.32	481.08	500.00	18.92-

SPECIAL NOTES: If you are interested in purchasing shares of the New Horizons Fund on a monthly basis, please complete the enclosed Systematic Investing Application Form (in duplicate) and return to the Fund. You will then be automatically billed in accordance with your instructions.

Remittance due within seven (7) business days after acceptance of order. Make check payable to New Horizons Fund. Stock certificate(s) and any refund will be forwarded by the Transfer Agent in about two weeks after receipt of payment.

ROWE PRICE NEW HORIZONS FUND, INC.

SYSTEMATIC INVESTING PLAN

IMPORTANT Retain this advice for any needed accounting or tax purposes.

J THOMAS EUBANK JR
1600 ESPERSON BUILDING
HOUSTON TEXAS 77002

IN ACCORDANCE WITH YOUR AUTHORIZATION, WE HAVE ACTED AS YOUR AGENT IN EFFECTING THE FOLLOWING TRANSACTION AND IN SENDING THIS CONFIRMATION PLEASE SEND REMITTANCE AS SHOWN BELOW, WHICH INCLUDES A SERVICE CHARGE OF 50 CENTS, WITH THE ENCLOSED COPY OF THIS STATEMENT TO MARYLAND NATIONAL BANK, AGENT. REMITTANCE IS DUE WITHIN SEVEN (7) BUSINESS DAYS AFTER SUBSCRIPTION DATE

MARYLAND NATIONAL BANK
P. O. BOX 987 BALTIMORE, MARYLAND 21203

NOTE THE NUMBER OF SHARES SHOWN IN THE BOX AT LOWER RIGHT MAY NOT REFLECT A PURCHASE OR REDEMPTION TRANSACTED WITHIN A FEW DAYS PREVIOUS TO DATE OF SUBSCRIPTION.

ACCOUNT NUMBER	DATE OF SUBSCRIPTION	NO. OF SHARES PURCHASED	PRICE PER SHARE	TOTAL REMITTANCE
14258450	10-02-67	7.730	$25.81	$ 200.00

TOTAL SHARES HELD IN PLAN ACCOUNT
7.730

ROWE PRICE NEW HORIZONS FUND, INC.

SYSTEMATIC INVESTING PLAN

IMPORTANT Retain this advice for any needed accounting or tax purposes.

▼ J THOMAS EUBANK JR
1600 ESPERSON BUILDING
HOUSTON TEXAS 77002

IN ACCORDANCE WITH YOUR AUTHORIZATION, WE HAVE ACTED AS YOUR AGENT IN EFFECTING THE FOLLOWING TRANSACTION AND IN SENDING THIS CONFIRMATION. PLEASE SEND REMITTANCE AS SHOWN BELOW, WHICH INCLUDES A SERVICE CHARGE OF 50 CENTS, WITH THE ENCLOSED COPY OF THIS STATEMENT TO MARYLAND NATIONAL BANK, AGENT. REMITTANCE IS DUE WITHIN SEVEN (7) BUSINESS DAYS AFTER SUBSCRIPTION DATE.

MARYLAND NATIONAL BANK
P. O. BOX 987 BALTIMORE, MARYLAND 21203

NOTE THE NUMBER OF SHARES SHOWN IN THE BOX AT LOWER RIGHT MAY NOT REFLECT A PURCHASE OR REDEMPTION TRANSACTED WITHIN A FEW DAYS PREVIOUS TO DATE OF SUBSCRIPTION.

ACCOUNT NUMBER	DATE OF SUBSCRIPTION	NO. OF SHARES PURCHASED	PRICE PER SHARE	TOTAL REMITTANCE
14258450	12-01-67	7.378	$27.04	$ 200.00

TOTAL SHARES HELD IN PLAN ACCOUNT
15.108

ROWE PRICE NEW HORIZONS FUND, INC.

In accordance with the Systematic Investing Plan authorized by you, we have acted as your Agent in effecting the transaction below, and in sending this confirmation. Your Systematic Investing Plan account has been credited with the number of full and fractional shares to which you are entitled, based on the net asset value on the payment date, as shown by the detail herein set forth.

J THOMAS EUBANK JR
1600 ESPERSON BUILDING
HOUSTON TEXAS 77002

12/?/67

ACCOUNT NO. 14258450

DIVIDEND REINVESTMENT CONFIRMATION

MARYLAND NATIONAL BANK, AGENT
P. O. BOX 987 BALTIMORE, MARYLAND 21203

SHARES OWNED ON RECORD DATE	DIVIDEND PER SHARE	AMOUNT RECEIVED	NET ASSET VALUE ON PAYMENT DATE	SHARES RECEIVED	TOTAL SHARES HELD IN PLAN ACCT.
34.108	1.58	53.891	27.06	1.992	36.100

NOTE: PURCHASES OR REDEMPTIONS AFTER RECORD DATE ARE NOT REFLECTED IN TOTAL SHARES.

ROWE PRICE NEW HORIZONS FUND, INC.

SYSTEMATIC INVESTING PLAN

IMPORTANT Retain this advice for any needed accounting or tax purposes.

▼ J THOMAS EUBANK JR
1600 ESPERSON BUILDING
HOUSTON TEXAS 77002

IN ACCORDANCE WITH YOUR AUTHORIZATION, WE HAVE ACTED AS YOUR AGENT IN EFFECTING THE FOLLOWING TRANSACTION AND IN SENDING THIS CONFIRMATION. PLEASE SEND REMITTANCE AS SHOWN BELOW, WHICH INCLUDES A SERVICE CHARGE OF 50 CENTS, WITH THE ENCLOSED COPY OF THIS STATEMENT TO MARYLAND NATIONAL BANK, AGENT. REMITTANCE IS DUE WITHIN SEVEN (7) BUSINESS DAYS AFTER SUBSCRIPTION DATE.

MARYLAND NATIONAL BANK
P. O. BOX 987 BALTIMORE, MARYLAND 21203

NOTE THE NUMBER OF SHARES SHOWN IN THE BOX AT LOWER RIGHT MAY NOT REFLECT A PURCHASE OR REDEMPTION TRANSACTED WITHIN A FEW DAYS PREVIOUS TO DATE OF SUBSCRIPTION.

ACCOUNT NUMBER	DATE OF SUBSCRIPTION	NO. OF SHARES PURCHASED	PRICE PER SHARE	TOTAL REMITTANCE
14258450	2-01-68	7.888	$ 25.29	$ 200.00

TOTAL SHARES HELD IN PLAN ACCOUNT
24.988

ROWE PRICE NEW HORIZONS FUND, INC.

SYSTEMATIC INVESTING PLAN

IMPORTANT Retain this advice for any needed accounting or tax purposes.

J THOMAS EUBANK JR
1600 ESPERSON BUILDING
HOUSTON TEXAS 77002

In accordance with your authorization, we have acted as your agent in effecting the following transaction [illegible]

MARYLAND NATIONAL BANK
P. O. BOX 987 BALTIMORE, MARYLAND 21203

NOTE: THE NUMBER OF SHARES SHOWN IN THE BOX AT LOWER RIGHT MAY NOT REFLECT A PURCHASE OR REDEMPTION TRANSACTED WITHIN A FEW DAYS PREVIOUS TO DATE OF SUBSCRIPTION.

ACCOUNT NUMBER	DATE OF SUBSCRIPTION	NO. OF SHARES PURCHASED	PRICE PER SHARE	[illegible]
14258450	4-01-68	8.116	$24.58	$ 200.00

TOTAL SHARES HELD IN PLAN ACCOUNT
33.104

ROWE PRICE NEW HORIZONS FUND, INC.

ONE CHARLES CENTER
BALTIMORE, MARYLAND 21201
TELEPHONE 539-1992

Certificate(s) will be registered as follows:

J. Thomas Eubank, Jr.
1600 Esperson Building
Houston, Texas 77002

BANK NOTE: Systematic Plan

We are pleased to accept the following subscription to the Capital Stock of the Rowe Price New Horizons Fund, Inc.

INVOICE NO.	DATE ACCEPTED MO.	DAY	YR.	NUMBER OF SHARES	OFFERING PRICE/SHARE	TOTAL COST	AMOUNT PAID	BALANCE DUE FUND OR REFUND (-)
4438	11	12	68	186	31.74	5903.64	.00	5903.64

SPECIAL NOTES:

Remittance due within seven (7) business days after acceptance of order. Make check payable to New Horizons Fund. Stock certificate(s) and any refund will be forwarded by the Transfer Agent in about two weeks after receipt of payment.

SHAREHOLDER COPY

INVOICE

Rowe Price New Horizons Fund, Inc.

SYSTEMATIC INVESTING PLAN

IMPORTANT. RETAIN THIS ADVICE FOR ANY NEEDED ACCOUNTING OR TAX PURPOSES

Refer to Account Number Below in All Correspondence	Social Security or Tax Identifying No.		
430- 002 58-450-6	433-36-2840	MM	8518

SHAREHOLDER

J THOMAS EUBANK JR
1600 ESPERSON BUILDING
HOUSTON TEXAS 77002

In accordance with your authorization, we have acted as your agent in effecting the last purchase transaction entered under "Transaction Date." Please send remittance as shown below which includes a service charge of 50¢ with the enclosed copy of this statement to State Street Bank and Trust Company, Agent, in the enclosed envelope. Remittance is due within seven (7) Business Days after the Transaction Date.

SUMMARY OF YOUR ACCOUNT

Date of Statement	Distributions for Current Year: Dividends Paid This Year	Capital Gains Paid This Year	Shares You Now Own: Certificates Held by You	+ Shares Held by Bank	= Total Shares Owned
12/02/68			19.000	59.008	78.008

Transaction Date Mo Day	Type of Transaction	Dollar Amount	Price per Share	Shares This Transaction	Total Shares
	BALANCE 5-30-68				33.104
5-31	CTF SHS ADDED			19.000	52.104
6-03	SHARES BOUGHT	199.50	30.11	6.626	58.730
8-01	SHARES BOUGHT	199.50	28.28	7.054	65.784
8-12	CONSOLIDATION			.000	65.784
10-01	SHARES BOUGHT	199.50	31.52	6.329	72.113
12-02	SHARES BOUGHT	199.50	33.84	5.895	78.008

+186 shares bought 11/17/68 @ 31.74 = 5903.64

PLEASE REMIT $ 200.00 WITHIN SEVEN (7) BUSINESS DAYS AFTER THE LAST TRANSACTION DATE

STATE STREET BANK AND TRUST COMPANY P.O. BOX 2357 BOSTON MASS 02107

YEAR-TO-DATE CONFIRMATION STATEMENT

Rowe Price New Horizons Fund, Inc.

DIVIDEND REINVESTMENT and SYSTEMATIC INVESTING PLAN

Refer to Account Number Below in All Correspondence	Social Security or Tax Identifying No.		
430 002 58-450-6	433-36-2840	MM	8518

SHAREHOLDER

J THOMAS EUBANK JR
1600 ESPERSON BUILDING
HOUSTON TEXAS 77002

SUMMARY OF YOUR ACCOUNT

Date of Statement	Distributions for Current Year: Dividends Paid This Year	Capital Gains Paid This Year	Shares You Now Own: Certificates Held by You	+ Shares Held by Bank	= Total Shares Owned
12/31/68			19.000	245.008	264.008

Transaction Date Mo. Day	Type of Transaction	Dollar Amount	Price per Share	Shares This Transaction	Total Shares
	BALANCE 5-30-68				33.104
5-31	CTF SHS ADDED			19.000	52.104
6-03	SHARES BOUGHT	199.50	30.11	6.626	58.730
8-01	SHARES BOUGHT	199.50	28.28	7.054	65.784
8-12	CONSOLIDATION			.000	65.784
10-01	SHARES BOUGHT	199.50	31.52	6.329	72.113
12-02	SHARES BOUGHT	199.50	33.84	5.895	78.008
11-29	DEPOSIT SHS ADDED			186.000	264.008

STATE STREET BANK and TRUST COMPANY P.O. BOX 2357, BOSTON, MASS. 02107

SHAREHOLDER COPY

INVOICE

Rowe Price New Horizons Fund, Inc.

SYSTEMATIC INVESTING PLAN

IMPORTANT RETAIN THIS ADVICE FOR ANY NEEDED ACCOUNTING OR TAX PURPOSES

Refer to Account Number Below In All Correspondence	Social Security or Tax Identifying No.		
430-00258-450-6	433-36-2840	MM	8518

SHAREHOLDER

J. THOMAS EUBANK JR
1600 ESPERSON BUILDING
HOUSTON TEXAS 77002

In accordance with your authorization, we have acted as your agent in effecting the last purchase transaction entered under "Transaction Date." Please send remittance as shown below, which includes a service charge of 50¢ with the enclosed copy of this statement to State Street Bank and Trust Company, Agent, in the enclosed envelope. Remittance is due within seven (7) Business Days after the Transaction Date.

SUMMARY OF YOUR ACCOUNT

Date of Statement	Distributions for Current Year: Dividends Paid This Year	Capital Gains Paid This Year	Shares You Now Own: Certificates Held by You	+ Shares Held by Bank	= Total Shares Owned
12/01/69	$47.52	$454.09	19.000	417.836	436.836

Transaction Date Mo Day	Type of Transaction	Dollar Amount	Price per Share	Shares This Transaction	Total Shares
	BALANCE 12-31-68				264.008
2-03	SHARES BOUGHT	199.50	30.34	6.575	270.583
2-14	CAP GAIN	454.09	30.29	14.991	285.574
2-14	DIVIDEND	47.52	30.29	1.569	287.143
4-01	SHARES BOUGHT	199.50	28.59	6.978	294.121
5-01	SHARES BOUGHT	199.50	29.30	6.809	300.930
5-14	ADJUSTMENT 5/01/69			-6.809	294.121
6-02	SHARES BOUGHT	199.50	29.71	6.715	300.836
8-01	SHARES BOUGHT	199.50	25.69	7.765	308.602
9-15	DEPOSIT SHS ADDED			114.000	422.602
10-01	SHARES BOUGHT	199.50	27.18	7.340	429.942
12-01	SHARES BOUGHT	199.50	28.94	6.894	436.836

PLEASE REMIT $ 200.00 WITHIN SEVEN (7) BUSINESS DAYS AFTER THE LAST TRANSACTION DATE

STATE STREET BANK AND TRUST COMPANY   P.O. BOX 2357 BOSTON MASS. 02107

YEAR-TO-DATE CONFIRMATION STATEMENT

Rowe Price New Horizons Fund, Inc.

DIVIDEND REINVESTMENT and SYSTEMATIC INVESTING PLAN

Refer to Account Number Below In All Correspondence	Social Security or Tax Identifying No.		
430-00258-450-6	433-36-2840	MM	1487

SHAREHOLDER

J THOMAS EUBANK JR
1600 ESPERSON BUILDING
HOUSTON TEXAS 77002

SUMMARY OF YOUR ACCOUNT

Date of Statement	Distributions for Current Year: Dividends Paid This Year	Capital Gains Paid This Year	Shares You Now Own: Certificates Held by You	+ Shares Held by Bank	= Total Shares Owned
12/15/70	91.74	524.20	485.000	38.854	523.854

Transaction Date Mo Day	Type of Transaction	Dollar Amount	Price per Share	Shares This Transaction	Total Shares
	BALANCE 12-31-69				436.836
2-02	SHARES BOUGHT	199.50	26.08	7.650	444.486
2-20	CAP GAIN	524.20	26.13	20.061	464.547
2-20	DIVIDEND	91.74	26.13	3.511	468.058
4-01	SHARES BOUGHT	199.50	25.68	7.769	475.827
6-01	SHARES BOUGHT	199.50	19.77	10.091	485.918
7-29	DEPOSIT SHS TO CTF			466.000	485.918
8-10	SHARES BOUGHT	199.50	18.67	10.686	496.604
8-24	SHARES BOUGHT	199.50	19.67	10.142	506.746
10-09	SHARES BOUGHT	199.50	22.91	8.708	515.454
12-14	SHARES BOUGHT	199.50	23.75	8.400	523.854

STATE STREET BANK and TRUST COMPANY   P.O. BOX 2357, BOSTON, MASS. 02107

YEAR-TO-DATE CONFIRMATION STATEMENT

Rowe Price New Horizons Fund, Inc.

Refer to Account Number Below in All Correspondence: 430-00258-450-6

Social Security or Tax Identifying No: 433-36-2840

MH 1487

SHAREHOLDER

J THOMAS EUBANK JR
ONE SHELL PLAZA 29TH FL
HOUSTON TEXAS 77002

1

SUMMARY OF YOUR ACCOUNT

Date of Statement	Distributions for Current Year: Dividends Paid This Year	Capital Gains Paid This Year	Shares You Now Own: Certificates Held by You	+ Shares Held by Bank	= Total Shares Owned
12/03/71	83.82	240.97	485.000	91.803	576.803

Transaction Date Mo Day	Type of Transaction	Dollar Amount	Price per Share	Shares This Transaction	Total Shares
	BALANCE 12-31-70				523.854
2-05	SHARES BOUGHT	199.50	25.67	7.772	531.626
2-19	CAP GAIN	240.97	25.96	9.282	540.908
2-19	DIVIDEND	83.82	25.96	3.229	544.137
4-12	SHARES BOUGHT	199.50	29.15	6.844	550.981
6-07	SHARES BOUGHT	200.00	30.05	6.656	557.637
8-09	SHARES BOUGHT	200.00	28.34	7.057	564.694
10-04	SHARES BOUGHT	200.00	32.89	6.081	570.775
12-03	SHARES BOUGHT	200.00	33.18	6.028	576.803

STATE STREET BANK and TRUST COMPANY P O BOX 2357, BOSTON, MASS 02107

Year-To-Date Confirmation Statement

Rowe Price New Horizons Fund, Inc.

Refer to Account Number Below in All Correspondence: 430-00258-450-6

Distribution Option: A

Social Security or Tax Identifying No.: 433-36-2840

01487

J THOMAS EUBANK JR
ONE SHELL PLAZA 29TH FL
HOUSTON TEXAS 77002

Transaction Date	Type of Transaction	Dollar Amount	Price	Shares This Transaction	Total Shares
1972	BALANCE FORWARD				576.803
2-09	INCOME DIVIDEND $.11	63.45	39.17	1.620	578.423
2-09	CAPITAL GAIN DISTRIB. $.62	357.62	39.17	9.130	587.553
2-07	CASH INVESTMENT	200.00	39.75	5.031	592.584
4-03	CASH INVESTMENT	200.00	43.13	4.637	597.221
6-05	CASH INVESTMENT	200.00	45.49	4.397	601.618
6-15	CERTIFICATE SHARES ISSUED			100.000	601.618
8-09	CASH INVESTMENT	200.00	44.35	4.510	606.128
10-04	CASH INVESTMENT	200.00	40.78	4.904	611.032
12-04	CASH INVESTMENT	200.00	43.57	4.590	615.622

THIS IS A SUMMARY OF YOUR ACCOUNT

Total Distributions	Capital Gains	Income Dividends	Certificate Shares	+ Shares on Deposit	= Total Shares Owned
421.07	357.62	63.45	585	30.622	615.622

Statement Date	Investment Year to Date Excluding Distributions
12-04-72	1,200.00

TRANSFER AGENT STATE STREET BANK and TRUST COMPANY P. O. BOX 2357 BOSTON, MASS. 02107

BEST COPY AVAILABLE

CUMULATIVE STATEMENT
1973 CALENDAR YEAR TO DATE

ROWE PRICE NEW HORIZONS FUND, IN

J THOMAS EUBANK JR
ONE SHELL PLAZA 29TH FL
HOUSTON TEXAS 77002

Tax I.D. or Soc. Sec. No. 433-36-2840
Account No. 2584506 EUBANK-J-T

PLEASE REFER TO THIS ACCOUNT NUMBER IN ALL CORRESPONDENCE AND MAIL TO:

STATE STREET BANK and TRUST COMPANY TRANSFER AGENT P.O. BOX 2357 BOSTON, MA. 02107

CONFIRM DATE	TRADE DATE	TRANSACTION		DOLLAR AMOUNT OF TRANSACTION	SHARE PRICE	SHARES THIS TRANSACTION	TOTAL SHARES OWNED
		BEGINNING BALANCE					615.6
2/06	2/06	CAP GAIN REINVEST	2.076	1,278.59	38.55	33.167	648.7
2/06	2/06	INCOME REINVEST	.125	77.38	38.55	2.007	650.7
/14	2/14	SHARES PURCHASED		200.00	37.99	5.265	656.0
/02	4/02	SHARES PURCHASED		200.00	32.12	6.227	662.2
4/30	5/01	200% STOCK DISTRIBUTION				1,324.576	1,986.8
/04	6/04	SHARES PURCHASED		200.00	8.87	22.548	2,009.41
/05	6/05	CERTIFICATE ISSUED				1,401.000	2,009.41
/06	8/06	SHARES PURCHASED		200.00	10.20	19.608	2,029.0
/05	10/05	SHARES PURCHASED		200.00	10.82	18.484	2,047.5
/06	12/06	SHARES PURCHASED		200.00	7.91	25.284	2,072.7

WHEN THIS STATEMENT IS MARKED 1099 THE INFORMATION BELOW WILL BE FILED WITH THE INTERNAL REVENUE SERVICE PURSUANT TO FEDERAL LAW IDENT NO 52-0791372

YOUR DISTRIBUTION OPTION IS: INCOME DIVIDENDS	CAPITAL GAINS	SHARES HELD BY YOU	+ SHARES HELD BY AGENT	= TOTAL SHARES OWNED
REINVESTMENT	REINVESTMENT	1,986.000	86.788	2,072.7

TOTAL DIVIDENDS AND OTHER DISTRIBUTIONS	INCOME DIVIDENDS	DIVIDENDS QUALIFYING FOR EXCLUSION	CAPITAL GAINS		
1355.97	77.38		1278.59	YEAR TO DATE INVESTMENTS	1,200.

CUMULATIVE STATEMENT
1974 CALENDAR YEAR TO DATE

ROWE PRICE NEW HORIZONS FUND, I

J THOMAS EUBANK JR
ONE SHELL PLAZA 29TH FL
HOUSTON TEXAS 77002

Tax I.D. or Soc. Sec. No. 433-36-2840
Account No. 2584506 EUBANK-J-T

PLEASE REFER TO THIS ACCOUNT NUMBER IN ALL CORRESPONDENCE AND MAIL TO:

STATE STREET BANK and TRUST COMPANY TRANSFER AGENT P.O. BOX 2357 BOSTON, MA. 02107

CONFIRM DATE	TRADE DATE	TRANSACTION		DOLLAR AMOUNT OF TRANSACTION	SHARE PRICE	SHARES THIS TRANSACTION	TOTAL SHARES OWNED
		BEGINNING BALANCE					2,072.76
'05	1/15	INCOME REINVEST	.0545	112.97	7.69	14.691	2,087.47
2/05	1/15	CAP GAIN REINVEST	.0308	63.84	7.69	8.302	2,095.78
4/04	4/04	SHARES PURCHASED		200.00	7.50	26.667	2,122.44
'05	6/04	SHARES PURCHASED		200.00	7.07	28.289	2,150.73
/26	8/26	SHARES PURCHASED		200.00	5.09	39.293	2,190.03
10/03	10/03	SHARES PURCHASED		200.00	4.53	44.150	2,234.18
'04	12/04	SHARES PURCHASED		200.00	4.90	40.816	2,274.99

WHEN THIS STATEMENT IS MARKED 1099 THE INFORMATION BELOW WILL BE FILED WITH THE INTERNAL REVENUE SERVICE PURSUANT TO FEDERAL LAW IDENT NO 52-0791372

YOUR DISTRIBUTION OPTION IS: INCOME DIVIDENDS	CAPITAL GAINS	SHARES HELD BY YOU	+ SHARES HELD BY AGENT	= TOTAL SHARES OWNED
REINVESTMENT	REINVESTMENT	1,986.000	288.996	2,274.9

TOTAL DIVIDENDS AND OTHER DISTRIBUTIONS	INCOME DIVIDENDS	DIVIDENDS QUALIFYING FOR EXCLUSION	CAPITAL GAINS		
176.81	112.97		63.84	YEAR TO DATE INVESTMENTS	1,000.0

CUMULATIVE STATEMENT
975 CALENDAR YEAR TO DATE

ROWE PRICE NEW HORIZONS FUND, I[illegible]

J THOMAS EUBANK JR
ONE SHELL PLAZA 29TH FL
HOUSTON TEXAS 77002

I.D. or Soc. Sec. No. 433-36-2340
Acct. No. 2534506 EUBANK-J-T

PLEASE REFER TO THIS ACCOUNT NUMBER IN ALL CORRESPONDENCE AND MAIL TO

STATE STREET BANK and TRUST COMPANY
TRANSFER AGENT
P.O. BOX 2357
BOSTON, MA. 02107

[illegible]	TRADE DATE	TRANSACTION		DOLLAR AMOUNT OF TRANSACTION	SHARE PRICE	SHARES THIS TRANSACTION	TOTAL SHARES OWNED
		BEGINNING BALANCE					2,274.5[illegible]
1/28	1/14	INCOME REINVEST	.0914	207.93	4.91	42.348	2,317.34
[illegible]03	2/03	SHARES PURCHASED		200.00	5.53	36.166	2,353.51
[illegible] 01	4/01	SHARES PURCHASED		200.00	6.46	30.960	2,384.47
[illegible]/30	5/30	SHARES PURCHASED		200.00	7.27	27.510	2,411.9[illegible]
[illegible]/31	7/31	SHARES PURCHASED		200.00	7.10	28.169	2,440.1[illegible]
[illegible] 06	10/06	SHARES PURCHASED		200.00	6.45	31.008	2,471.1[illegible]
[illegible]01	12/01	SHARES PURCHASED		200.00	6.90	28.986	2,500.1

IF THIS STATEMENT IS MARKED 1099 INFORMATION BELOW WILL BE FILED WITH THE INTERNAL REVENUE SERVICE PURSUANT TO FEDERAL LAW. IDENT. NO. 52-0791372

YOUR DISTRIBUTION OPTION IS: INCOME DIVIDENDS	CAPITAL GAINS
REINVESTMENT	REINVESTMENT

SHARES YOU NOW OWN: SHARES HELD BY YOU	SHARES HELD BY AGENT	TOTAL SHARES OWNED
1,986.000	514.143	2,500.14

TOTAL DIVIDENDS AND OTHER DISTRIBUTIONS	INCOME DIVIDENDS	DIVIDENDS QUALIFYING FOR EXCLUSION	CAPITAL GAINS		
207.93	207.93				YEAR TO DATE INVESTMENTS 1,200.[illegible]

CUMULATIVE STATEMENT
197[illegible] CALENDAR YEAR TO DATE

ROWE PRICE NEW HORIZONS FUND, I[illegible]

[illegible]
[illegible] PLAZA [illegible]
[illegible]

Tax I.D. or Soc. Sec. No [illegible]
Account No [illegible]

PLEASE REFER TO THIS ACCOUNT NUMBER IN ALL CORRESPONDENCE AND MAIL TO

STATE STREET BANK and TRUST COMPANY
TRANSFER AGENT
P.O. BOX 2351
BOSTON, MA. 0210[illegible]

CONFIRM DATE	TRADE DATE	TRANSACTION		DOLLAR AMOUNT OF TRANSACTION	SHARE PRICE	SHARES THIS TRANSACTION	TOTAL SHARES OWNED
		BEGINNING BALANCE					2,530.1
1/20	1/[illegible]	[illegible] REINVEST	.0742	185.51	6.[illegible]8	26.[illegible]64	2,527.1
[illegible]/0[illegible]	[illegible]	SHARES PURCHASED		200.00	7.[illegible]1	26.[illegible]91	2,[illegible]
[illegible]/01	[illegible]	SHARES PURCHASED		200.[illegible]	7.55	26.493	2,590.[illegible]
[illegible]/03	[illegible]	SHARES PURCHASED		200.[illegible]	7.[illegible]6	28.329	2,608.[illegible]
8/06	8/06	SHARES PURCHASED		200.00	7.10	28.169	2,637.[illegible]
[illegible]/05	10/05	SHARES PURCHASED		200.00	6.91	28.944	2,666.0
[illegible]/06	12/06	SHARES PURCHASED		200.00	7.16	27.933	2,693.[illegible]

WHEN THIS STATEMENT IS MARKED 1099 THE INFORMATION BELOW WILL BE FILED WITH THE INTERNAL REVENUE SERVICE PURSUANT TO FEDERAL LAW
IDENT NO [illegible]

YOUR DISTRIBUTION OPTION IS: INCOME DIVIDENDS	CAPITAL GAINS	SHARES HELD BY YOU +	SHARES HELD BY AGENT =	TOTAL SHARES OWNED
REINVESTMENT	REINVESTMENT	1,986.000	707.963	2,693.[illegible]

TOTAL DIVIDENDS AND OTHER DISTRIBUTIONS	INCOME DIVIDENDS	DIVIDENDS QUALIFYING FOR EXCLUSION	CAPITAL GAINS		
185.51	185.51				YEAR TO DATE INVESTMENTS 1,200.

T. ROWE PRICE NEW HORIZONS FUND, INC.

T. ROWE PRICE FUNDS

CUMULATIVE STATEMENT 1977 CALENDAR YEAR TO

J. THOMAS EUBANK JR
ONE SHELL PL 37A 29TH FL
HOUSTON TEXAS 77002

Account No. 2534506 — 433-36-2843

PLEASE REFER TO THIS ACCOUNT NUMBER IN ALL CORRESPONDENCE AND MAIL TO

STATE STREET BANK and TRUST COMPANY TRANSFER AGENT P.O. BOX 2157 BOSTON, MA

Date	Trade Date	Transaction		Dollar Amount of Transaction	Share Price	Shares This Transaction	Total Shares Owned
		BEGINNING BALANCE					2,693.[illegible]
/19	1/07	INCOME REINVEST	.0707	190.46	7.08	26.901	2,720.[illegible]
/08	2/09	SHARES PURCHASED		200.00	6.93	28.860	2,749.[illegible]
4/05	4/05	SHARES PURCHASED		200.00	6.69	29.895	2,779.[illegible]
/06	6/06	SHARES PURCHASED		200.00	6.91	28.944	2,808.[illegible]

ON 6/30/77 YOUR ACCOUNT'S VALUE WAS $19,407.17 AT $6.91 PER SHARE

ID No.	Your Distributions Options: Income Dividends	Capital Gains	Shares Held by You	Shares Held by Agent	Total Shares Owned
52-0791372	REINVESTMENT	REINVESTMENT	1,986.000	822.563	2,808.[illegible]

Total Dividends and Other Distributions	Income Dividends	Dividends Qualifying for Exclusion	Capital Gains		
190.46	190.46				YEAR TO DATE INVESTMENTS 600.

The reverse side of the detachable ORDER FORM may be used for corrections or changes to your account.

STATEMENT OF LEWIS M. COSTELLO, WINCHESTER, VA.

BACKGROUND

Mr. Chairman, I am Lewis M. Costello, an attorney in Winchester and Frederick County, Virginia. Although I am immediate past President of the Board of Governors of the Section on Taxation of the Virginia State Bar, that organization is an official arm of the State Supreme Court and a creature of statute. Therefore, I am not authorized to speak on behalf of that organization. I am asking as an individual and a tax practitioner.

Both my practice and experience may be of some interest to the Subcommittee, since I am not a theoretician.

For the most part, I represent clients in a basically agrarian and small business community. Much of my practice is in cooperation with other attorneys and CPA's. This essentially problem-solving practice extends over a broad area of the Seventh Congressional District of Virginia and the panhandles of West Virginia and Maryland.

My background is as an Economics Major, Lawyer and a Certified Public Accountant. Primarily, I am engaged as an attorney in all phases of tax planning and the implementation of those plans for small businesses and farmers.

Presumably, I work with many of the people for whose benefit special provisions were inserted in the Tax Reform Act of 1976, (hereafter, TRA '76) and for whose benefit several provisions of the Technical Corrections Bill of 1977 are included (hereafter TCB '77).

It may come as a surprise to you to realize how the entire small business and farmer community has been set back by these two bills. The Estate and Gift Tax portions of the TRA 1976 are virtually incomprehensible to the business community generally. The only thing certain is that it is the law of the Pharisees and not the Philosophers. The philosophy is frankly inconsistent and confusing to the point of frustration. Personally, despite 15 years of practice, my background education and over 70 hours of continuing education in the past year, I am incompetent to explain the law or its logic.

As a result, I suggest to you that in the small business and farming section of this nation there has arisen an annoyance with the practitioner (be he Attorney, CPA, Banker, Insurance Advisor or Estate Planner), a contempt for the

Congressional process, and a loathing for the Pharisaic Government in Washington unmatched in modern times, even by OSHA.

I. CARRYOVER BASIS PROBLEM

The single biggest problem is the complication from the carryover basis. The other speakers will cover this difficulty in detail. I attach to this presentation an article by Byrle M. Abbin entitled "Carryover Basis: Opening Pandora's Box." As Mr. Abbin, a CPA points out, the complications will exist well into the 21st Century.

My comment on this grievous bit of legislation is practical, not philosophical. Three questions my clients keep asking are:

1. With regard to the taxation of the step up in basis at death—how large a "loophole" exists when an individual must die to get through?

The common man's conception of a loophole is a special tax section which gives unfair tax advantage to one who has advantages already. It is very difficult for the common man to understand that his death gives him such an unfair advantage.

2. How long may my government pursue me for bad recordkeeping and when do I know I have satisfied the government?

In our heritage of law, it has historically been recognized that a Statute of Limitations was a desirable and useful thing. It was a statute of repose. It put to rest conflicts between the parties. Problems of proof, of duty, of penalty and of records are forever stilled by such statutes. It is recognized in our tax law as to assessments and collections,[1] as well as refunds[2] for criminal[3] as well as civil purposes.[4]

Essentially, the same function has historically been performed by the step up in basis at death under the Internal Revenue Code.[5] Each generation knew it could square away all prior errors and omission by properly reporting the assets and paying the tax. Now, thanks to carryover basis, there will be no end to the strife, and the sins of the fathers will carry over, according to Abbin, even unto the third and fourth generations.

Certainly has been killed. My clients feel that thereby a tremendous tool of political oppression has been placed in the hands of government. Not only is the power to tax the power to destroy, but also the ability to adjust is the ability to harass by government license.

3. Doesn't anyone care about the complications involved, the executor's duties, the recordkeeping, the problems generated for years to come?

I earnestly submit that the American small businessmen and farmers, together with all Americans, ought not have such burdens placed upon their backs. They are entitled to certainty, and a statute of limitations on basis, and to have their deaths regarded as more than the seizing of a loophole.

The elimination of carryover basis would solve most of the distressing problems I now intend to describe for you.

II. CRUEL HOAX

The TRA '76 has perpetrated a real hoax on the Farmer and Small Businessman. Real difficulties have been engendered for businessmen and farmers by:

A. The emasculation of prior relief provisions;

B. The false impression of new relief given by Congress and the proponents of both TRA '76 and TCB '77;

C. The vitiation of present reasonable commercial agreements that has been effected;

D. The removal of certainty in transactions.

A. Emasculation of prior relief provisions

The only source of funds for the payment of taxes for small businesses and farmers is often the business or farm that has been the source of decedent's livelihood, often the family's primary support for several generations. For the farm, this has historically been accomplished by selling part of the homeplace or borrowing the funds.

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[1] I.R.C. § 6501–6504.
[2] I.R.C. § 6511–6515.
[3] I.R.C. § 6531.
[4] I.R.C. § 6532.
[5] I.R.C. § 1014.

But for the small businessman, the source has generally been the corporation itself, quite often by redemptions (so-called 303 redemptions).[6] The validity of this source of financing was specifically recognized when accumulations to meet such redemption requirements were specifically exempted from any possibility of unreasonable accumulations tax.[7]

(1) But TRA '76 has frustrated this source of funds because the purposes of redemption for which exemption is provided do not include the payment of federal or state income taxes. It only speaks of Section 303 redemption needs.[8] Therefore, such redemption will now constitute ordinary income to the extent of such redemption necessary to pay federal and estate income taxes and, presumably, an accumulation to meet such redemption would not be exempt from unreasonable accumulations tax at the corporate level. Both of these are reductions of prior relief provisions now in effect whereby all taxes plus interest caused during administration could be raised by the redemption without fear of dividend treatment[9] and without fear of unreasonable accumulations tax on the small business entity.[10]

(2) More importantly, the carryover basis has caused a significant hardship on small corporations by creating a problem which did not previously exist. Historically, when the father wanted to turn his small business over to his son, he would often freeze his equity in the corporation by issuing preferred stock[11] and then selling or giving his common stock to the son. By this method, the father's lifetime of work stayed somewhat protected by the preferred position, and at the same time, the son reaped the gain or loss that his management caused.

The preferred stock so issued was called "hot stock" or 306 stock and resulted in ordinary income if sold or redeemed by the father during his lifetime.[12] This prohibited the removal of earnings and profits of the corporation by this device during the father's lifetime.

However, on death the taint was specifically removed because the basis of the stock was stepped up to market value pursuant to the basis adjustment sections. This preferred stock, together with common stock, could then be used by redemption to pay death taxes. Regulations specifically said so.[13]

Under TRA '76, we have a distinction not previously existing. The basis of such preferred stock no longer gets adjusted to market value. It receives adjusted decedent's basis plus adjustments for death taxes paid on appreciation and fresh start adjustments. Preferred stock now appears not to qualify for 303 redemption.[14] I say "appears" because the Code is not consistent between 303 redemption for taxes and expenses giving capital gain and preferred stock redemptions giving ordinary income.[15]

There is absolutely no rational reason that it should not so qualify. The purpose of Section 306 was to prevent a bail-out of earnings at capital gains rates rather than dividend rates. This is the same reason that distributions essentially equivalent to a dividend (ordinary income) results from a distribution with respect to common stock on an unqualified partial redemption. Section 303 was enacted as a relief provision to permit sale or exchange treatment rather than dividend treatment when stock was redeemed to pay Estate Taxes and expenses and recognized that this sale or exchange treatment would be income tax free due to the stepped up basis. To continue the exemption under § 303 but to exclude § 306 stock makes no philosophical sense when the true purpose of § 303 is considered. It does render § 306 stock treacherous.

Further, the TOB '77 is moving in precisely the opposite direction of prior-existing relief. Proposed changes would make it clear that 306 stock cannot be used for 303 purposes, a treatment which is completely opposite to the purposes behind both § 303 and § 306.[16]

A small business, therefore, completely transferred to the next generation with the father holding only preferred stock (his only asset) to provide him

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[6] I.R.C. § 303.
[7] I.R.C. § 537(a)(2).
[8] I.R.C. § 537(a)(2).
[9] I.R.C. § 303(a)(1).
[10] I.R.C. § 537(a)(2).
[11] I.R.C. § 305(a).
[12] I.R.C. § 306.
[13] Reg. § 1.306-3(e), Reg. § 1.303-2(d).
[14] I.R.C. § 306(a)(2).
[15] Compare I.R.C. § 303(a) and I.R.C. § 306(a)(2).
[16] Reg. § 1.303-3(a) clearly indicates the specific intent to exempt from tax as a dividend or distribution to which 303 is applicable, thereby specifically permitting a switch under prior law from ordinary income treatment to no gain because of stepped up basis. Presently, a transfer from ordinary income otherwise required to capital gain under the new law.

income and security in his old age is faced with estate tax, income tax and all ordinary income tax to boot where there was no previous impediment. It is redundant to again point out that the accumulation by the corporation to make such redemption would also be exposed to unreasonable accumulations tax.

Because the ordinary income taint of preferred stock was removed at death, many small businessmen have already used preferred stock in their estate planning. The vast majority of these plans were put into effect long before TRA '76 was even considered. These plans, implemented long ago, now carry very serious tax detriments with them, and these adverse tax consequences cannot now be avoided in many cases. To so penalize such prior planning is grossly unfair.

(3) A new bite has been put on small businesses also in that the percentage tests have been raised to qualify for redemption at all in solving the liquidity problem. Old tests of 35 percent of the gross estate and 50 percent of the taxable estate have been replaced by a test of 50 percent of the value of the gross estate of decedent over certain deductions.[17]

The reason for such higher percentage is not apparent since no particular evidence of widespread abuse existed under previous ratios and they worked. Since the same ratios are preserved elsewhere under in the Code under the caption "Extension of Time for Payment of Estate Tax Where Estate Consists Largely of Interest in Closely Held Business,"[18] it is difficult to understand why such large interests will no longer qualify for redemption.

Obviously, attempts by farmers and small businessmen to cure their own liquidity problem may alter ratios in estates sufficiently to disqualify any redemption. Attempts to give or sell to a family any portion of the stock would do the same. The reduction of a business interest immediately prior to death by adverse business conditions would further result in a compounding of the estate liquidity problem in a failing market by such disqualification under the redemption section even while the Code and Congress acknowledge the interest to be large and closely held under another Code Section regarding the time for payment of the taxes.

Small businessmen and farmers need to have the benefit of at least their prior status even if you are not really helping them now. Therefore, all 306 taint should be cured on death in closely held businesses, and we need you to say so. Redemption without dividend treatment should be permitted on all taxes imposed because of death and consequent redemption including all state and federal income taxes resulting therefrom, and it should be made clear that all accumulations for these purposes are exempted from unreasonable accumulations tax. The ratios should be returned to the former § 303 requirements of 35 percent of the gross estate or 50 percent of the taxable estate.

B. False impression of New Relief

Most of the so-called relief for farmers and small businessmen under TRA '76 is illusory. There are many reasons but the naive Treasury attitude toward farmers and farming may be responsible. Very few farmers in my area are living and farming today who started in the last twenty years, and have bought all their own land, equipment, livestock, and supplied their own working capital and are now making a living. Gifts, death transfers, bargain purchases or growing up in the business have been the primary ways such farms have been established. Farming today is a low profit, high volume, capital intensive business. A typical 200-acre farm in my area now will cost for land $200,000 to $350,000 and require extensive additional investment otherwise. Financing is a continuous process. No farmer starting out, nor any heir, of even the oldest and most skilled farming family will get by without financing.

TRA '76 was built by theoreticians in an "other world" concept without adequate comprehension of real world problems.

(1) A 15-year payment period for taxes will not really benefit farmers much. No lender will advance funds to an heir without this tax being paid, and virtually no farming operations with which I am familiar have gone 15 years without refinancing. This provision without the ability to refinance the tax lien will not help a great deal in the practical world.[19]

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[17] See Tax Reform Act of 1976 (TRA), Public Law 94-455, § 2004(e) which amended I.R.C. § 303(b).

[18] I.R.C. § 6166A. Section 6166A was amended by the TRA but the old percentage requirements were not changed.

[19] IRS News Release 1823, June 2, 1977 purports to provide some relief for this problem. However, banks and other lenders may not rely on a news release when they would rely on a statute.

(2) The problem of a minor beneficiary, without the legal capacity to consent, and the duty of the Executor to get approval and file necessary elections for special use valuations is likewise a substantial impairment.[20] Elections will not be available in many cases where needed most.

(3) Elections even if available theoretically will be of limited use. The farm family most often has more than one child, and the children are to be treated equally. One child will normally have to buy out his brothers and sisters. Where the purchase is made from the estate under will provisions permitting such a purchase by one or more of the heirs, the qualification for deferred treatment may be jeopardized, and use valuation will be lost, since the property would neither be "acquired from" nor "pass from the decedent"[21] and the additional income tax and estate tax triggered.

The disqualification of leased lands may force older parents to dispose of the family farm since the lease, even to a family member does not appear to qualify. The test is the same as the self-employment income test. Therefore, the lease may lead to disqualification and the pressure to sell results. The loss of the independence of property ownership by the older generation is a questionable virtue. There is no discernible reason that a cash lease to a qualified heir ought not be adequate, but this treatment is not clear from the statute.[22] Nor that active farming of a Virginia farm, while leasing out a Georgia farm, while the Virginia farm is going through a 3-year rezoning and subdivision process for disposition, should lead to the disqualification of the Georgia real estate, particularly where a tax free exchange of a portion of such Virginia farmland acquired the Georgia property. This would be the result under present law.

(4) The existence of a valuation trap will militate against the use of special valuation. This trap is sprung if valuation of a farm results in election and later a disposition triggers a recapture of tax. In Loudoun, Fairfax and Prince William Counties of Virginia, and certainly elsewhere, this unintended disposition has been caused by fantastic property tax increases to the point that farms are made uneconomic. The triggering by disposition apparently results in a recapture of estate tax, a loss of special valuation, and a capital gains tax but without any stepup in basis that would otherwise occur if the higher valuation was used originally.

(5) The bill pretended to cure "unwarranted discrimination" against those who sell before death as opposed to those who sell after death. TRA '76, by the carryover basis, was intended to remove the substantial "lock-in effect." HCR 8/2/76, p. 36 and 37. With adverse results of a poor selection of assets for gifts, the gamble involved in changing stock ratios or improving liquidity so far as both deferred tax payout provisions are concerned (6166 and 6166A) and for redemption purposes (303) the exact reverse is the result. There is absolutely no incentive for transfer by sale or gift unless there is a lead pipe cinch substantial increase in asset value available.

Gifts have dried up in my practice since January 1, 1977—a far cry from the facilitation of transfers promised. It was a hoax, pure and simple.

C. The vitiation of reasonable commercial arrangements

Buy-sell agreements were converted by the TRA '76 into significant tax traps for the unwary. The Act left reasonable businessmen with a hopeless dilemma on death.

(1) Execution of a buy-sell agreement now carries not just estate tax but income tax consequences. The estate must either accept substantial tax penalty for short-term payout, or continue financing by long-term payout a closely held business no longer under the control of the executor or heirs. Long payouts in closely held businesses seldom make sense. Crippling taxes in the short term are the result.

(2) Insurance Buyouts for such businesses are also suspect because the decedent's estate may not be able to afford the sale. Certainly the insurance held in the entity will cause a problem if less than total redemption occurs since the limited usefulness of the capital gains redemption[23] and the danger of attribution will always be present in family buyout situations. The problem will exacerbate in the future when inflation against a relatively fixed tax table (Estate, Gift and Income) makes the tax result on the business an ever-increasing multiple grab by the Internal Revenue Service.

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[20] I.R.C. § 2032(d)(2) requires consent of "all persons in being" having any interest in the special valuation property.

[21] I.R.C. § 2032A(c)(2) and perhaps 6166(g)(1)(D).

[22] I.R.C. § 2032A(b).

[23] I.R.C. § 303.

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(3) Entity buyouts, which are clearly the most convenient in many cases, will be severely restricted. This will occur not only because of the reticence of the decedent's estate to sell for the reasons already given, but also because no basis adjustment results from the buyout on the subsequent death of the survivor. The individual will be forced to consider, for income tax reasons alone, the holding of insurance at the individual level to fund the buyout. Despite its adverse income tax result to the shareholder, he will do so simply to retain the family business. Therefore, heirs wishing to retain a family business will do so because of family and emotional reasons, and despite the serious tax trap involved. They will, in effect, incur tax penalties by keeping the business rather than selling to outsiders. I sincerely hope that Congress did not intend this result.

(4) As in the situation with preferred stock, many farmers and small businessmen entered buy-sell agreements long before TRA '76. In many cases, the income tax results of these longstanding agreements may be extremely harsh. As indicated by example,[24] it is possible for the income tax resulting from a buy-sell agreement in an estate totaling $120,000 to exceed the estate tax on a prior law estate of $393,000 and a current law estate of $469,000.

I hasten to point out that because the current business situations under some of these old buy-sell agreements may be far different from the situations existing at the time they were executed; it may be impossible for the parties to agree to a change in the agreement. Even if the agreement can be changed, one party may now have great bargaining advantages he did not have at the time of the agreement.

D. Removal of certainty in estate planning transactions

(1) I am not competent to advise clients on the transfer or preservation of their farms and closely held businesses. This lack of competence is not due to my own lack of knowledge or experience, but is due to the manner in which the uncertainties of the future will affect the estate of a farmer or small businessman.

(*a*) Slight variations in the values of the individual assets of an estate can greatly affect the tax elections made by the estate. As previously explained, this problem is very serious after the death of the individual. Now, imagine what difficulties are involved when you are not contending with just the possibility of an agent's valuation adjustment but with an estimate of future values. Without knowing even the date of death, much less the future economic fluctuations over an unknown period, the fact is that these estimates of values cannot be made. Without these estimates, the success or failure of my advice to clients becomes a random event. A coin toss may well be as accurate.

(*b*) To begin any disposition program is very dangerous because of the percentage requirements. The question is: should the farm or small business assets be disposed of or should other assets be disposed of? If you dispose of the farm or small business assets, the benefits, such as they are, of capital gains redemptions,[25] and, worse, the benefits of the special valuation[26] and installment payment provisions[27] may be lost. If you keep the farm or small business assets, these percentage requirements will be met, but the clinet will not have sufficient liquidity to live in his old age, much less to pay taxes. If farm or small business assets and other assets are disposed of pro rata, the individual will probably lose his liquidity and is still likely not to qualify for the benefit provisions.

After these considerations are explained to the client, if they can be explained at all, the client is most likely to make absolutely no lifetime transfers. TRA '76 was intended to have exactly the opposite effect. I submit that the "lock in" effect of uncertainty is far more serious than the 'lock in" effect of the old law and is far more unfair. What can possibly be more unfair than making a

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[24] For example, assume two brothers formed a purely service partnership with a zero basis on January 1, 1972 and concurrently executed an insurance funded buy-sell agreement to buy out the other at fair market value as of the date of death. Assume the first brother dies on December 31, 1981 with his partnership interest being worth, for estate tax and buy-sell purposes, $120,000. Under current law there would clearly be no Federal estate tax payable. But, assuming the decedent's basis remained zero at his death, his estate would receive a step up of 60,000 in basis (one-half the appreciation based upon the date of acquisition and death), and his estate would have a capital gains tax of $11,150, and a minimum tax of $3,000, a total of $14,150 in Federal tax. By comparison, assuming maximum marital deduction under prior law an adjusted gross estate of $393,000 and under current law as of 1981 an adjusted gross estate of $469,000 would both have paid less estate tax.

[25] I.R.C. § 303.

[26] I.R.C. § 2032A.

[27] I.R.C. § 6166 and § 6166A.

farmer or small businessman sit on a fence for the rest of his life simply because he cannot decide upon which side to get down!

(c) Similarly, any attempt to diversify investments for balance or liquidity would be fatal to a family plan. Of course, not to do so can be equally as fatal because farming and small business both involve great economic risks. If an estate is balanced and diversified, the provisions intended to provide relief will not be available. If it is not diversified and balanced, even a short period of business decline or economic downturn can have disasterous effects on the individual.

There they are again, the farmer and small businessman sitting together on that fence!

(2) Even if the farmer or small businessman is able to decide to implement a gift or other lifetime transfer program, he must then gamble on the selection of assets for such a program. He does not dare to give away an asset which might decline in value because, if he does so in a taxable gift, the previously high value will, in effect, be included in his taxable estate because of the gross up provisions. Of course, the donee's basis would not be adjusted for any post '76 appreciation since it is a lifetime transfer. A gift of property which increases in value is taxed at its lower value, but, again, at the cost of lower basis in the hands of the donee. But, the non-tax effects of giving appreciating property are far more important.

If an individual gives away all of his appreciating assets, he will be left with only depreciating asset until they are fully depreciated. Then he will have nothing. It is small consolation indeed that he also has no estate tax problems.

Which side should I tell my clients to get down? What I feel I must tell clients is to keep depreciating asset and transfer only a small portion of their appreciating assets. Again, a substantial "lock in" effect is the result.

(3) Even if a plan can be developed from the estate and gift tax point of view, then income tax and, therefore, basis must be considered.

Basis may only be "considered." It cannot possibly be determined because of a myraid of adjustments, all of which can be determined only after death.

To properly consider basis, the date of death must be first estimated, usually by way of several hypothetical dates of death. Then the effects of inflation or deflation or both must be estimated. The best economists in the world cannot do this well, much less the farmer or small businessman or their estate advisors.

This process is cumbersome, very expensive and imprecise. By way of example, suppose you hypothesize dates of death, five, ten and 15 years in the future (for a 60-year-old man, you should probably add 20 and 25 years), and inflation rates of six percent, eight percent and ten percent (the addition of four percent and twelve percent would not be unwarranted). Then you hypothesize gifts of (1) farm or small business assets, of (2) other assets, and (3) of a combination. If you stop hypothesizing right here, you must work 27 examples. If you add the possibility of the wife not surviving, you now have 54 examples. Consideration of gifts of appreciating property, depreciating property, or both requires 162 examples. If you then think about 303 redemption or no 303 redemption (324 examples), special or regular valuation (648 examples), and deferred or non-deferred tax payment (1,296 examples), any further consideration becomes totally academic because the bill for the estate planning will be a significant portion of the estate.

The point is that unless you can do estate planning with a substantial degree of certainty, it is the work of soothsayers, not rational men.

The transition from logical thought to fortune telling has occurred. The ordinary taxpayer can accept the fact that he cannot understand the tax law in general, but I doubt that he will long accept the fact that he cannot understand the tax law as it relates to him and his family.

(4) I realize that to this point I have been addressing planning problems and that, necessarily, planning must involve some uncertainty. However, the uncertainty is not gone even when the farmer or small businessman dies.

The executor or administrator of the farmer's or small businessman's estate will be faced with an unprecedented number of elections and choices to make respecting both estate and gift and income taxation. Some elections may preclude the making of other elections, some may, not with the result that the personal representatives will be faced with permutations and combinations of elections in a magnitude of possibilities which boggle the mind.

Furthermore, the valuations reported in the estate tax return and upon which the personal representative bases his elections will be subject to change upon

examination of the estate tax return by the Internal Revenue Service. In many cases, such a change will either disqualify an election or render it less advantageous. In order to protect against such changes, the personal representative will need to file a large number of protective claims for refund, protective claims for election, and amendments, all of which will be prospective in nature.

The problems of carryover basis will be the most difficult. Carryover basis can never be determined until the final estate, inheritance and succession taxes are determined, but the time for making such elections usually expires with the time for filing of the estate tax return.

The personal representative's determination of basis is not subject to a statute of limitations until the property is sold, perhaps a time well into the 21st century.

At the other end of the spectrum, if the property is sold immediately after death, it is possible that the reporting of the sale will be required, and the statute of limitations on the sale will have run before the basis can finally be determined.

The hardship which can result is that if after the statute of limitations has expired on the income tax return the estate tax is adjused upward, not only will the additional estate tax be payable, but also, an otherwise proper income tax refund resulting from increased basis on account of increased estate taxes will be denied by the statute of limitations.

IV. RECOMMENDATIONS

(*a*) Do away with carryover basis and most of the problems are solved.

(1) 306 stock is again eligible under 303. Closely held stock and farm land again can be sold in an amount necessary to pay the tax.

(2) You get what you pay for in the reevaluation of closely held stock and farm land.

(3) Special valuation elections make you pay the penalty later in income tax.

(4) The entity purchase financing problem is alleviated because the insurance value is reflected in the stepped up stock value.

(*b*) If you cannot do that, then at least:

(1) Cure the 306 taint on death for closely held business. And clearly say so.

(2) Permit 303 redemption for all taxes, including state and federal income taxes.

(*c*) Reduce 303 redemption percentages tests to the old 35 percent of gross estate and 50 percent of taxable estate. It worked. It could be understood.

(*d*) Permit refinancing under tax liens.

(*e*) Permit altered elections on disqualification of special use valuations and allow basis adjustments therefor.

(*f*) Consider special treatment for lump sum buy-sell agreements settlement, perhaps by ten-year averaging or other lump sum relief provisions.

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CARRYOVER BASIS: OPENING PANDORA'S BOX

(By Byrle M. Abbin*)

History in replete with instances where the "last item affecting a major compromise" has become more significant than all of the issues originally considered. As radical as such changes as unification of the transfer tax system, the increase of the marital deduction, and the taxation of certain generation-skipping transfers now appear, it is very possible, in time, that the carryover basis provisions of the 1976 Tax Reform Act will prove to have the most far-reaching impact upon the taxpayer.

Agitation for estate and gift tax reform has been around for several years. In 1969, the Treasury Department joined the reform "band-wagon" by issuing a lengthy study of the estate and gift tax law, together with recommended changes.[1] Most of the changes approved by Congress in the 1976 Tax Reform Act were forecast in this report. Among these recommendations was a change in the

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[1] Tax Reform Studies and Proposals presented December 1968, published February 5, 1969, jointly by Committee on Ways and Means and Committee on Finance of the U.S. Senate. For an excellent summary and bibliography background to the 1969 TRA, see "Background Materials in Federal Estate and Gift Taxation" published March 8, 1976, by Committee on Ways and Means.

law which had accorded a "tax-free" step-up in basis to certain assets included in the gross estate of a decedent.

The "tax-free" step-up basis has been consistently presented by many reform-minded commentators as one of the *major* tax loopholes in the Internal Revenue Code. It afforded a taxpayer a means of avoiding the payment of income tax upon the unrealized appreciation inherent in an asset by simply holding it until death. The arguments for and against the basis step-up have been chronicled in many articles and position papers.[2]

Essentially, the attack upon the basis step-up normally rested upon two arguments, both of which were ultimately cited in the various Committee Reports issued in conjunction with the 1976 Tax Reform Act. First, it was contended that it discriminated against those who sold appreciated property during their lifetime, and were thereby forced to build their estate with aftertax proceeds, and favored those who chose to retain their assets until death. Second, it was found to create a "lock-in" effect that induced individuals, who might otherwise dispose of appreciated property, to defer disposition until death.

In recognition of the probability of change, the American Banker's Association proposed an alternative entitled, "The Additional Estate Tax" (AET).[3] This "alternative" represented a flat rate capital gain tax upon unrealized appreciation which was camouflaged and collected as an estate tax.

THE COMPROMISE

The give and take of the legislative process, including strong pressures for relief to farmers and small businessmen from "excessive" transfer costs and liquidity problems, resulted in an increased marital deduction (i.e., for estates of up to $500,000 and for the first $100,000 of gifts), a unified credit in lieu of the prior gift and estate exemptions, and a special use valuation for real estate. However, the benefits associated with these measures would have been severly reduced, or eliminated by a provision requiring the immediate income taxation of the appreciation in a decedent's assets at death. Thus, a last minute compromise was effected, resulting in a carryover basis subject to modification for December 31, 1976 value.[4] Two ostensibly palatable aspects flowed from this: (1) delay of taxation until a transaction of sale or exchange, and (2) minimization of the impact of the change for some time as a result of a December 31, 1976 "fresh-start" valuation date.

Stated simply, the 1976 Tax Reform Act under Act Section 2005, which adds Section 1023 to the Internal Revenue Code, provides that with certain modifications, a decedent's predeath Federal income tax basis now will carryover to his estate and ultimately the beneficiary thereof, irrespective of the value of the property actually reflected in his Federal estate tax return. It is significant to realize that this change affects only the income tax portion of the Internal Revenue Code (Subtitle A, Chapter 1, Subchapter 0). It is affected by, and determined with reference to, Chapters 11 and 12 under Subtitle B comprising estate and gift taxes, but does not create an estate or gift tax liability. Thus, the carryover basis provisions have application only to the recipient of the transferred property, and irrespective whether or not the estate is subject to a transfer tax.[5] A complementary carryover basis provision affects lifetime gift transfers; however, the mechanics differ somewhat in application.[6] In either event, the transferor's holding period will carryover and tack on the transferee's holding period.

"Carryover Basis Property" is defined to be any property acquired from or passed from a decedent and which is not specifically excluded by the new pro-

[2] Covey, "Possible Changes in the Basis Rule for Property Transferred by Gift or af Death," 50 Taxes 831 (1972); Covey, Surrey, and Westfall, "Perspectives on Suggested Revisions in Federal Estate and Gift Taxation," 112 Trusts & Estates 102 (1973); Somers, "The Case for a Capital Gains Tax at Death," 52 American Bar Association Journal 346 (1966); Wormser, "The Case Against a Capital Gains Tax at Death," 51 American Bar Association Journal 851 (1965).

[3] Commentary on Proposed Tax Reform Affecting Estates and Trusts, The American Bankers Association 1973, Appendix A, Section 2, included in background material footnote 1. Supra, at pages 381, 437, 482.

[4] Sec. 1023(h).

[5] Sec. 1023(a).

[6] Sec. 1015(d)(6).

visions.[7] These exclusions from the application of the new carryover basis property rules include: (1) income in respect of a decedent; (2) life insurance proceeds; (3) certain joint and survivor annuities and payments received under certain deferred compensation plans; (4) property included in an estate but which has been disposed of by the transferee prior to the donor's death in a transaction where gain was realized; (5) stock or stock options to the extent income is includible in gross income; and (6) property relating to foreign personal holding companies.[8] Additionally, household goods and personal effects may excluded from this characterization if the executor elects, up to a limitation of $10,000.[9]

Property acquired from a decedent is defined in a broad, all-encompassing context, including revocable transfers, property passing as a result of an exercise in a decedent's will of a general power of appointment, a surviving spouse's interest in community property, obviously property acquired by bequest, devise, or inheritance and any property acquired from a decedent by any means if estate tax is imposed on such transfer.[10]

FOUR ADJUSTMENTS TO CARRYOVER BASIS

The adjustments to a decedent's basis are four in total, two of which are primary. These are amounts which may add to the decedent's basis for use in determining gain or loss upon sale by a transferee and for purposes of computing depreciation, depletion, or amortization.[11] The two primary adjustments are (1) a "fresh-start" adjustment to the December 31, 1976 fair market value[12] and (2) an adjustment for death taxes comprising both Federal estate tax and state death taxes (estate or inheritance), attributable to post-1976 appreciation.[13] Additionally, to the extent applicable, an aggregate minimum basis adjustment of $60,000 is provided,[14] and lastly, basis can be increased to the extent of death taxes attributable to post-1976 appreciation paid by the transferee (recipient) of the property.[15]

These adjustments are to be made in the order set forth above, i.e., beginning with the December 31, 1976, fresh-start and progressing through to the addition for death taxes paid by the transferee of the property.[16] As these adjustments are made, except for the "fresh-start" adjustment, they may not accumulate (i.e., increase) the basis above fair market value of the property[17] on the date of death or the alternative valuation date if that is elected. This upward limitation also includes a special use valuation for certain farm and business real property where the election to reduce the value from its highest use to special use has been recognized in filing the estate tax return.[18]

FRESH-START

"Fresh-Start" Adjustment.—As noted above, the December 31, 1976 "fresh-start" adjustment was a compromise thrown in at the last minute in order to obtain passage of the estate and gift tax reform, avoid immediate taxation of appreciation as a capital gain at death and yet utilize the carryover method in a manner amenable to the more conservative elements of Congress. The rationale is that in order to accord the estate and beneficiaries of all decedents dying after December 31, 1976, a transitional approach into the carryover basis, a "fresh start," providing a step-up in basis for purposes of determining gain only, is available for all assets which a decedent is treated for estate tax purposes as holding on December 31, 1976. Under this "fresh-start" provision, the stepped-up basis of qualifying property will be the higher of (1) the decedent's adjusted cost

[7] Sec. 1023(b)(1).
[8] Sec. 1023(b)(2).
[9] Sec. 1023(b)(3).
[10] Sec. 1023(f)(1); Sec. 1014(b); Since the surviving spouse's share of community property is considered to be acquired from a decedent, it would appear that consistent with marital deduction transfers, the "fresh start" and $60,000 minimum basis adjustments (but not the death tax add-on) would apply.
[11] Sec. 1023(a)(1); Sec. 167(g).
[12] Sec. 1023(h).
[13] Sec. 1023(c).
[14] Sec. 1023(d).
[15] Sec. 1023(e).
[16] Sec. 1023 (c), (h), (d), (e).
[17] Sec. 1023(f)(1).
[18] Sec. 1023(g)(1); Sec. 2032A.

basis or (2) the fair market value of such property on December 31, 1976.[19] In other words, the "fresh-start" adjustment increases the tax basis under the second alternative from the decedent's cost basis to the fair market value on the "fresh-start" valuation date. It is important to note that the adjustment for December 31, 1976 "fresh-sart" value is applicable only for the purpose of determining gain.[20] If the original cost basis in the hands of the decedent is higher, that basis carries over under the new provisions for purposes of boh determining gain and loss. This distinction can be better understood through the example in Exhibit 1. As will be discussed below, one ambiguity in the 1976 Tax Reform Act involves the computation to determine the amount of the death tax add-on when the "fresh-start" valuation is involved, since basis for purposes of determining gain only is affected by December 31, 1976 value.

Property acquired on or after January 1, 1977 will have a basis of cost even if this exceeds the date of death value. Cost basis will be increased by the amount of the death tax add-on, only if the total does not exceed fair market value at date of death.[21]

EXHIBIT I

	A	B	C
1. FMV—date death	$300,000	$300,000	$300,000
2. FMV—Dec. 31, 1976	400,000	400,000	200,000
3. Cost basis	100,000	500,000	100,000
4. Death tax add-on [1]	50,000		[1] 30,000/ 50,000
5. Basis:			
Sale at gain	400,000	500,000	230,000
Sale at loss	150,000	500,000	159,000

[1] Death tax on appreciation element should differ when determining basis for gain and loss since fresh-start value is utilized only in determining basis for gain; thus, the appreciation element is greater in determining basis for loss computation, resulting in a greater death tax add-on.

EXHIBIT II

Facts

Assume a decedent acquires unimproved investment real estate on June 30, 1970, at a cost of $175,000. If, upon his death on May 31, 1979, the real estate had a Federal estate tax value of $925,000, the December 31, 1976, basis adjustment would be computed as follows:

Step One: Ascertain total appreciation occurring over period during which decedent held property:

Federal estate tax value	$925,000
Adjusted cost basis of property	(175,000)
Total appreciation	750,000

Step Two: Determine number of days decedent held property prior to January 1, 1977, and total days held:

June 30, 1970 through December 31, 1976	2,376
June 30, 1970 through May 31, 1979	3,257

Step Three: Compute ratio; 2,376 days divided by 3,257 days equal 0.7295.

Step Four: Apply ratio to total appreciation; $750,000 by .7295 — $547,125

Step Five: Determine adjusted basis:

Decedent's adjusted cost basis	$175,000
December 31, 19776 adjustment	547,125
"Fresh-start" basis (before death tax add-on)	722,125

Further, the "fresh-start" basis would be $722,125 even though decedent had appraisals (or more concretely, a firm purchase offer for $1,250,000) indicating that the properties December 31, 1976, fair market value was $1,250,000.

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[19] Sec. 1023(h); Sec. 1023(a)(1); Fair market value limitation applies only to Sec. 1023 (c), (d) and (e); Sec. 1023(f)(1). Committee Reports to the contrary have been acknowledged to be in error.

[20] Sec. 1023(h)(1) . . . "then for purposes of determining gain."

[21] Sec. 1023(f)(1).

The method of determining the "fresh-start" fair market value at December 31, 1976 depends on the nature of the particular assets. A different approach is involved for marketable bonds and securities and all other property.[22]

MARKETABLE SECURITIES

The normal methods previously employed for the valuation of listed securities for Federal estate and gift tax purposes are to be used to ascertain the valuation of any security held by decedent on December 31, 1976, for which there was on such date a market on a stock exchange, in an over-the-counter market or "otherwise." [23] Based on the Conference report,[24] the definition of market would not seem to be restricted just to listed securities on a demonstrable market, but seems broader to include "securities for which market quotations are readily available" and "common trust fund units." As will be discussed below under problem areas, undoubtedly this definitional problem will become a major area for contention because of the differing interpretations espoused by the drafters and that which probably will be set forth in regulations and the taxpayers' broader viewpoint of what that term means.

It should be noted that the "fresh-start" valuation rule applies only to asset that have passed through an estate.[25] Thus, if assets held on December 31, 1976, are the subject of a lifetime gift transfer before a decedent dies, the donee does not get a "fresh-start" step-up and his gain or loss will be based on the gift tax carryover rules. However, if such donee holds the assets to his death, the "fresh-start" basis adjustment will be applicable. On the other hand, marketable securities owned on the "fresh-start" valuation date do not have to be included in the decedent's estate directly so long as the property in his estate actually reflects the basis thereof, i.e., a substituted basis resulting from a tax-free stock exchange.[26] It is evident that under extreme circumstances reference may be required to be made to the December 31, 1976 values many years after the commencement of the 21st century.

Mandatory daily basis Formula.—For all property other than marketable bonds and securities discussed above, a *mandatory* formula valuation approach is provided in order to avoid the necessity of obtaining appraisals for such property held on December 31, 1976. [27]

Under this formula the amount of appreciation occurring prior to December 31, 1976, for which a step-up in basis is granted, is calculated by multiplying the total amount of appreciation occurring over the entiire period during which a decedent is treated as holding the property by a ratio. This ratio is determined by dividing the number of days that the property has been held by decedent before January 1, 1977, by the total number of days that he (she) held the property. For an example of the computational steps required, refer to Exhibit II.

The principal assumption underlying the special valuation method is that appreciation occurs with reference to the property at a constant rate over the entire holding period. It is evident that this formula may result in substantial inequities. For example, if expert appraisals from a number of reputable appraisers indicated that as of December 31, 1976, the fair market value of real estate was $500,000 dollars, and that at the time of death in 1979 depressed market condtions resulted in a reduced valuation of $350,000 dollars, the "special valuation method" still would require a basis calculation such as that delineated above. Thus, the tax basis of the real estate carried over to the transferee would be limited to a percentage of $350,000 dollars in spite of the availability of experts' appraisals reflecting an amount substantially higher. On the other hand, if, under the facts above, the property consisted of shares in listed companies, the "fresh-start" basis would have been at the higher amount of $500,000 dollars. It should be evident, however, that the correlative also is true. The inequity may be in favor of the taxpayer and his transferee as well as contrary

[22] Sec. 1023(h) (1) and (2).

[23] Sec. 1023(h)(2)(E)(i).

[24] "Marketable bonds or securities are . . . securities locally traded for which quotations can readily be obtained from established brokerage firms; and units in a common trust fund."

[25] "If the adjusted basis immediately before the death of the decedent . . ." Sec. 1023(h); Heading of Sec. 1023: Carryover basis for certain property acquired from a decedent dying after 12/31/76."

[26] Sec. 1023(h)(1). If the adjusted basis . . . of any property . . . reflect the adjusted basis of any marketable bond or security on December 31, 1976 . . ."

[27] Sec. 1023(h)(2)(A).

to the best interests of the Treasury, if the asset being valued under the formula had a depressed value on December 31, 1976, and substantial growth occurred after January 1, 1977.

Undoubtedly, the main area for contention between the use of the market value approach and the mandatory formula approach for determining December 31, 1976, value will involve buy-sell agreements. Often, buy-sell agreements set a valuation in terms of book value. Disregarding the propriety of using this approach, if it is assumed that on December 31, 1976, the book value of a company was $800,000 and $1,000,000 in 1985, when the decedent died and the company repurchased its shares, under a narrow interpretation the mandatory special valuation method calculation will be required since the corporation stock was not listed on an ascertainable market.[28] Even though the market value of the shares of decedent was fixed and determinable as of December 31, 1976, the book value formula would be ignored. Thus, while most of the appreciation occurred prior to 1976, the Tax Reform Act mandatory formula requires the arbitrary assumption that the appreciation occurred at an even rate over an entire holding period. In this situation, a result occurs that both is economically untrue and inequitable.

As another complicating factor, a substantial improvement to property is to be treated as an acquisition of separate property.[29] As a result, the determination of the December 31, 1976 basis-adjustment for one property entity may involve a number of separate formula calculations whenever substantial improvements have been made. It will remain for the regulations to amplify upon what is meant by a substantial improvement to property.

Depreciable/depletable property.—For depreciable or depletable property, the same mandatory formula described above applies. However, this formula is amplified by subtracting from Federal estate tax value of the property the amount of depreciation, amortization or depletion claimed for the entire period the property has been held by the decedent.[30] The net difference between the adjusted Federal estate tax value and the decedent's carryover basis is subject to the daily basis fraction. To the amount deemed as occurring prior to January 1, 1977, is added the amount of depreciation, amortization or depletion claimed prior to December 31, 1976. The result is to exclude from the "fresh-start" adjustment depletion, depreciation or amortization claimed subsequent to December 31, 1976. To follow the mechanics of this computation, refer to Exhibit III.

DEATH TAX "ADD-ON" (2)

The second major adjustment to the decedent's basis is the "death tax add-on."[31] This limited step-up in basis is provided to the extent of Federal and state death taxes allocable to the unrealized appreciation element only (the excess of fair market value at the date of death over cost basis, or if applicable, the excess over the "fresh-start" adjustment). As noted above, the death tax add-on is considered after the "fresh-start" adjustment, if any, is made. The amount is computed based on the ratio that the appreciation element is to the total fair market value subject to the estate tax. This calculation is made on an individual asset-by-asset basis and there is no netting of appreciated and depreciated assets to determine the unrealized appreciation for the estate as a whole.[32]

EXHIBIT III

Facts

If decedent's real property in Exhibit II was used in a trade or business and, therefore, subject to depreciation, the "fresh-start" valuation adjustment calculation is a modification of the basic approach. It is assumed for purposes of the example that the original cost of the asset was $175,000; that its adjusted cost basis at decedent's date of death, May 31, 1979, was $50,000 (original cost, less $125,000 depreciation claimed); and that its adjusted cost basis at December 31, 1976, was $100,000 (i.e., $175,000, less depreciation claimed $75,000). The adjust-

[28] Sec. 1028(h)(2)(E).
[29] Sec. 1028(h)(2)(D).
[30] Sec. 1023(h)(2)(B)(i) and (ii).
[31] Sec. 1028(c).
[32] Id: ". . . the adjustment is limited to the portion of the Federal Estate and State Estate taxes that is attributable to the appreciation . . . that portion for each individual carryover basis asset is determined . . ."

ments to basis are solely attributable to depreciation and the Federal estate tax value of the property was $925,000.

Adjust the Federal estate tax value of realty for total depreciation taken by decedent between date of acquisition and date of death:	
Federal estate tax value	$925,000
Less total depreciation taken by decedent ($175,000—$50,000)	125,000
Federal estate tax value, as adjusted	800,000
Determine the amount of appreciation inherent in asset values, as adjusted:	
Federal estate tax value, as adjusted	800,000
Adjusted cost basis	50,000
Total appreciation	750,000
Determine number of days decedent held property prior to January 1, 1977, and total days held:	
June 30, 1970, through Dec. 31, 1976	2,376
June 30, 1970, through May 31, 1979	3,257
Compute ratio: 2,376 days divided by 3,257 days	0.7295
Apply ratio to total appreciation: $750,000 times $0.7295	$547,125
Determine amount of "fresh-start" basis:	
Decedent's adjusted cost basis[1]	$50,000
Depreciation through Dec. 31, 1976	75,000
"Fresh-start" adjustment for appreciation through Dec. 31, 1976	547,125
"Fresh-start" basis (before tax add-on)	672,125
"Fresh-start" basis of property not subject to depreciation	722,125
"Fresh-start" basis under above example	672,125
Difference—i.e., amount of depreciation taken by decedent between Dec. 31, 1976, and date of death	50,000

No basis adjustment was accorded for the $50,000 depreciation taken by decedent after Dec. 31, 1976. This can be demonstrated by comparing the "fresh-start" basis of the unimproved realty computed above.

No basis adjustment is to be made with reference to property for which a charitable or marital deduction is allowed (or the surviving spouse's share of community property), since these transfers are considered not subject to estate tax.[33] This computation is exemplified in Exhibit IV. The amount of the adjustment, under this computation, is determined with reference to the average applicable death tax rate. Thus, each asset is accorded equality of treatment without requiring a decision as to the first and last asset on a stacking approach.

Minimum $60,000 basis.—The third adjustment to the decedent's basis is the "$60,000 minimum basis."[34] If the $60,000 exceeds the aggregate basis of all carryover property after both the "fresh-start" and death tax add-on adjustments have been made, then the basis of such appreciated carryover basis property will be increased by this difference up to $60,000. Again this adjustment is required to be apportioned to all appreciated carryover basis property on an asset-by-asset basis.

Succession taxes paid by transferee.—The fourth and last adjustment which is to be made only after the other three have been made in consecutive order, is that for certain state succession taxes paid by a transferee of property.[35] Thus, a tranferee receiving appreciated carryover basis property will be entitled to increase the basis of such property for the state succession taxes attributable to post-1976 appreciation. In order to qualify, the transferee must receive property from a decedent and pay death taxes with respect to such property for which the estate is not liable.

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[33] Id.
[34] Sec. 1023(d).
[35] Sec. 1023(e).

Reconstructing unknown basis.—For those many situations likely to exist where decedent's basis is unknown, it is considered to be fair market value on date of acquisition by the decedent assuming decedent pair fair market value.[36] If the decedent was not the acquiring party, basis will reflect that of the last preceding holder whose basis was determined in a taxable acquisition.[37] Thus, it is impartive to obtain all information with respect to acquisition date and acquisition cost basis of all property held on December 31, 1976. Failing exact information, reconstructions with as close approximations as possible would appear to be a necessary act for all property owners.

EXHIBIT IV

Assume that decedent's total estate subject to tax was $6,150,000, and that US and State death taxes totaling $3,533,800 were paid on the asset in Exhibit II.

The amount of tax add-on adjustment based on the prior example is calculated in the following manner:

Determine basis of property:

Decedent's cost basis	$175,000
"Fresh-start" basis adjustment	547,125
Adjusted basis	722,125

Ascertain total appreciation subject to add-on adjustment:

Federal estate tax value	925,000
Less: adjusted basis	(722,125)
Net appreciation subject to add-on	202,875
Calculate amount of add-on: $202,875 (net appreciation) over $6,150,000 (total estate subject to tax) divided by $3,533,800	116,573

Determine basis of the real estate:

Decedent's basis	175,000
"Fresh-start" basis adjustment	547,125
Tax add-on adjustment	116,573
Total basis	838,698

As noted above, the "fresh-start" adjustment is relevant for determining taxable gain only. The decedent's carryover basis, plus the tax add-on adjustment, however, are relevant for determining both the taxable gain *or loss* from a sale or exchange. Thus, a taxable gain would be recognized from a sale of the real estate at a price *in excess of* $838,698, while a taxable loss would occur only as a result of a sale *at a price below* $605,951 (i.e., $175,000 (decedent's carryover basis) plus $430,951 (tax add-on adjustment)). $750,000 over $6,150,000 divided by $3,533,800.

Household goods exclusion.—A special exclusion is also provided for personal and household effects of the decedent to the extent that the fair market value does not exceed $10,000, if so elected by the executor.[38]

New basis rules for gifts.—Similar but not identical rules are provided to increase the carryover basis for US transfer tax (but not state gift tax) allocable to the appreciation element only of lifetime gift transfers.[39] This new rule substantially reduces the carryover basis for lifetime transfers, since under prior law the basis was increased by the entire amount of the gift tax incurred (limited so the adjustment could not provide a basis in excess of the assets' fair market value on date of transfer). Thus, there will now be complete parity in adjustment for lifetime and death transfers. In lifetime transfer situations, net appreciation is the excess of fair market value over the adjusted basis of the donor immediately preceding the gift.

PROBLEM AREAS

Problem areas.—Estate executors are now confronted with expanded duties. They must ascertain with reference to "carryover basis property."

The decedent's adjusted tax basis for all property includible in his estate,

[36] Sec. 1023(g)(3).
[37] Id.
[38] Sec. 1023(b)(3).
[39] Sec. 1015(d)(6).

The fair market value of all such property as of the date of death, the alternate valuation date, and in the case of listed securities, as of December 31, 1976, and

Compute, on an asset-by-asset basis, the amount of appreciation inherent in each asset.

Calculate the December 31, 1976 basis adjustment for all assets other than listed securities using the "Special Valuation Method." Modify the basis of such assets to reflect the tax add-on adjustment, considering the effect of revenue agent adjustments.

Keep estate beneficiaries informed as to the correct Federal income tax basis of property received from a decedent.[40]

Noncompliance Penalties.—Moreover, the executor must furnish the IRS with basis information as well as providing such information to each recipient of property from an estate. Failure to furnish required information may result in penalties of $100 for each failure to furnish to the IRS, the total of which cannot exceed $5,000; and $50 for each failure to furnish to each beneficiary, the total not to exceed $2,500.[41] It can be anticipated that the detailed duties of the executor, as a result of the carryover basis rules, will be most substantial, not to say frustrating.

DEFINING "MARKETABLE SECURITY"

What is a marketable security? The definition of marketable securities, especially those falling within the "or otherwise" category, is likely to engender a substantial amount of litigation. Mentioned above was the buy-sell agreement. Where the agreement covers a few shareholders or partners, it would appear likely that regulations will conclude that such agreements do not create a market. On the other hand, substantial organizations, such as brokerage and advertising firms, also use the buy-sell agreement extensively. In such larger firms, the company may, in essence, create a market by redeeming out retiring and/or deceased shareholders under a consistently applied formula approach. The number of transactions occurring annually under these circumstances may be substantial. It appears that this type of situation should qualify for more liberal treatment, reflected by the Conference report which seems to go beyond a demonstrable market.

Similarly, at the current time it is uncertain whether owners of interests in investment partnerships or personal holding companies, whose entire asset makeup consists of listed or marketable securities, can qualify for the "fresh-start" approach based on underlying asset value, rather than be required to use the arbitrary daily allocation approach. Clarification will have to await temporary or proposed regulations and, again, perhaps ultimately court action. It appears that listed securities held by trusts should not have the same problem and the typical valuation methods would be utilized for determining December 31, 1976 value.

UNCERTAINTY REGARDING NEGATIVE BASIS PROERTY CALCULATIONS

SECTION 306 DILEMMA

A very crucial problem arises with respect to the status of Section 306 stock under the new carryover basis rules. Under prior law, little concern was given to this stock, provided it would be held by the owner until death, since it was considered that death cleansed the Section 306 taint.[42] Actually, the taint was not removed by death, but because of a new stepped-up basis. Since the provisions of Section 306 will continue if the basis of the stock is "determined with reference to the decedent's basis,"[43] substantial concern exists that through the mechanics of the carryover basis rules, as now written, basis will be determined with reference to the decedent's basis since the "fresh-start" adjustment and the death tax add-on are merely additions to such decedent's basis. This being so, the Section 306 taint may continue indefinitely until one of the disqualifying transactions is effected, such as a complete termination of interest that avoids ordinary income treatment.

Although an argument can be made that at least to the extent of the "fresh-start" adjustment, the taint has been expunged, this approach does not carry

[40] All of Sec. 1023; see Footnote 41 infra.
[41] Sec. 6694 (a) and (b).
[42] Sec. 306; Regs. Sec. 1.306-3(g).
[43] Regs. Sec. 1.306-3(e).

certainty with it. Whether or not it was congressional intent to provide for conjectural, but it would appear a change in treatment could not be accomplished by regulations, but rather would have to be done, if at all, through amendatory legislation.

SECTION 303 REDEMPTION NOW CREATES CAPITAL GAIN

To the extent that Section 306 stock is redeemed under a qualifying Section 303 redemption in payment of estate taxes and administration expenses, the taint status is not overruled and the provisions of Section 303 will not control completely.[44] Additionally, it would appear that when a Section 303 redemption takes place, basis will be recognized to the extent of (1) carry-over, (2) the "fresh-start" adjustment, and (3) the death tax add-on. This will reduce the amount of taxable gain (usually ordinary income) upon effecting the redemption.

At the same time, it must be recognized that any Section 303 redemption effected on or after January 1, 1977, automatically may create capital gains tax. In fact, this will affect all buy-sell agreements whether they involve corporate redemptions or cross-purchase agreements. Thus, in obtaining funds to pay the death taxes, a capital gains tax will be incurred which *cannot* be funded through a further Section 303 redemption, since the provisions are limited solely to providing for death taxes and not to income taxes generated in order to fund the death taxes. As a result, additional consideration will have to be given to a required lump-sum redemption or buy-sell which will bunch the capital gains and preference tax resulting therefrom into one taxable period. Additionally, consideration will have to be given to an installment payout, so that the capital gains tax may be at the 25 percent rate or less if spread out over a sufficient period of time.

UNCERTAINTY REGARDING NEGATIVE BASIS PROPERTY CALCULATIONS

An especially acute problem, likely to be the source of substantial controversy, affects what typically has been termed "negative basis" assets. These ordinarily involve tax shelter type investments owned either in outright form or quite often as a general or limited partner. Because of leveraging (i.e., substantial mortgage or other borrowing), the property owner's tax basis is much higher than his direct, personal equity investment.[45] Because of accelerated depreciation and other operating expenses, including interest, usually deductions occur more quickly than does the mortgage amortization that builds up additional equity. As a result, after a short period of time, many of these investors (whether owning in outright form or as a partner group venture) have realized more tax deductions than their own direct equity investment. As a shorthand description, this is usually referred to as a "negative basis."[46]

For outright ownership, it is possible to make the December 31, 1976 mandatory formula calculation, although it is unclear what is the appropriate approach, inasmuch as it is necessary to deal both with positive and negative numbers. For partnership interests, the problem is more acute inasmuch as the tax basis not only reflects depreciation, amortization or depletion, but it also is affected by other operating expenses, including interest, that generate the loss which reduces the partner's basis to a negative status. The accounting problems of determining the amount of loss due to depreciation, amortization or depletion, as contrasted to other items, could prove to be most difficult, if not insurmountable.

Even under the simpler example of direct ownership, it is possible for at least four approaches to be used in determining the "fresh-start" basis as of December 31, 1976. One involves applying the daily ratio to the negative "appreciation element" and offsetting this negative number by the positive number derived from the add-back of pre-1977 depreciation. (The decedent's cost basis is considered to be zero.)

The other alternative positions regarding the carry-over basis of tax shelter investments are:

If the investment has a "negative" basis, the carryover basis should be zero, since basis cannot be more than nor less than zero.

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[44] Regs. Sec. 1.303-3(d) should be read in context of the balance of the paragraph; it primarily affects Section 306 stock created after death.

[45] *Crane*, 337 US 1 (1947); 47-1 USTC Para. 9217.

[46] Id; See Kanter, Real Estate Tax Shelters, 51 Taxes 770, at 865 (Dec. 1973); The Tax Reform Act of 1976, with the exception primarily of real estate, eliminates this situation unless the taxpayer is "at risk."

The carryover basis should be equal to the cash sales price adjusted by the applicable daily fraction.

A direct carryover of the negative basis to the transferee assuming that the daily ratio cannot be applied. This is the least desirable and the most strained interpretation with respect to assets acquired prior to 1977, but would appear to be the most likely approach applicable to assets acquired on or after January 1, 1977.

Flower bonds less desirable.—Based on a draftsmanship flaw, it would appear that deep discount or flower Treasury bonds acquired on one's death bed could result in short-term capital gain;[47] it is understood that this is a very likely item for amendment in the 1977 Technical Amendments Act. Even so, the utility of using these bonds, acquired at a discount for payment of death taxes at par, has substantially been diminished because of the inherent capital gains taxes now payable.

Obtain appraisals.—Should appraisals be obtained in spite of the unambiguous words of the Section 1023 and Committee reports to the contrary?[48] Many are reading the words or "otherwise" broadly; in addition, some are suggesting that this section is nonenforcible due to retroactivity or is unconstitutional for other reasons. Others suggest that this segment is so complex that it is likely to be amended and/or changed dramatically.[49] In any event, obtaining appraisals of assets that may or may not fall within the definition of a marketable security concept would not appear to be harmful. However, one must evaluate the additional cost and likely benefit.

Other problems.—One other problem area involves the qualification for the marketable security "fresh-start" valuation of stock subject to blockage valuation, restricted stock under SEC Rule 144, and items such as certain corporate and many municipal bonds for which quoted prices are not available. Qualification of these items for the market value approach will, of course, have to await clarification in regulations.

Lastly, during the period of administration, the tax basis of various assets floats or is suspended, since all factor necessary to make a basis determination will not be available with certainty until completion of the estate administration, including tax audits both by Federal and state authorities. Thus, any change in estate tax payable or the valuation of included assets will affect the basis step-up of every asset. As a result, protective refund claims and amended returns likely will become a common occurrence. The ultimate determination, too, is affected by the fact that property finally distributed to satisfy a marital trust, or a charitable distribution, does not really receive a step-up, but until this decision is made, it is impossible to know where the tax add-on and other adjustment factors will be taken into account in allocating basis.

Many planning aspects have become apparent to cope with the new carryover basis rules. First, with respect to lifetime gifts, it would be advisable to consider as a subject of gifts, property acquired on or after January 1, 1977, that is not affected by the "fresh-start" basis. When pre-1977 property is involved, it is well to consider high basis assets litle affected by the "fresh-start" approach and those that have substantial probability of appreciation.

Second, avoid where possible creation of Section 306 stock either from a preferred stock dividend or an inappropriately planned corporate reorganization. This especially should be the course of action until more liberal interpretation in regulations is obtained and/or an amendatory code provisions is enacted.

Third, give special consideration whether to elect the special use valuation afforded real estate used in farms and other businesses, inasmuch as the subsequent basis for sale is dependent, at least in part, upon this value, if the property is held beyond the 15-year special use recapture period.

Fourth, because of the carryover of recapture (Sections 1245 and 1250) status, consider a bequest of such property to low bracket heirs and devises. In fact, because of the uncertain nature of negative basis assets, perhaps the appropriate consideration should be the transfer of such type of assets to one's most unfavored family member or enemy! On the other hand, consideration should be given to providing for a disclaimer of such interest by one not desiring to step into the recapture and negative basis shoes of the transferor.

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[47] Sec. 1014(d); sec. 1223(11).

[48] Sec. 1023(h)(2).

[49] The Future of Tax Reform: A Talk with Expert Stanley Surrey, December 15, 1976, Forbes 46.

Fifth, can advantage be taken of the mandatory daily basis formula by transferring, for business reasons, assets held a short period of time into existing corporations, partnerships or other business entities that were created many years prior to the "fresh-start" valuation date of December 31, 1976? The benefit, of course, is to obtain the substantially increased numerator in the fraction, while the denominator has been affected much less so proportionately.

Sixth, a planned sale in contemplation of death under appropriate circumstances, where the transferor and his estate will be in the highest tax brackets and it is known that assets will have to be sold to pay death taxes, may provide lower overall taxes and other costs. Whether to do this depends on consideration of the Federal and state income tax rates, preference taxes costs of administration and similarly affected items when contrasting the mathematics of a sale before and just after date of death. Income taxes generated before death become liabilities of the estate and affect not only the tax liabilities, but also distributions based on adjusted gross estate, i.e.. marital deductions, amongst others.

Seventh, subsequent to death, i.e., post-mortem, it may appear advisable to effect a step-up in basis by making distributions in kind where discretionary trusts are in existence. This will "wring out" distributable net income from the trust and in the process step up the basis to fair market value in the hands of the distributee. Similar considerations may be involved with distributions, whether final or partial, from an estate where absorption of a large amount of distributable net income through property distributions in kind will result in step-up in basis. Likewise, trapping distributions from one fiduciary, i.e., estate or trust, to another, may result in a step-up in basis to the extent that fair market value of the asset exceeds its basis and the amount distributed is covered by the distributing entity's distributable net income.

Eighth, consideration must be given, consonant with local law, with respect to a distribution of assets with differing tax basis among estate beneficiaries. It is obvious that amounts passing to charity should absorb low basis assets if investment considerations are somewhat neutral. Similar considerations may affect the funding of a marital trust on the basis that wasting assets such as low basis property will reduce the amount remaining at the surviving spouse's death. Obviously, this can be accomplished only if the decedent provides such flexibility, since fiduciaries may be concerned about their duty of impartiality otherwise and make distributions on a pro rata basis without specific instructions allowing them to do otherwise.

In general, it would appear that in drafting the appropriate will and trust documents, more discretion should be considered to provide for the executor's and/or trustee's capability of accomplishing a number of the planning considerations mentioned above. Inflexible drafting will result in less capability of post-mortem planning, let alone the possibility that violating the requirements could generate capital gain, i.e., on a sale or exchange basis. In this context, it would appear evident that any marital deduction to be funded based on a consideration of decedent's tax basis should be redrafted. Distribution of low basis assets to the marital trust also preserves higher basis assets in the residuary as a source of immediate sale to pay death taxes and other expenses. The result, of course, will be lower capital gains tax during the period of administration

It is evident that the carryover basis is an extremely complicated area, one fraught with substantial administrative problems, let alone technical drafting problems as now written. It is one which does not satisfy those favoring the prior law, let alone the reformers who are alreadying calling for its repeal in favor of their desired capital gains tax at death.[50] In spite of all of the discussion and haranguing over other changes of complexity and restriction, such as generation-skipping trusts, it is suggested that carryover basis provide the greatest amount of concern in the future. No longer will estate planning be a once or twice in a lifetime act done with some expedition. Lifetime planning must give consideration to carryover basis, the nature of gifts, the amount of potential capital gains to heirs and the estate and fiduciaries powers in executing documents. Likewise, similar considerations must be involved to accomplish effective estate administration and post-mortem planning.

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[50] Footnote 49 Supra. also see Lenzinger, Death and Taxes—Drastic Changes in Rules will Affect the Market. Barrons, December 20, 1976.

STATEMENT OF DORIS D. BLAZEK, COVINGTON AND BURLING

[This statement is made by me as an individual, practicing attorney, and it does not necessarily reflect the views or position of any organization or group with which I may be associated or of which I may be a member.]

I. INTRODUCTION

Carryover basis is, without question, the most far-reaching and important provision in the area of estate planning and estate administration in the Tax Reform Act of 1976. What Congress achieved for the surviving spouse and the small estate in the form of the increased marital deduction and the increased exemption as a credit, it took away in the concept of carryover basis.

The provision is an administrative nightmare. It affects every estate which has an asset other than cash and insurance which has appreciated in value; this is true even if there is no executor appointed and no federal estate tax return is required for the estate. The cost of compliance to the taypayer will often far exceed the amount of tax dollars at issue.

The economic impact of carryover basis is great. Though apparently meant to place the taxpayer who sold an appreciated asset after death in the same position as the taxpayer who sold such an asset prior to death, that objective has not been achieved. Just as Congress "corrected" the inequities of the single taxpayer who paid more tax than his married counterpart by creating a tax penalty for married persons, so too the carryover basis provisions may operate, if the adjustment to December 31, 1976 values is not applicable, to impose a greater tax on the appreciated asset if it is sold after death than if it were sold prior to death. Sales in contemplation of death will become a new estate planning technique. Moreover, the post-death situation carries with it the necessity of raising funds with which to pay the federal estate tax obligation of the estate. As a result of carryover basis the esttae must now pay a capital gains tax to raise those funds. It is a tax which is generated by a tax. To that extent the pre-death and post-death situations are inherently dissimilar.

Remember too that it is in the post-death situation that the family of the decedent is required to cope with the debts of the decedent and the expenses of administration, which too generate the need for liquidity and further capital gains taxes, as well as the loss of the family's main wage earner or the guiding force in the family business.

In their efforts to plug a loophole perceived in the tax law, tax theorists forgot or ignored the practicalities of estate administration and how people actually live. To make certain that no dollar of appreciation escaped taxation within capital gains concepts, all property (other than a few items specifically expected) passing from a decedent is subjected to the new tax concepts and reporting requirements. Intricate provisions were designed to acheive a precise equity under the tax law (though not, in fact, achieved, as noted above and discussed more fully on pages 20-21 below) at the sacrifice of simplicity. The current carryover basis provision is a law which invites evasion rather than compliance.

II. THE ADMINISTRATIVE PROBLEMS OF CARRYOVER BASIS

A. Determining the decedent's basis

Under the law as it existed prior to the 1976 Tax Reform Act, it was not necessary for the executor or other recipient of property from a decedent to establish the decedent's basis in property held at death. Rather, one simply established the value of the asset at the date of death or alternate valuation date and used that value for both the federal estate tax and the basis for income tax purposes. Under the carryover basis provision the date of death and alternate values will have to be established, but now the executor will also have to establish the decedent's basis in each asset. Any "substantial improvement" is to be treated as a separate asset. That is not a simple or easy undertaking.

Consider the decedent's home. How many people have records from which the cost and capital improvements over the years can be easily and readily determined. The answer is very few—even among those sophisticated in tax matters. Those records are required of the taxpayer if he sells his house prior to death, so why not require them after death? The answer is that the decedent is not to reconstruct the facts needed; his special recollection of what transpired is gone.

However, the new carryover basis provisions place an affirmative burden on the "executor", often as a stranger to the decedent when it comes to such intimate personal financial details, to establish that basis.

Consider the stock of a single corporation purchased in several lots. Each lot is a separate asset for basis purposes. Stock splits and dividends complicate the basis picture. Consider the mutual fund investment in which the elderly decedent opted for a dividend reinvestment and systematic monthly withdrawal program. The basis of each share is affected by each withdrawal and calculation of basis is an intricate, complex, time-consuming matter.

While the taxpayer must deal with complex basis problems during his life, it is unlikely he will have to fix basis in all assets at one time. To the extent he has accounting or legal fees in assisting in that determination, they will generally be spread over his lifetime and be borne from his income. The carryover basis provision means that the effort to establish basis of all of the decedent's assets must be met at death. The costs of that undertaking will often be significant. At brokerage houses and transfer agents are swamped with requests for data on decedents' accounts, they will have to charge for this service which they now provide free. The spectre of huge data banks as a new business has already been raised. Who will bear these costs? The decedent's surviving spouse, his children or other legatees, and since administrative expenses are a deduction on the federal estate or fiduciary income tax returns, the Federal Government will bear the cost.

B. Household and personal effects

The carryover basis provision exempts $10,000 of household and personal effects selected by the "executor" from the carryover basis provisions. In addition, any such asset which has depreciated in value may not have a basis greater than its federal estate tax value for purposes of determining loss.

Assets in the category of household and personal effects present special and significant problems in this area. First, the problem of establishing the decedent's basis in such assets is particularly acute. As a prospective decedent, your aunt may not be offended if you ask her the basis of the few shares of stock she gave you on your sixteenth birthday, but consider her reaction when you ask her what she paid for the large silver tray she gave you for your wedding. Compliance with the new carryover basis provisions would require you to do so. It is in this area especially that the new law invites evasion. Rather than meet these imponderables, the silver tray will simply not appear on any inventory of the decedent's assets.

How many persons know what they paid for the table in their dining room? Perhaps it was acquired from others in the family. Even if they know what they paid for the table, how many have a receipt or records to prove the price? Some would suggest that there is no problem since the table will either come within the $10,000 exclusion or will be a depreciated asset. That is simply not the case, however, First, the $10,000 exclusion will not cover many middle-class households. Different traditions in the valuation of tangible personal property for probate and for tax purposes have developed in different states. In those states which require appraisals at full fair market value to be filed with the court, most notably in the northeast, the value of the middle-class decedent's personal and household effects often exceeds $10,000. That limit on the exclusion is too low. Second, the "executor" must, of course, know the basis of the table in order to establish the asset is, in fact, a depreciated asset.

The election with respect to which assets are to be included within the $10,000 exclusion also creates problems. It is to be made by the "executor", and "executor" is defined within the Internal Revenue Code to include any person in possession of property from a decedent if no executor is qualified. Therefore, if no probate is required in an estate, there may be competing elections; each child will elect to have his share of the household and personal effects come within the $10,000 exclusion. Also, problems arise if the value of any item within the exclusion is raised on audit.

C. The incredible calculations

Once basis is established the new law provides for four possible adjustments to basis. Each adjustment turns on calculations made in the preceding adjustment.

The adjustments must be made with respect to each asset, and even a modest estate will have many assets. Moreover, there may not be one, but several bases, for a single asset since the adjustment to December 31, 1976, values is made

only for the purposes of determining gain, not loss. Since only assets subject to tax qualify for some of the adjustments, assets will have a different basis if allocated to a marital deduction share for the spouse than if allocated to the residue. Basis will be suspended during the period of administration until that allocation is made. That means there may be as many as four possible bases for a single asset.

For example, assume that an estate of a decedent dying after 1980 consists of two assets: Asset X, the family home, has a basis of zero and a value of $500,000 and Asset Y, marketable securities, has a basis of $500,000 and a value of $500,000. The will contains a maximum marital deduction pecuniary formula clause, so the surviving spouse receives one-half of the estate, or $500,000. The federal estate tax, after allowing for the $47,000 unified credit and the state death tax credit of $12,400, would be $96,400. If Asset Y, the marketable securities, is used to fund the formula provision, the basis of Asset X, the house, is increased by the full amount of federal estate tax, or $96,400, but if Asset X, the family home, is so used, there is no basis increase for federal estate taxes paid. Thus, the basis of each asset is "suspended" until distribution is made. Tax factors now significantly affect decisions on which assets to sell and which to distribute to whom—decisions which should turn on investment and family considerations.

These adjustments will have to be made to comply with the reporting requirements which accompany the carry over basis provisions. Nor is it a matter of doing the calculations just once with respect to each asset. Basis calculations will be needed after the estate is open to determine which assets to sell to raise funds; if the basis report is due with the federal estate tax return, they will have to be done at that time; and they will be done again when audit of the federal estate tax return is complete.

The elements of the calculations (average federal estate tax rate) are such that the change on audit of one dollar in value of any carryover basis asset subject to tax will change the adjusted basis of every such carryover basis asset in the estate. Doing the laborious calculations will consume incredible amounts of professional time and will greatly increase the cost of administering an estate. Computer services may ultimately be available to expedite the procedure, but there will still be substantial additional expense to the estate, and it may be difficult for accountants and practitioners in a general practice to avail themselves of such services. Experienced accountants, attorneys and banks are still wondering, ten months after the Tax Reform Act passed, how they will cope with these calculations. Again, the costs of compliance are likely to far exceed the amount of tax at issue.

D. The reporting requirements

The Tax Reform Act requires every "executor" to file an information report on carryover basis property with the Internal Revenue Service and with the recipient of the property. The requirement carries with it a maximum penalty of $7.500 for failure to comply.

"Executor", as noted earlier, is defined for this purpose as the recipient of any property acquired from the decedent. It is this requirement which hits the surviving spouse who receives $500 in joint carryover basis property from her deceased spouse. If there is no asset which must be probated, the survivor may not be advised of the reporting requirement. There is clearly no federal estate tax return due, yet the spouse will face a penalty of $100 for her failure to report to the Internal Revenue Service the basis of this asset. Presumably she would not be assessed a penalty for failure to report to herself as beneficiary.

The reporting requirement penalties have made banks and others reluctant to serve as executor. Often the decision of whether to serve must be made before full financial information can be developed. Rather than risk not being able to comply with the reporting requirements or to be able to do so only after great expenditure of time, executors will simply refuse to serve. This effect of the carryover basis provision hits the small and middle size estates the hardest, whose fees do not compensate for that added risk.

With all of the complex calculations and reporting requirements, two practical questions are paramount. First, what will the Internal Revenue Service do with the basis reports? Does it have the funds and capability to match the reports with the subsequent sale reported in the income tax return of the beneficiary, or, as is more likely, will the reports simply be held and then ultimately shredded as the press recently reported occurs with many forms 1099? Second, is the beneficiary bound by the executor's determination of basis? There will be

many instances in which the decedent's basis is not clear. In those cases, it would appear that the beneficiary is not bound by the basis reported by the executor with respect to assets received and subsequently disposed of by him. Litigation on basis issues is to be expected; that will be an added burden on both our taxing and judicial systems. Under prior law basis was established in the audit of the federal estate tax return and the beneficiary was bound by that determination.

E. More records and open issues

Most taxpayers like to "clean house" once in a while. It is particularly natural to want to dispose of a decedent's personal financial records after his estate is closed. Carryover basis means that accountants and attorneys must now advise that such records may not be disposed of until the decedent's last asset is sold, for there must be evidence of basis. The usual case will be quite different, however. The decedent will have followed a practice of throwing out his old tax returns every few years; the realization of their importance will come as a shock to the surviving spouse or children and add to the resentment of our taxing system already engendered by the federal estate tax.

More important than being able to "clean house" physically is the desire to have matters settled. Prior law provided a method for final determination of basis in a manner binding on all interested parties without disposition of the asset; the carryover basis provisions do not provide an opportunity for final resolution of a disputed basis issue involving a decedent's asset short of sale.

III. SPECIAL FIDUCIARY PROBLEMS

A. New fiduciary concerns

Carryover basis creates fiduciary problems never faced before in estate administration. Now, if the decedent leaves a $10,000 legacy to his brother and the executor wants to satisfy that legacy with 100 shares of XYZ Corporation, which happens to have a low basis, the decedent's brother may object as the asset carries with it a significant income tax obligation. Under prior law, of course, the basis to the brother of the XYZ Corporation stock would have been the value on the date of death distribution. On the other hand, the decedent's children may insist that the XYZ stock be distributed to their uncle since if it is sold in the estate, they will bear the burden of that income tax.

Under prior law, assets could be distributed on a non-pro rata basis since they had a basis at or close to their value at the time of distribution. Carryover basis will dictate pro rata distribution of assets unless the will provides that a different distribution scheme is possible. Thus, now if an executor has 100 shares of XYZ Corporation with a value of $100 and a basis of $10 and 100 shares of ABC Corporation with a value of $100 and a basis of $100, each of two children will have to receive 50 shares of XYZ and 50 shares of ABC rather than passing all of one issue to each of them as was possible before.

Carryover basis thus pits beneficiary against beneficiary as never before. Litigation on these new issues is inevitable. Executors will be reluctant to act without consents of a court order. This all means complexity and delays in administration and added cost to the beneficiaries and the judicial system.

B. Delays in completing administration

Since the basis of every carryover basis asset in an estate cannot be finally determined until conclusion of the federal estate tax audit, estate administration will be delayed. Amended fiduciary returns and refund claims will become the rule rather than the exception. Protective refund claims may have to be filed to avoid the statute of limitations. Beneficiaries already complain about delays in closing estates. It is not possible to provide examples of these effects on estate administration since estates of decedents dying on January 1 of this year are not yet at this point, but that consequence of the carryover basis provision is inevitable.

C. Tax planning

Carryover basis increases the importance and complexity of tax planning. Prior to the Tax Reform Act, the post-mortem options and maneuvering done to achieve income tax savings for an estate and its beneficiaries were limited. Faced with the increased income tax which results from carryover basis, planning to achieve income tax savings on carryover basis property will acquire new importance.

Carryover basis encourages the use of multiple taxpayers to spread the taxable gain and avoid the minimum tax provisions. For example, if gain of $200,000

must be recognized to raise funds to pay the federal estate tax, it might be spread between two fiscal years of the estate. In addition, it will become advantageous for an estate to borrow money to pay those taxes and thus delay sales for later fiscal years or to be passed through and taxed in the beneficiaries' returns if they are low brackets. Multiple revocable trusts created by the decedent during lifetime would accomplish the same result. This becomes particularly important to multiply the $10,000 exemption from the minimum tax.

Carryover basis places a premium on tax planning. Those estates which get competent advice will minimize this new tax and those which do not will be hit the hardest. Again, if one must generalize, it is the small and middle size estate that will bear this burden to the extent it is comprised of appreciated assets.

All estates will bear the burden in a different sense, however. To the extent that there is a potential for tax savings, lawyers and accountants, pushed by the threat of malpractice actions, are practicing defensively. They run tax calculations on eight different plans to demonstrate that they have considered the alternatives and chosen the best for the client. That cost is borne by the estate and, as suggested earlier, in part by the Federal Government to the extent administration expenses are a deduction on the federal estate or fiduciary returns.

IV. THE ECONOMIC BURDEN

The economic impact of carryover basis combined with the federal estate tax will be severe on estates of all sizes with appreciated assets. Any taxpayer who owns his own home is generally in that position.

The increase in the amount which may pass free of federal estate tax from $60,000 to $175,000 effected by the Tax Reform Act saves $25,000 in estate taxes. If there is gain inherent in those assets of $100,000 after the basis adjustments are made and if the beneficiary has little or no other income, with the impact of the minimum tax, the estate tax savings will disappear in the form of income tax on the capital gains. It is not unusual for a widow or widower to decide, for personal reasons, to sell the family home. A survivor may feel she does not want to hold the small equity investments accumulated during lifetime because of the risks of the market, so she sells. Presto, the Government takes $25,000 in capital gains tax. This means that the surviving spouse in an estate of $160,000 can be in exactly the same position she was in before the increased marital deduction, which was heralded as a recognition of the need and desire to provide for one's spouse.

It is not unusual for the estate of the middle class taxpayer to be in the $250,000 to $500,000 range. The marginal estate tax rate in that estate, if there is no surviving spouse, is 32 to 34 percent. State inheritance taxes range widely and will often add another 3 to 6 percent tax—perhaps more—on the estate's top dollar. The tax on appreciation in such an estate is roughly one-half the taxpayer's marginal rate on ordinary income plus 7½ percent on gain in excess of $20,000. If a surviving child has $20,000 in earned income, gain hit by the preference tax will be subject to federal income tax at the marginal rate of 24 percent. State income tax will add another 3 percent on the top dollar. The combined federal and state estate and income tax burden on the top dollar of appreciation in such an estate is 62 percent. The compares with a marginal estate tax rate under the old law of 35 percent.

As we move farther away from December 31, 1976, and the fresh start becomes inapplicable, it will be clear that small and middle size estates will pay more tax under the Tax Reform Act with carryover basis than under the prior law contrary to the policy implicit in the unified credit and the new marital deduction to permit a modest estate to pass to a surviving spouse free of tax in recognition of her needs. For example, consider the decedent who graduates from college in 1977, borrows $10,000 to start his own business; the decedent dies domiciled in Virginia five years later leaving his successful business valued at $500,000, a widow and two small children; the widow has no interest or facility for running the business and she sells it soon after her husband's death. Under prior law, the federal and state estate taxes due on this estate were $57,391; no capital gains tax was assessed on the sale. Under the Tax Reform Act, the federal and state estate taxes due on this estate will be $34,208; capital gains tax on the sale will be $161,487; total taxes equal $197,695, or 40 percent of the decedent's assets. See Exhibit A for the calculations. That tax is due just at the time the family has lost its sole source of support.

Obviously, the tax impact on larger estates is even greater. The top estate tax bracket for estates over $5,000,000 is 70 percent. The inheritance and income tax

brackets in such estates are obviously quite high. The adjustment to basis for taxes paid in the carryover basis provision was apparently made to make certain that the total taxes paid on the top dollar of appreciation in an estate did not exceed 100 percent. For decedents with estates in excess of $5,000,000 domiciled in states with high income and inheritance taxes combined estate and income taxes will exceed 90 percent of the gross estate.

Presumably one of the objectives of carryover basis was to place the taxpayer whose state sells an asset after death in the same position the taxpayer would have been in if he had sold the asset prior to death. That objective has not been achieved since the income taxes paid on sales made prior to death are not subject to the federal estate tax. For example, consider the estate of a Virginia decedent consisting of a single asset valued at $500,000 with a zero basis and no surviving spouse. If the asset is sold prior to death, total capital gains tax and federal estate tax will be $252,620, or 51 percent of the total value. If the asset is sold after death with no fresh start adjustment, total estate taxes and income taxes will be $270,805, or 54 percent of total value. See Exhibit B for calculations. By effecting a sale during lifetime there is a tax savings of $18,185. Hence, the suggestion that tax planning will now involve sales from the deathbed.

The present provision not only fails technically to equate pre-death and post-death situations, it places the penalty on the post-death side. If there is to be unequal treatment, it should favor the post-death situation. Death is, after all, involuntary, unlike most lifetime sales. Moreover, death carries with it the need for liquid funds to satisfy the decedent's debts which he has financed with his earning power, estate and inheritance taxes and the expenses of administration. All of these demands come together at one time to be met just at the time the survivor faces the loss of the decedent's earned or retirement income. These demands mean the post-death situation is inherently not like pre-death, for there is a necessary for the sale of assets. Carryover basis creates a tax which feeds upon a tax.

The impact of carryover basis on equity investments is clear. A total marginal tax rate of 90 percent is regarded as confiscatory by taxpayers. Therefore, it will be advantageous for the taxpayer to avoid the tax on appreciation by fixed return investments. The capital for equity investments will be reduced. Such rates also smother the incentive to work in a family business to make it grow. While some might suggest an estate of $1,000,000 to $5,000,000 deserves no sympathy and does not represent a closely-held corporation, that is, in fact, not the case with many successful closely-held businesses across the nation. If it is viewed as important to permit such business to survive locally and not to have to sell out to a large corporation, incentives to develop and expand must be retained in the tax laws. Tax theorists failed to appreciate the economic burden and effect of the carryover basis concept, I believe.

V. POSSIBLE SOLUTIONS

Repeal carryover basis. That is the one solution which helps the farmers, the small businessman, and taxpayers in general and simplifies the tax laws.

If repeal is not possible, then all of the following alternatives should be considered in developing a statute which works in practical terms:

A. Exemptions

1. Exempt from its operation all assets which reflect basis on December 31, 1976, to remove the harsh effect of having to establish the decedent's basis when the taxpayer was not on notice of the necessity of maintaining such records.

2. Exempt all personal and household effects and the decedent's residence as they are assets on which basis records are rarely maintained.

3. Increase the $10,000 exemption on personal and houshold effects to a level which will cover the midde class home—perhaps $25,000 is more appropriate.

4. Exempt all estates under asset value—such as $120,000 to $175,000 as the amounts which are covered by the unified credit and do not require the filing of a federal estate tax return; or such as $500,000 since that amount is frequently reached in the middle class estate by the decedent's residence, life insurance, tangible personal property and modest savings during lifetime.

B. The Calculations

1. Provide a step-up in basis for all taxes paid and forget about the intricate calculations. If an adjustment is made on audit, it would affect only the asset adjusted.

2. Compute the step-up in basis for taxes paid on the appreciation in an asset at the estate's top tax rate rather than at the estate's average tax rate. Estates will generally not move between rate brackets as the result of adjustments on audit, and thus adjustments will not necessarily affect the basis of all other carryover basis assets, and then the problems of amended returns and refund claims disappear.

3. Increase the minimum basis adjustment from $60,000 to cover the small to middle size estates. Consider the $500,000 and $120,000 to $175,000 figures noted in A.4 above.

4. Allow the value of all assets on December 31, 1976, (the "fresh start") to be determined by a back down from federal estate tax value as proposed in the Technical Corrections Bill for tangible personal property. But, write the statute so it can be read and understood—don't use "1.0066 to the *n*th power."

5. Allow fixed return preferred stock which is non-marketable and held on December 31, 1976, a fresh start equal to its federal estate tax value to place preferred stock of a company with non-marketable securities in the same position as marketable preferred stock.

6. Provide that property taxed under the "special use valuation" have the advantages of fair market value in the calculations for fresh start and taxes paid.

7. Allow an adjustment to basis with respect to taxes paid to a foreign jurisdiction and to a possession of the United States.

C. Liquidity and fiduciary matters

1. Allow or require the executor to use all of the step-up with respect to taxes paid against gain generated in the estate and permit him to allocate any adjustment not so used in the manner provided for distribution of property subject to tax under the will.

2. Permit optional averaging or borrowing of basis between assets. Treat basis as an asset and let the executor allocate it as he sees fit. This will alleviate the liquidity problems at death and the fiduciary problems raised in estate administration and yet the Government will ultimately get its tax dollars on appreciation.

3. Change the percentage test for qualification under Section 303 back to what it was prior to the Tax Reform Act.

4. Reverse the proposal in the Technical Corrections Act so that Section 306 stock may be used in a Section 303 redemption, as permitted under prior law.

5. Provide that all Section 306 stock issued prior to January 1, 1977, loses its "taint" on death.

6. Expand Section 303 to have it cover capital gains taxes generated on assets sold to pay estate taxes and administration expenses.

D. Administrative matters

1. Extend the statute of limitations on all fiduciary returns to three (3) years after the conclusion of all federal and state estate and inheritance tax proceedings.

2. Exempt persons not actually qualified as an executor from the reporting requirements.

3. Eliminate the reporting requirements for estates which are not required to file a federal estate tax return.

4. Remove the penalties for failure to comply with the reporting requirements absent fraud.

5. Provide that the beneficiaries shall be bound by the basis report within a procedure which provides them notice and an opportunity to object.

E. Theory

1. Provide that net operating losses may be carried forward to the estate and beneficiaries consistent with the concept that the estate "steps into the shoes of the decedent."

2. Provide that capital losses may be carried forward to the estate and beneficiaries consistent with the concept of carryover basis.

EXHIBIT A

I. Date of death, 1982; decedent's basis, $10,000; DOD value, $500,000; widow with two minor children surviving.

A. Old law:

1. Federal Estate Tax if decedent died prior to December 31, 1976:

Assets	$500,000
Marital deduction	(250,000)
Exemption	(60,000)
Taxable Estate	190,000
Tax	47,700
State death tax credit	(2,400)
Total tax	45,300
Virginia inheritance tax	12,091

2. Income taxes on sale of business by widow:

Gain	0
U.S. tax income	0
Virginia income tax	0
Total taxes	57,391

B. New law:

1. Federal estate tax if decedent died in 1981:

Assets	500,000
Marital deduction	(250,000)
Taxable estate	250,000
Tax	70,800
Unified credit	(47,000)
Subtotal	23,800
State death tax credit	(2,400)
Total tax	21,400
Virginia inheritance tax	12,808

2. U.S. income tax on sale of business by widow:

Gain ($60,000 minimum basis)	440,000
½ gain	220,000
Standard deduction	(2,400)
Exemptions	(2,250)
Taxable income	215,350
Tax—Head of household	127,865
Minimum tax	23,410
Subtotal	151,275
Virginia income tax	12,212
Total taxes	197,695

Exhibit B

I. DOD, 1977; decedent's basis, $10,000; date of death value, $500,000; decedent widower, two adult children surviving.

A. Sale predeath:

1. U.S. income tax on gain of	$490,000
½ gain	245,000
Standard deduction	(2,400)
Exemption	(750)
Taxable income	241,850
Tax	152,385
Credit	(180)
Subtotal	152,205
Minimum tax	25,335
Total U.S. income tax	177,540
Total Virginia income tax	13,738
Total combined taxes	191,278
2. Federal estate tax on balance:	
Assets	500,000
Less income tax	(191,278)
Net estate	308,722
Tax	90,765
Unified credit	(30,000)
Credit for State death taxes	(3,879)
Total Federal estate tax	56,886
Total Virginia inheritance tax	8,426
Total tax	61,342
(51 percent of DOD value)	252,620

B. Sale postdeath without fresh start:

1. Federal estate tax estate	500,000
Tax	155,800
Unified credit	(30,000)
Credit for State death taxes	(10,000)
Total Federal estate tax	115,800
Total Virginia inheritance tax	8,426
Total combined taxes	124,226
2. Gain taxable to the estate:	
Asset	500,000
Basis adjusted for taxes paid	(124,226)
Gain	375,774
½ gain	187,887
Exemption	(600)
Taxable income	187,287
Tax	116,591
Minimum tax	19,439
Total U.S. income tax	136,030
Total Virginia income tax	10,549
Subtotal	146,579
Total taxes (54 percent of DOD value)	270,805

STATEMENT OF JOSEPH KARTIGANER

Mr. Chairman and Members of the Subcommittee, I thank you for the opportunity you have afforded to me to address some of the problems which have arisen in the planning and administration of estates and trusts because of provisions in the Tax Reform Act of 1976.

I appear before you as an individual. I do not have, and indeed I did not seek, authority to speak either for the firm of which I am a partner or for any committee or organization which I chair or of which I am a working member. However, I have attached a brief summary of my credentials, primarily to give credibility to my representation that my views have been formed as a result of travels throughout the country, hearing the reactions of co-panelists on lecture circuits, discussion with lawyers and other professionals who have attended lectures given by me, and studying the considered opinions of experts in the field who have devoted untold hours to the analysis of the law and of its effects, as well as my actual experience in my own practice.

I. SCOPE OF THIS PRESENTATION

The submissions of, and oral presentations by, Ms. Blazek and Messrs. Costello and Eubank will have discussed in depth important problem areas in this field. You will have heard about the concern of the probate bar that the changes in the tax law have significantly diminished, and perhaps completely nullified the effects of, the streamlining of the probate process which has been undertaken in many states and which is at least under study in many other states. You will have heard about the difficulties and complexities the law imposes on the estates of small businessmen and farmers. And you will have heard about the economic impact of the law, primarily in the area of carryover basis, on all estates from the relatively small to the very large.

I will attempt in this presentation to avoid duplicating the efforts of the other witnesses and to avoid burdening your time with a repetition of the points made by them. As you know, any assemblage of witnesses will, almost of necessity, have a divergence of views on some points, major or minor. I can not in this presentation give blanket approval to the views of the other witnesses. However, since I know the general thrust of those views, I can say that, whatever disagreements we may have among ourselves on either technical or policy points, we are agreed on general approach.

I would like to address a basic point which has not received the discussion I believe it deserves. Estate and gift tax provisions, and related provision such as carryover basis, affect almost everyone in this country. Carryover basis is a problem which must be faced by every individual who has, or who aspires to the acquisition of, property. As to estate and gift taxes, even though the new exemption equivalent will eliminate all Federal estate tax filing requirements for over 90 percent of the estates, the remaining percentage results in a number of affected estates which is large in any absolute terms and includes an extremely large proportion of the small business, executive and entrepreneurial population.

Unfortunately, the population affected by these provisions, in many if not in most instances, can not afford the talents of specialists (legal or non-legal) and the professional who provide services for this population, in most instances, can not afford the time required to become familiar with the arcane and extremely complex provisions now affecting their clients.

This gap between the needs of the clients and the abilities of counsellors will inevitably result in individuals (or their estates) being burdened with unnecessary taxation and will give birth to a new growth industry, litigation among beneficiaries, between beneficiaries and fiduciaries, and between beneficiaries and the attorney or other counsel.

Therefore, in a plea for simplification and practicality, I would like to discuss some of the provisions in the new law which create traps for the unwary, which offer inducement to do the nonsensical, or which have built in to them unnecessary seeds of conflict.

Finally, exercising an assumed prerogative as the last witness, I would like to offer some suggestions for change which, if adopted, would eliminate some of the more serious problems in a manner not inconsistent with the basic policy decisions reflected in the Tax Reform Act.

II. REVIEW OF PROVISIONS, CAUSING UNNECESSARY OR UNDUE DIFFICULTIES

A. *"Relief" provisions which provide no relief*

Probably because of the absence of testimony on the provisions of the Tax Reform Act, provisions have been added to the Internal Revenue Code which purport to give relief but which, upon analysis, probably work to the detriment of the taxpayer. Such provisions serve no useful purpose and in fact may generate litigation because the unsophisticated may make use of them to the ultimate detriment of family members.

1. Qualified Joint Interests

Principal among the misleading provisions are those relating to so-called qualified joint interests. Jointly-owned property has always been anathema to the sophisticated estate planner. However, it has always been recognized that, for the small estate and for the family home, it is a widely used form of ownership. However, it has always been recognized that, for the small estate and for the family home, it is a widely used form of ownership. Under the old law, assuming the husband provided all of the consideration and died first, the entire value of the property was includible in his estate and then taxed in the estate of the surviving spouse when she died. However, if the wife died first, nothing would be taxed in her estate and the entire amount would be taxed in the husband's estate when he died.

If the temptation provided by the Tax Reform Act is not resisted, the husband will make a transfer creating a qualified joint interest, his estate tax will not be significantly reduced (because the transfer will be brought back into his estate, in whole or in part, as an adjusted taxable gift or the transfer will reduce his available marital deduction) and the entire property will still be taxed in the estate of the surviving wife. On the other hand, if the wife dies first, there will now be a tax burden in her estate (the value of her joint interest) and the entire property will again be taxed in the husband's estate on his subsequent death (since the property is held jointly and passes by operation of law, there is no way to avoid having the property revert to him).

This is a provision which, because of its superficial appeal, will be taken "advantage" of and will, in the long run, lead to criticism of the counsellor.

2. Provisions Relating To Interspousal Transfers

The Tax Reform Act provided significant relief in permitting the transfer of $100,000 to a spouse without gift tax consequences. Part of this relief was taken away by the provision which reduces the spouse's available marital deduction, but this provision is not too onerous and does make some sense. However, the interrelationship between interspousal transfers and unification of gift and estate taxes has made any interspousal transfer of more than $100,000 a losing proposition. The arithmetic is compelling and sophisticated practioners have concluded that, unless there is a strong likelihood of significant appreciation in the transferred property after the date of the transfer, the client should be told not to transfer property in excess of $100,000 to his or her spouse. Such a result seems contrary to any espoused policy.

However, even assuming the result was the intended result of more concern to me is the fact that most practitioners and most clients will not preceive the economic loss involved in such a transfer and will be faced ith a situation in which the ultimate family beneficiaries receive less than they would have received if the transfer had not been made and, in our litigious society, more litigation will ensue.

B. *Unnecessary complexity or retroactivity causing errors and malpractice claims.*

1. Transitional Rules in Generation-Skipping Tax

In my practice, I have never seen a provision affecting the lives and the planning of individuals (as opposed to business entities) which matches in complexity the transitional rules in the generation-skipping area. Lawyers throughout the country, even those who are looked upon as experts, have thrown up their hands and declared an inability to advise clients concerning what they can and can not do within the framework of those transitional rules. Even those steps which are clearly within the protection of the rules are required to be taken in ways which are unnatural and costly for the client and his or her family. There has been

profusion of codicils as opposed to new wills and a general avoidance of the substitution of an inter vivos trust for a will where such a trust otherwise might be called for either to minimize probate expenses or to insure against the infirmities of age.

Furthermore, and to the legitimate dismay of members of the bar and their clients, the transitional rules were made retroactive to a date prior to the publication of any intention to legislate in this area. As a further insult to the careful practitioner, the transitional rules were changed from those first announced on May 24, 1976 (retroactive to April 30, 1976) until the time of final adoption in October of 1976 (again retroactive to April 30, 1976); thus, even for the practitioner who was watching, there are undoubtedly a multitude of instruments which violate the rules ultimately adopted, either because of changes made from the rules initially announced or because the rules initially announced were of so little benefit that clients decided they would forego that limited protection.

Lest this problem be dismissed as pertaining only to the very rich, I point out that there are many situations in which the grandchild exclusion (which in most cases will protect the small estate) is not available. The most obvious example I cull from my own practice is the case of the retarded grandchild whose interests must be protected and must be protected in a way which would not qualify for the grandchild exclusion unless a tax is attracted in that grandchild's estate. Wills for that type of problem which were in existence prior to the effective date will be protected if the client dies before 1982. However, those clients whose lawyers were not aware of the transitional rules and whose wills were replaced by new wills, for whatever reason (even if only to provide a legacy for a friend or employee), will have lost the protection.

Staying with the focus of my remarks, I am concerned about the potential for malpractice claims. It is an open invitation to litigation which serves no useful public policy purpose.

2. Changes in Law Which Affect Preexisting Transactions

Many of the provisions in the Tax Reform Act have retroactive effect, regardless of their effective dates. I need do no more than point to those changes relating to carryover basis, which spill over into matters such as plans for 303 redemptions, the economic cost of tax shelters, and the like. How will advisers respond to the need to review files and communicate with clients concerning the necessity for restructuring preexisting plans to make them work? How will the lawyer who put together a buy-sell agreement for a closely-held business be able to identify that transaction from among the files of his hundreds or thousands of clients, communicate with his client, and convince his client of the need to restructure the arrangement (which may involve renegotiation with a third party)? Who will pay for this? And what is the liability of the lawyer if he fails to do this?

3. Transfers of Stock in Closely-held Businesses

You have already heard that the Technical Corrections Bill introduced before the House Ways and Means Committee contains a proposed amendment to Section 2036. Among practitioners who are aware of its existence, the overhang of that amendment has frozen all planning for lifetime transfers of interests in closely-held businesses. But freezing is not enough, since the proposed amendment would relate back to all transfers made on or after June 22, 1976, and one shudders at the impact of such a change on transfers made towards the end of 1976 at the perfectly correct instigation of advisers who were telling their clients that unification would make such gifts less desirable from 1977 on. And what of the adviser who, even if he has the time to study a new law once it is enacted, does not have the time for study of pending legislation?

Quite apart from the fundamental policy error inherent in this proposed amendment, one sees the dangers of retroactivity. I must repeat that we are dealing with individuals, not large corporations; the clients are not being represented by the legal giants, but by the small practitioner who can not afford to devote the time required to stay out of the traps.

4. Gift-Splitting and Contemplation of Death

Unification has created still another trap, namely in the area of split gifts as they are affected by the contemplation of death rules. Under the old law, if a person made a split gift (a gift to a third party with the consent of the

donor's spouse), the death of the donor within three years could result in the entire transfer being brought back into his or her estate. The surviving spouse's gift tax bracket would be increased but there would be no effect on the surviving spouse's estate tax bracket. Under unification, that same transfer would have the same effect on the donor's estate but now will also increase the estate taxes on the estate of the surviving spouse (because it would constitute an adjusted taxable gift). Therefore, there will be taxes on 150% of the amount of the gift.[1]

Again, there is a potential for an increase in litigation. It is not sufficient to respond that people (or lawyers) should be careful. We are dealing with concepts which are extremely complex and Internal Revenue Code provisions which are of even greater complexity. They are being applied by individuals who can not afford the time to become familiar with, and to understand, them. And they will affect everyone, because every one dies.

Taking this gift-splitting problem as an example, as a lecturer throughout the country, I have noticed that an explanation of the problem has never failed to draw gasps from virtually every member of the audience; this means that most of the audience members had not thought of this problem themselves and leads me to conclude that the lawyers who do not attend these lectures (and who constitute a large percentage, if not a majority, of the practicing bar) will also not think of this problem.

C. Theoretically "perfect" systems which create administrative difficulties and invite tax litigation.

1. Unification of Gift and Estate Tax Structure

Although individuals may differ on the policy decision which led to unification, unification is at least conceptually sound. However, in the years to come it will create more and more serious problems in administration and more and more difficult audit procedures. This stems from the requirement that the decedent's executor must establish the amount of all adjusted taxable gifts made by the decedent after December 31, 1976. The old three-year statute of limitations which applied to outright transfers no longer applies and the executor, before verifying the estate tax return, will have to search the decedent's records for the entire period after 1976 to determine whether any transfers made by the decedent constituted adjusted taxable gifts (whether or not a gift return was filed). The costs of administration, the burden on the executor, and the potential for conflict with an auditing agent all will increase as the period to be covered increases with the passage of time.

2. The Technical Corrections Bill Provision Concerning Transfers in Contemplation of death

Presumably because of unhappiness with the probable construction of the language relating to contemplation of death in the Tax Reform Act, the Technical Corrections Bill contains a provision which would include all property transferred to an individual in any year within three years of death if a gift tax return should have been filed with regard to transfers to that individual for that year. This would mean that a transfer to a daughter of $3,000 would be wholly excludable while a transfer of $3,001 would be wholly includible. I do not address the unfairness of such a provision (which I believe is obvious on its face), but I am terribly concerned about the potential for conflict on audit. A minute change in the value of transferred property can cause a very large difference in tax. Similarly, there is a built-in temptation to argue that other transfers made to the same individual, though not reported, and not considered, as gifts, did in fact constitute gifts which would bring the amount transferred to that individual above the $3,000 level; obvious examples are the taking of an adult family member to dinner and Mr. Eubank's "necktie" gift. Such a provision will inevitably result in an increase in administrative burdens and costs.

D. Conflicts among beneficiaries

Perhaps the most regrettable result of many of the Tax Reform Act provisions is the manner in which they induce squabbling among beneficiaries. The probate lawyer knows that even the closest of families have their disagreements and that

[1] The Technical Corrections Bill addresses this problem, but it attacks it from the wrong end, forgetting that the purpose of gift splitting was to equate common law jurisdictions with community property jurisdictions.

the death of a family member (particularly if it is the titular head of the family) can bring to the surface disagreements which have been submerged for years. Aside from tax litigation, the greatest source of litigation in the probate process is disputes among family members. The new law exacerbates this problem.

1. Carryover Basis

Obviously, the single biggest source of conflict will be carryover basis. Wills typically authorize fiduciaries to distribute property in satisfaction of legacies or residuary interests in cash or in kind, and most provide that such distributions may be made other than pro rata.

How does the fiduciary respond to a request by a preresiduary legatee that his or her legacy be funded in cash (because he or she does not want the built-in capital gains tax liability)? When the decedent provided a $10,000 legacy to his or her brother, did he or she mean $10,000 in cash or $10,000 in property with a liability attached? Does the answer change if the legacy gets larger (e.g., $50,000 to my daughter to balance a lifetime gift of stock in the family business to my son)? Of if the gift is of a major portion of the estate (e.g., a pre-residuary bequest to the surviving spouse in the amount necessary to secure the maximum marital deduction)?

The conflict among beneficiaries has very real economic significance. The preresiduary legatee wants the amount in cash so that the net economic benefit is the full amount of the legacy. He or she probably is not concerned that, in order to raise the cash, the estate will have to sell securities and realize a capital gains tax (because of carryover basis), the burden of which will fall on the residuary beneficiaries. How is the fiduciary to resolve these problems? Should he take into account tax brackets? Or whether or not the property is likely to be sold? Or when the property is likely to be sold? Is the fiduciary entitled to make adjustments among beneficiaries to reflect built-in capital gains tax liability?

Similar problems exist even among pre-residuary beneficiaries. For example, if the household effects are worth more than $10,000, how will the $10,000 exclusion be apportioned among the children to whom the decedent has left this property? And the problem can exist among residuary beneficiaries. Traditionally, a fiduciary has been able to apportion residuary property among the beneficiaries in accordance with their needs (*e.g.*, the bonds to a son and the stock to a daughter), but now the fiduciary will have to take into account built-in capital gains tax liability.

The net effect of these problems is hamstrung administration or, worse yet, conflicts between beneficiaries.

2. Other Provisions Creating Conflicts

Similar, but not as serious, problems are created by other Code provisions. Any time the Code becomes more complex and increases the availability of arguments for or against the inclusion of property in the estate for tax purposes conflicts inevitably arise among beneficiaries. The most obvious example of conflict relates to marital deduction formula clauses, which depend on the size of the estate. Thus, doubt about whether or not a transfer is to be brought back in as a gift in contemplation of death, or as a transfer with a retained life interest, creates the possibility of conflict.

The most serious of these arises under Section 2039, which deals with the tax treatment of qualified plan benefits. Under the Tax Reform Act, if the property is taken down in a lump sum, the beneficiary gets favorable income tax treatment but the property is includable in the estate for estate tax purposes. On the other hand, if the property is taken down in more than one year, the property is excluded from the estate for estate tax purposes at the price of unfavorable income tax treatment. In the small estate (one which would not have an estate tax liability in any event), this is no problem. Similarly, it is not a problem if the surviving spouse is the beneficiary of the entire estate, including the qualified plan benefit. However, as soon as the benefits are split (even if only between a marital and non-marital trust), the economic pushes and pulls work in opposing directions. The beneficiary of the qualified plan presumably would be interested in more favorable income tax treatment, regardless of the fact that the increase in the estate tax burden will be borne by the residuary estate.

E. Lack of conformity with state laws in the area of disclaimers

Under prior law, many of the mistakes and many of the conflicts could be resolved by post mortem planning, primarily through the use of disclaimers. This

device has long been recognized as a legitimate method of restructuring estate plans which, for one reason or another, did not adequately take into account the requirements of the law or the needs of the beneficiaries. Because of one or two instances of unfortunate results, the Tax Reform Act leveled a blunderbuss at the disclaimer and attempted to create a Federal substantive law which would supplant local property rules.

Unfortunately, the disclaimer provisions of the Tax Reform Act are technically faulty (primarily because of the "passing" requirement) and, perhaps worse yet, are in conflict with property rules in many of the states. These defects result in substantial uncertainty and the minimization of an important relief provision (to no important policy end).

III. SUMMARY OF EFFECTS OF PROBLEMS AND SUGGESTED SOLUTIONS

This has been a very brief presentation of practical problems created by the Tax Reform Act in the administration of, and planning for, estates and trusts which have not received the publicity afforded to the more dramatic economic and practical problems addressed by the other witnesses. However, even though less dramatic, these problems are real and substantial and promise serious burdens for the public.

It bears repetition that the probate process has been made substantially more complicated, and the interests of the "consumers" in this area have been adversely affected to a serious extent. Some of these problems are inevitable. However, I am reminded of a story about the automobile built by a perfectionist who ground the gears to tolerances so fine that, when a speck of sand found its way into a gear, the car could no longer function. I think this perfectionism is a major source of the problems arising under the Tax Reform Act. The legislation evidences a singleminded purpose, to achieve perfect equity and internally consistent results in all cases. There is a failure to focus on an equally important objective, to keep the planning and administration of human affairs as uncomplicated and as straight forward as possible.

With that thought in mind, I would like to suggest legislative action in certain areas which would result in substantial improvement with no significant change in tax policy.

A. With regard to unification:

1. In order to solve the problem of searching records for the entire period from January 1, 1976 through the date of death, provide:

(*a*) "Yes or no" boxes on the Federal income tax return (similar to that used for foreign accounts) to force the taxpayer to disclose whether or not he has made any transfer which would constitute an "adjusted taxable gift" (translated into English);

(*b*) Authorization to a fiduciary to rely on the responses made by the taxpayer on the income tax returns; and

(*c*) Some statute of limitations which will close off old years if income tax returns have been filed and either a "yes" or "no" box checked.

2. To solve the contemplation of death problem, provide:

(*a*) Treatment of the gift tax paid on a transfer made within three years of death as a part of the gross estate;

(*b*) Treatment of transfers of life insurance made within three years of death as part of the life insurance section (Section 2042); and

(*c*) For all other purposes, treat transfers within three years of death the same way as all other transfers are treated (as part of the "adjusted taxable gift" structure) and repeal Section 2035.

B. With regard to transfers of interests in closely-held businesses, insure that the "anti-Byrum" amendment is directed only at the problem it is designed to cure, and make it prospective in operation.

C. With regard to the problems related to elections concerning benefits under qualified plans, either eliminate the estate tax exclusion entirely or provide that it will be available in all cases. My own inclination is to eliminate the exclusion; this will have no effect on the vast majority of covered workers who pay no estate tax in any event, and eliminates a "tax loophole" with regard to higher salaried executives.

D. With regard to the generation-skipping tax transitional rules:

1. Change the operative date from April 30, 1976, to December 31, 1976;

2. Authorize changes by new instruments, so long as the size of the generation-skipping transfer is not increased; and

3. Subject only the increase in the generation-skipping transfer to the generation-skipping tax.

E. With regard to disclaimers, eliminate the requirement that property "pass" to another and allow for a procedure to conform the Federal procedure with state laws.

F. With regard to carryover basis: 1. I assume that total repeal, with no alternative form of taxation of appreciation during lifetime being substituted, is not politically feasible. I so conclude reluctantly because I think that decision gives too little weight to—

(a) The need for simplicity;

(b) The policy of helping the small estate; and

(c) The very large estate tax burden already borne by the large estate

However, assuming that conclusion, I suggest that carryover is far preferable to the alternatives which have been suggested.[3] I so conclude because I believe all of the alternatives have most of the same problems inherent in carryover and have the significant drawback of requiring the imposition of tax on an asset which has not been, and may never be, sold.

2. If carryover is retained, I strong urge:

(a) That all assets which "reflect" December 31, 1976 values be grandfathered, and that their tax treatment should remain the same as under the old law, namely that there should be a full step-up (or step-down) of basis to Federal estate tax value. This will eliminate the two largest burdens of carryover, the search for basis information and the upsetting of prior financial arrangements (*e.g.*, planning for 303 redemptions, problems inherent in 306 stock, and the like). It will not cause a "lock-in," because older people, even under the current law, will hold on to their assets until death in order to take advantage of the "fresh start" adjustment and younger people are unlikely to make investment decisions based on a step-up in value which will occur only when they die. The loss of revenue will relate only to post-1976 appreciation in assets held by older people.

(b) That the estate tax adjustment be at the top estate tax rate rather than the average rate. This will eliminate the need for most of the refund claims since audit changes which do not move an estate into the next bracket will not change the estate tax adjustment. I would recommend the same change with regard to the Section 691(c) deduction (which would reinstate the provisions of prior law). And to complete the recommendation on this point, I would urge an automatic extension of the statute of limitations for refund claims resulting from changes on an estate tax audit to eliminate the need for protective refund claims.

(c) That a fiduciary be allowed to elect to average the basis of any assets so that he can provide equality among beneficiaries without taking each asset and allocating that asset pro rata among all of the beneficiaries.

(d) Consideration be given to exempting all "non-investment" assets (*e.g.*, the house, furnishings, cars, hobby items such as stamps, books, and the like) to eliminate the prospective problem of record searches (taking care not to create new loopholes).

(e) Consider increasing the $60,000 minimum basis to some substantially higher figure.

If at least the first three proposals are adopted, I believe that carryover will work and will not be as serious an administrative problem as it is under the current law.

Thank you for this opportunity to address your Subcommittee on these very important issues.

BIOGRAPHY OF JOSEPH KARTIGANER PARTNER, WHITE & CASE, NEW YORK, N.Y.

Lecturer in Law, Columbia University School of Law; Author, "Generation-Skipping, The Law, Its Problems, and Some Planning Ideas," Major Taxes 1977; Author, "Charitable Giving and Split Interest Trusts" (N.Y.L.J., Jcne 17, 1975); Co-Author—"Reformation and Renunciation in Charitable Remainder Trusts" (N.Y.L.J., June 16, 1975); Co-Author, "Community Property for the Common Law Lawyer" (2 Probate Notes, No. 1, p. 3, 1975); Fellow, American College of Probate Counsel; Member, Board of Editors, "The Probate Lawyer" and "Probate Notes", publications of the American College of Probate Counsel; Faculty Member on Continuing Legal Education Panels sponsed by ALI-ABA, PLI, New York State, Texas and Seattle Bar Associations, New York State Surrogates'

[3] In taking that position, I am in a minority. A recent poll of the Estate and Gift Tax Committee and Executive Committee of the American College of Probate Counsel showed only one dissent (me) from the proposition that AET was preferable to carryover.

Association, and Southern California and Florida Estate Planning Councils; Past Chairman, Committee on Probate Law Reform, American College of Probate Counsel; Past Co-Chairman, Committee on Gift and Estate Tax Changes, ABA Section of Real Property, Probate and Trust Law; Member, Committee on Gift and Estate Tax Changes, American College of Probate Counsel; Past Chairman, Committee on Uniform Law of Property, ABA Section of Real Property, Probate and Trust Law; Past Vice-Chairman, Committee on Administration Expenses, ABA Section of Real Property, Probate and Trust Law.

APPENDIX

Example Showing Conflicts and Claims Arising Out of Typical Estate Under TRA of 1976

I. Status at death (death in 1981)

A. Decedent, age 60, survived by widow (2nd marriage), two children (son and daughter) by prior marriage each of whom has two children (one child of son is brain-damaged (age 12)).

B. Assets:

	Estate tax value
1. House	$70,000
2. Tangibles	30,000
3. Cash	10,000
4. Marketable securities	180,000
5. Interest in qualified plan	100,000
6. Stock in closely-held business:	
(a) Voting preferred (306 stock)[1]	15,000
(b) Non-voting preferred (306 stock)	185,000
(c) Common	300,000
Total	890,000

[1] Represents 75 percent of vote: balance held by partner.

C. Liabilities: None.

D. Estate cash requirements (excluding capital gains taxes): $150,000.

II. Lifetime.

A. Gave 100 shares of common of closely-held business outright to son in December, 1976.

B. Designated wife as beneficiary of qualified plan benefits (she can elect lump-sum or annuity).

C. Entered into agreement with corporation to have non-voting preferred redeemed under § 303.

D. Executed new will in December, 1976—

1. Gave legacy to daughter (to balance gift of stock to son).
2. Rest of will unchanged from prior will.
   - (a) (i) Voting preferred to son; (ii) balancing cash legacy to daughter.
   - (b) House and tangibles to wife.
   - (c) Marital deduction (pecuniary) outright to wife.
   - (d) Non-marital residuary (subject to all taxes) in sprinkling trust for wife (?) and issue, to terminate after date of wife, children and brain-damaged grandchild, at which time assets are to be distributed to issue, *per stirpes*
   - (e) Wife and children are executors and trustees.
   - (f) Will authorizes satisfaction or legacies in cash or in kind.

III. Conflicts among beneficiaries at death.

A. Wife elects lump-sum payment under qualified plan.

(1) She gets favorable income tax treatment.
(2) Marital deduction increased (but offset by fact wife has plan benefits charged against share).
(3) Residuary estate pays increase in estate taxes.

B. Wife as executor argues for inclusion of 100 shares of common stock given to son (under § 2036 as amended by TCB).

(1) Marital share increased.
(2) Increased taxes paid out of non-marital share.

C. Daughter seeks cash legacies in cash (not in kind)
 (1) She has no built-in capital gains
 (2) Capital gains tax (carryover basis) paid out of residuary
D. Wife seeks same for marital deduction (i.e., in cash)
 (1) She has no built-in capital gains
 (2) Capital gains tax (carryover basis) paid out of residuary
E. Daughter and wife argue that, to extent legacies are satisfied in kind, they want high-basis assets
F. To raise cash (since § 303 does not solve problem—cash requirements increased and income tax liability on redemption)
 (1) Wife and daughter argue for sale of common stock in company
 (2) Son argues for sale of marketable securities

IV—Possible liability of lawyer

A. Did not amend § 303 agreement
 (1) § 303 (as amended by TCB) not available for § 306 stock
 (2) Even if TCB provision does not go through:
  (a) Did not advise that § 303 redemption involves dividend treatment (for E & P at time stock was issued)
  (b) Did not advise § 303 does not eliminate capital gain on amounts not treated as dividend
 (3) Estate now unable to meet cash requirements (possible dividend treatment and certain capital gains taxes)
B. Rewrote will instead of doing codicil
 (1) Generation-skipping tax unnecessarily attracted
 (2) If brain-damaged grandchild survives wife and children, no grandchild exclusion.
C. Did not counsel client concerning lack of liquidity
D. Did not counsel client concerning qualified plan conflict
E. Did not counsel client on "in cash or in kind" conflict

OUTLINE OF STATEMENT OF JOSEPH KARTIGANER BEFORE THE SENATE COMMITTEE ON FINANCE

I. Speak as an individual
II. Focus on:
 A. Inducements to do the nonsensical
  1. Qualified joint property
  2. Marital gifts in excess of $100,000
 B. Tax traps for the unwary arising from unnecessary complexity or retroactivity
  1. Transitional rules for generation-skipping transfers
  2. Retroactivity
   (a) Carry-over basis and sections 303 and 306
   (b) "Byrum amendment"
  3. Gift-splitting and contemplation of death
  1. Unification and record-searching problem
 C. Undue "perfection"
  1. Unification and record-searching problem
  2. Transfers in contemplation of death and the technical corrections bill
 D. Conflicts among beneficiaries
  1. Carryover basis
  2. Inclusion in estate
   (a) Contemplation of death
   (b) Transfers with retained life interests
   (a) Contemplation of death
   (c) Qualified plan benefits
 E. Lack of conformity with State laws in the area of disclaimers
III. Suggestions for change
 A. Unification
 B. "Anti-Byrum"
 C. Qualified plans
 D. "Orphan's exclusion"
 E. Generation-skipping tax transitional rules
 F. Disclaimers
 G. Carry-over basis

Senator BYRD. The committee will stand in adjounment.

[Thereupon, at 11:35 a.m., the subcommittee was adjourned.]

APPENDIX

COMMUNICATIONS RECEIVED BY THE COMMITTEE EXPRESSING AN INTEREST IN THIS HEARING

M. D. ALLISON, ATTORNEY AT LAW,
Rockford, Iowa, August 5, 1977.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
Dirksen Senate Office Building,
Washington, D.C.

DEAR SIR: As a part of the Iowa State Bar Association continuing legal education program I have attended three different programs at which the Tax Reform Act of 1976 was the topic of discussion by experts in that field. While I consider myself a lawyer of at least average ability I must confess that I am very much confused by the provisions of the tax act as the same involve the "carry-over-basis rule".

During the breaks and at the conclusion of these meetings there were discussions among those attending, all of whom were practicing attorneys and it is my impression that the application of the "carry-over-basis rule" is not at all understood by the majority of the members of the Bar.

I believe that it will be impossible for the Internal Revenue Service to administer this provision and there will be an excessively large number of persons who are engaged in working with the provisions of this rule subject to penalties for indavertent errors and mistakes in attempting to apply the same.

From my own experience I do not see how, in a great many cases, the information necessary in order to apply the rule can be obtained. The additional paper work, complex calculations and records required by this rule pose a nightmare to the average practicing attorney. Even an estate of modest size, and in particular a farm estate involving livestock, grain and a full line of machinery, will require untold hours of additional work in order to obtain, record and calculate all of the various computations necessary in order to determine basis for the purpose of gain and loss for the heirs and the estate. This will undoubtedly greatly increase the cost of probate.

I seriously doubt if the general public will be able to comprehend the provisions of the "carry-over-basis rule" and therefore will not be able to accumulate and record the information which will be necessary to apply the same in their estates.

I therefore urge in the strongest possible terms that the "carry-over-basis rules" be retroactively repealed. When a majority of the persons who will be directly responsible for preparing the calculations and returns involving the application of the rule, throw up their hands in despair due to the complexity of the problems created by the rule and all of its ramifications then something is drastically wrong and requires correction.

Yours very truly,

M. D. ALLISON.

STATEMENT OF HAROLD T. BECKMAN, OF SMITH, PETERSON, BECKMAN & WILSON—TESTIMONY REGARDING TECHNICAL AMENDMENTS

The following testimony is offered to assist the Congress in weighing the practical effects of the Tax Reform Act of 1976 which has created an unconscionable burden on the citizenry, an impossible burden on executors and administrators of estates and their attorneys, and an impossible enforcement duty upon the Internal Revenue Service.

95-026—77——9

The witness has now attended five different schools of continuing legal education in an effort to learn the methods of compliance with the provisions complained of, discussed the subject matter with attorneys for the Estates and Trusts Division of the Internal Revenue Service, and read the Tax Services and Periodicals subscribed to by his law firm and finds the experts stumped as to how to effect compliance with the law as written. In their puzzlement, the witness had heard many experienced practitioners threaten to abandon this portion of their practice rather than submit themselves to possible malpractice charges and the penalties imposed by the law for errors that may be made.

The Iowa State Bar Association has annually conducted a Tax School longer than any other state bar association in the United States and has been credited with developing the greatest percentage of practicing lawyers capable of assisting taxpayers file accurate tax returns—thus making the lawyers of this State one of the better arms of the Internal Revenue Service for collection of Revenue for the United States Government. In the opinion of the witness, unless the areas of taxation herein complained of are corrected there is extreme danger that it can lead to a destruction of will on the part of taxpayers and their advisers to carry out their devotion to compliance with the maze of law that now constitutes the Internal Revenue Code. The cost of compliance through the assistance of professional tax advisers will create an unconscionable burden on the citizenry; cost of enforcement will create an impossible burden to the net revenues for the United States Government; and the net result will be completely negative to all concerned.

With more specificity, I offer the following for consideration by the Committee on Finance and the Congress:

I. WITH REGARD TO THE "CARRY-OVER-BASIS RULE":

Under the prior Act it was possible for taxpayers to determine their basis of property for capital gains purposes and for estate tax purposes with a reasonable effort. In reliance on the provisions of the Internal Revenue Code clients were advised in the matter of record keeping as to the limited number of documents that they must keep, including their check records and invoices on property acquired. Iowa has a ten-year Statute of Limitations on written contracts. The Statute of Limitations under the Internal Revenue Code fell within the State Statute of Limitations.

The fact that a new basis would be acquired as to all property of which a person was the owner at the time of his death made it unnecessary to keep records with regard to the cost of acquisition of assets that would with certainty be retained until death. As a result many taxpayers have destroyed records that now would be necessary in order to assist them in establishing the cost basis of many items of property. It will be utterly impossible for them to comply with the current provisions of the law other than by utilization of an educated guess. Unless the law is changed executors and administrators of estates will be exposed to extreme liability as they will be unabe to furnish beneficiaries of estates with accurate basis information and in the event the beneficiaries at any time become involved with the Internal Revenue Service by inability to clearly establish their cost basis on property for either depreciation or capital gains purposes the executors and administrators of estates could become subjected to litigation. In the alternative, if executors and administrators fail to supply the basis they will be subjected to penalties with the Internal Revenue Service. At the present time, in an effort to make the maximum amount available for distribution in estates, the surviving spouse or a child of the testator is named as executor and such executor serves without compensation. With a burden imposed upon them with regard to furnishing basis to beneficiaries, the only safe procedure for the testator to follow is to name a corporate fiduciary and impose this burden on the corporate fiduciary. The net result will be to deprive his intended beneficiaries of a substantial amount of money that will have to be paid to corporate fiduciaries for serving as executors.

In fact, we are certain that many banks and trust departments currently serving as corporate fiduciaries may well get out of the business due to the additional burdens imposed upon them unless the statutory fees or court allowed compensation is increased substantially to cover the additional risk that they will have to undertake by serving in such capacity. In our smaller communities the banks and trust companies are not sufficiently staffed to carry out these additional burdens and the net result would be to force the administration into the hands of the

larger banks and trust companies far removed from the situs of the decedent and his estate.

II. REGARDING GIFT-IN-CONTEMPLATION-OF-DEATH RULE

Prior to the adoption of the Tax Reform Act of 1976 gifts made within three years prior to death were presumed to be made in contemplation of death. However, in many instances gifts were made by persons who were in excellent health with a life time motive of seeing their children provided for through education and in other manners. If the donor of such gift met an untimely death as a result of accident or disease unknown at the time of making the gift, the executor could sustain its burden of proof that the gift was not made in contemplation of death, thus preserving for the prematurely deprived widow and children the use of funds that would otherwise have to be paid for federal estate taxes. Under the Tax Reform Act of 1976 there is no way to preserve for the prematurely deprived family such funds which, in our current inflationary economic society, could be direly needed to provide for the surviving spouse and family. The net effect of the TRA of 1976 is to limit lifetime motives for giving solely to the rich. Children or spouses of the middle class are sorely handicapped by these provisions. It appears that by good and sufficient amendment to the TRA this depravation could be restored without opening up the Pandora's box of abuse and advantage which some have taken of the prior act. Possibly an age limitation of 65 years or so before application of the harsh new rule would be a solution. I can see no need for the harshness of the act as presently drafted. A further method might be a specification of accidental death or death from a limited number of causes known to be non-ascertainable within three years prior to death.

III. DIFFICULTIES ENCOUNTERED BY FARMERS AND SMALL BUSINESSMEN

We have not had an opportunity to experience the great number of difficulties that farmers and small businessmen will sustain as a result of the new act. However, some have already become evident. For Example:

(1) I have had a situation where a widow residing in Nebraska was the owner of Iowa land. Her only relative is a niece who lives in Florida. A few years ago, the niece enticed her aunt to convey her Iowa farm to the niece, reserve a life estate therein and pay the gift tax then imposed thereon which at that time was not a great amount of money as Iowa farm land then had a much lower value. The farm has been farmed for 20 years by a tenant who has served the widow and her later husband well. The widow desires to sell the farm to the tenant but on examination of the title it was disclosed that this was not her sole right so to do. The niece does not desire to sell the farm. On her aunt's insistance that the aunt be authorized to make the sale, the niece consulted her Florida attorney and was advised that if she surrendered her remainder interest in the land to her aunt she would have to pay gift tax thereon and advised her that the tax would run approximately $30,000.00. The aunt advised that she would be willing to pay the $30,000.00 in order to be able to carry out her wish. However, on being advised of the aunt's willingness to pay the gift tax in such amount the niece again consulted her Florida attorney and was advised that as a result of the combined gift and estate tax the niece really would not know until her death what her exact tax would be; that due to the fact that her husband had a substantial estate of his own and that in his estate planning he was leaving a substantial portion of his estate to the niece, the Florida attorney could not even estimate what the total tax would ultimately be if she reconveyed the property to her aunt.

The aunt is faced with the possibility of having to sue her niece in an effort to set aside the deed to the remainder interest on the basis that the deed was obtained by fraud, duress and undue influence since the niece did show a profound interest in the aunt until she succeeded in obtaining the deed but has neglected her woefully since that time. The aunt does not cherish the idea of disgracing her niece, but the harsh results of the combined gift and estate tax may force her to do so if she insists in seeing that the tenant farmer becomes the owner of the land that he has worked for so many years for the benefit of the aunt and her late husband. In my nearly 30 years in the law practice I have often found landlords desirous of selling their land to their tenants rather than having it sold and disposed of by their executor or heirs solely to the highest bidder or risking the chance that an absentee beneficiary far removed from the land becomes the owner thereof and insists on holding the land for speculative purpose.

I am sure that many more instances of contravening excellent motives on the part of owners of property benefited by long years of service of tenants and employees will develop if we are forced to live under the combined method of taxation. Off hand, it appears that if the two tax rates were equalized rather than combined the loss of revenues that arose under the prior law could be avoided. However, I saw nothing wrong with the prior law which had the incentive of placing productive property in the hands of younger, more efficient producers, thus increasing income tax revenue.

(2) The record keeping requirements under the TRA are mind-boggling for the farmer and small businessman. At a time when they have finally become experienced in the matter of record keeping under the prior act many of the rules of record keeping have been changed in such a manner that the farmer and small businessman is faced with a possibility of becoming a full-time bookkeeper or undertaking a substantial overhead that immeasurably adds to their risk of doing business, the net result of which will be to discourage many persons from entering business and speed the increase of a class society in our country. I am certain that most of our congressmen and senators, if they but reflect on their own experiences in life and the life of their families, will recognize the contribution that small businessmen and farmers have made to our system of government and the standard of living which we all now enjoy. To relegate families of low and moderate income to a life of servitude as tenants and employees is not only detrimental to the individual but to our nation.

To force an individual taxpayer into using guess-work in seeking basis for property will encourage individuals to believe that similar guess-work is sufficient for other tax paying purposes. A method of taxation that breaks down the morality of the taxpayers can reduce our nation to a nation of law-breakers and law-enforcers with no room for the honest and enterprising, the basic fiber upon which our nation has been built. While these elements may appear frothy and intangible, those of us who live among the people and work toward maintaining the moral fiber of our nation know how important the elements of honesty and enterprise are to a free society.

The creation of a web of laws that no individual can escape will speed the process of killing off individual initiative, imagination, and honesty to a degree that even the most devoted bureaucrat cannot imagine.

* * * * * * *

Lest the committee surmise that I am a hide-bound conservative and/or a rich attorney, I hurriedly point out that I am neither.

With regard to the former, I am accused by many of my Republican friends as being too progressive to be a member of their party. I recognize the wisdom of many actions that have been taken by our Congress as necessary to protect the masses against voracious elements in our society who make money their god. However, I also recognize that too stringent government controls can kill off the productive elements in our society. Maintaining the vital balance is a never-ending chore. Were America not a land of opportunity, I, as one of three sons of a farmer struggling under a huge debt during the drought and depression of the 1930's, would not have had the opportunity to become a lawyer and serve my fellow man as envisioned by me as a youthful idolator of Abraham Lincoln. As with many of my contemporaries, seven years of college without a penny from home and service to our country during World War II did not seem like a burdensome undertaking but a privilege in a land of freedom and opportunity.

With regard to the latter, I am proud of the success that I have enjoyed as a member of my profession. I have lived in the Holmesian philosophy that "Good lawyers work hard, live well and very frequently die poor." In my efforts to serve my clients, I have too often neglected making prudent and wise investments even when urged to do so by my friends. My security is in my family and the God-given ability to work long hours. I am not poor—but I am not rich in the material goods and money measured in light of today's standards and value of a dollar. Should my God-given abilities last long enough I hope to leave my wife secure as a result of the sacrifices that she has made by enduring me for a great number of years. In this regard I am not unlike many of my fellow practitioners of law in the State of Iowa.

I am extremely hopeful that a thoughtful Congress will maintain the vital balance hereinabove referred to so that my children and their children will enjoy the same opportunities to live a life of freedom and opportunity in the greatest nation on earth.

KELLY & MORRISSEY, ATTORNEYS AT LAW,
Fairfield, Iowa, August 8, 1977.

Hon. JOHN C. CULVER,
U.S. Senator, Senate Office Building,
Washington, D.C.

DEAR SENATOR CULVER: I wanted to write you a letter stating our law firm's disagreement with present workability of "carry-over basis rule" as it is presently constituted by the Tax Reform Act of 1976. At the time Congress adopted the Tax Reform Act of 1976, it was my understanding that the reason for change was to make our tax laws easier to understand and simpler for tax practitioners to apply. By this standard alone the act has failed. I would hazard to estimate that very few lawyers, let alone taxpayers, completely understand the 1976 Tax Reform Act.

The "carry-over basis rule" is impossible in actual practice. I am sure that in many situations the decedent is the only person who could supply the information necessary to comply with the rules. Additionally, there is a limit to the recordkeeping which can logically be expected by the taxpayer or his attorney. The Tax Reform Act of 1976 imposes unreasonable demands upon the taxpayer to keep such records if the "carry-over basis rule" is to have any value.

It is my understanding that a proposal to reconsider some of the more burdensome aspects of the Tax Reform Act of 1976 is presently before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee. It is our hope that "carry-over basis" provisions of the new act will be retroactively stricken.

We will appreciate your assistance to the farmers and small businessmen of Iowa who will be benefitted by change in the presently enacted law.

Kindest regards,

EDWIN F. KELLY, Jr.,
Attorney at Law.

H. W. WALTER, ATTORNEY AT LAW,
Council Bluffs, Iowa, August 8, 1977.

Re Tax Reform Act of 1976.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
Dirksen Senate Office Building,
Washington, D.C.

DEAR SIR: I understand that there is currently being taken before the Committee testimony with regard to the so called "carry-over-basis rule."

Let me voice my opposition to this "reform" as an attorney in that it is unworkable and burdensome for both I.R.S. and the family and attorney involved. Any supposed relief for the family is in many cases merely postponement of the payment of tax and the attendant recordkeeping involves many hazards. There is also the constant problem that the deceased may be the only person who had the knowledge of the basis.

I urge the committee to seriously consider a return to the "stepped-up basis." There seems to be a general consensus that the area of taxation is one where simplification should be the goal. The new "carry-over-basis rule" is a step in the wrong direction.

Sincerely,

MICHAEL A. SCIORTINO.

NORTHWOOD, IOWA, *August 4, 1977.*

Re Senate Finance Committee hearings on carry-over basis rule in tax reform act of 1976.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
Dirksen Office Building,
Washington, D.C.

DEAR MR. STERN: I would like to offer a comment on the effect of this carry-over-basis rule as affecting the small taxpayers. It was my understanding that the tax reform act was enacted to give tax relief to the small businessman and farmer. Basically I deal with farmers and handle a certain amount of work with

farm type of estates. It goes without question in reviewing these carry-over-basis rules that they cannot be administered effectively by the Internal Revenue Service and in many instances the person who could supply the information necessary to comply will be deceased. The average taxpayer is not going to be able to understand the effect that this Act is going to have on them.

If you were to take the example of an average widow who inherits a typical farm estate of $120,000.00, which is not a great estate by any means, the net effect of this new act is to increase her taxes, complicate her record keeping, and there is no question that she is in a worse situation than when the old law applied.

I would urge the Senate to adopt the previous "carry-over-basis rule" which is more fair, and something that the very average client and taxpayer that I come in contact with daily can understand and live with.

Very truly yours,

JOHN H. GREVE,
Attorney at Law.

ALTA CHAMBER OF COMMERCE,
Alta, Iowa, August 8, 1977.

Re Written testimony as to changing the Tax Reform Act.

Mr. MICHAEL STERN,
Washington, D.C.

DEAR MR. STERN: We are a farming community, and our farmers were asking their government to change the Estate Taxes to allow higher exemptions and that farmers should have their lands in an estate valued at what they produce, not a value based on what they might get if the farms were sold. This was done in the new law, which pleased the farmers, but they did not like the idea that their property should get a new basis for income tax purposes and they desire you to help repeal that part of the new laws. They feel that whatever value they have to use for estate taxes, the same value should also be used as a tax basis for other taxes, such as income taxes, and that it is too confusing to expect them to have a different basis, or more than one basis, or to keep special books or records, for different tax purposes.

Thank you for any assistance you make in getting this part changed.

Sincerely,

THOMAS S. PETERSON,
Secretary, Alta Chamber of Commerce.

DIEHL, DIEHL & HAYNES,
Albert City, Iowa, August 9, 1977.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
Dirksen Senate Office Building,
Washington, D.C.

DEAR MR. STERN: I am writing in regard to the committee hearings on the "carryover basis" problems created by the Tax Reform Act of 1976. I understand that consideration is being given to retroactive repeal of this portion of the new federal estate tax law.

I am a small town lawyer specializing in probate and tax law. I am a member of the Probate and Trust Committee of the Iowa State Bar Association. I deal with this new law every day. I don't believe you really understand the difficulties created by this carryover basis requirement. I have a number of matters pending in my office now where the principal asset of each of these estates is a modest home which goes to the surviving spouse. In the past we have handled such estate in the "short form" way with a minimum of time and at a relatively small charge to the beneficiaries. Now I have informed each surviving spouse of the necessity of searching for records as to the cost of the home and the cost and date of purchase of each improvement. We have delayed filing any kind of a report of this carryover basis because no regulations or forms have been prepared by Internal Revenue Service. I have heard that IRS personnel has not been able to agree on regulations and forms. Meanwhile small probate matters which should have been completed six months ago are still pending in my office while we await forms.

If you can realize that it is difficult to find the information needed to compute the carryover basis in small estates, then you must realize that it is nearly

impossible (unless one has access to a computer) to determine the carryover basis for each item in a large estate. Consider the ordinary situation where the decedent owned a herd of dairy or stock cows, with each animal having been purchased or born on a different date. Or consider the case of a lawyer or political office holder or business man with an office filled with books and furniture, each item having been purchased at a different cost on a different date. If you would suddenly pass away, would the executor of your estate be able to furnish the attorney with the information required by the new federal law? I can't believe that any tax bill designed to simplify the tax structure could contain such a difficult and impractical procedure. For the sophisticated corporate tycoon, there may not be so much of a problem because the principal assets in his estate will be stocks and bonds. But for the small unincorporated business man and his lawyer, this law imposes very difficult requirement.

I ask that you eliminate the carryover basis provision of the 1976 Tax Reform Act and restore the "stepped up" basis provisions of the old tax law.

Yours very truly,

DIEHL, DIEHL & HAYNES,
MARY ANN DIEHL.

DIEHL, DIEHL & HAYNES, LAWYERS,
Albert City, Iowa, August 25, 1977.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: I wish to voice my objections to the "carryover basis rule" contained in the Tax Reform Act of 1976. This provision is particularly onerous when applied to farmers and small businessmen.

As a lawyer practicing in a small Iowa town and dealing primarily with estates of farmers and retired farmers, I am appalled at the long-range ramifications of the "carryover-basis rule." In many situations, it will be totally impossible to accurately determine the carryover basis because the necessary information just will not be available, especially with regard to livestock and machinery. In many cases, the Executor of an estate will not know or have any way of finding out when a particular cow or pig was purchased or born, let alone the cost of the animal.

Even if today's farmer begins keeping such accurate records, each will need at least an extra room on his house to keep his records. Lawyers who handle a large amount of probate and tax work in farming communities will need a computer bank in which to store information.

Or consider the widow who has only household goods and a car, all in joint tenancy. At her husband's death, she does not contact a lawyer. She may be liable for penalties up to $7,500.00 for failure to notify the Secretary and herself of the carryover basis information.

The carryover basis provision seems to be another shining example of the simplification of our tax laws. I urge repeal of this section of the 1976 Tax Reform Act retroactively.

Sincerely,

MARJORIE HAYNES.

COMMENTS RELATING TO CHANGES AFFECTING "SECTION 306" STOCK BY BYRLE M. ABBIN, ARTHUR ANDERSON & CO., CHICAGO, ILL.

INTRODUCTION

In H.R. 6715, a bill was introduced in the House of Representatives "to correct technical and clerical mistakes in the tax laws" under the entitlement, "Technical Corrections Act of 1977." Within that bill, as Section 3, are amendments under the description "Technical, Clerical, and Conforming Amendments to Estate and Gift Provisions."

A most substantive amendment has been proposed that would eliminate qualification of Section 306 stock from the special redemption provisions of Section 303. This change would remove capital gain treatment and thus would present untoward liquidity problems for estates composed of significant amounts of Section 306 stock representing an interest in a family business. The additional tax burden, apparently not mitigated in most situations by an amendment provid-

ing a "fresh-start" adjustment to basis of Section 306 stock, would result in the forced sale of many family owned businesses.

This dire result would be caused by Tax Correction Bill of 1977, Section 3(a)(2), that is headed "Clarification that Section 306 Cannot be Used for Section 303 Purposes." Under it, Subsection (b) of Section 303 is to be amended by adding a new paragraph (5) stating, "Subsection (a) shall not apply to any distribution in redemption of Section 306 stock. The preceding sentence shall not apply to new stock which meets the requirements of paragraphs (1), (2) and (3) of Subsection (c) if the old stock was not Section 306 stock." The effective date is to estates of decedents dying after December 31, 1976. The other proposed change related to the treatment of Section 306 stock, Section 306(a) is to be amended by allowing an adjustment in the amount realized for December 31, 1976, fair market value. (Sec. 3(a)(1) of the Technical Corrections Bill of 1977.)

After a review of the history of Sections 303 and 306, it is concluded that there is no policy reason either before the passage of the 1976 Tax Reform Act or as a result thereof that provides the rationale for a difference in the treatment of Section 306 stock under Section 303, the provision that considers the special liquidity needs of closely held business interests, than that applicable to other preferred stock and common stock owned by comparable shareholders. Moreover, there is nothing in the legislative history of the 1976 Tax Reform Act that justifies the adoption of this momentus policy decision as a mere clarification of a technical, clerical or conforming nature. Section 303 has been and should continue to be controlling in all situations where there may be a conflict with other Internal Revenue Code provisions such as Sections 301, 302, and 306.

Because of its vast impact on literally thousands of taxpayers who have relied on the previous qualification of any type of stock for the Section 303 relief provisions (provided the percentage tests were met), fairness demands that such a significant change in law must be accomplished prospectively only and then based upon a clear understanding by the members of the House Ways and Means Committee and the Senate Finance Committee of the impact it will have on the owners of closely held business interests, farms, etc.

Section 306

The Internal Revenue Code of 1954 attacked frontally the preferred stock "bail out" benefits under the prior law, as exemplified in the *Chamberlain* case,[1] by establishing an elaborate set of rules providing that a sale or other disposition of Section 306 stock will produce ordinary income rather than capital gains (as noted below, a few exceptions to the stringent rules were provided). Thus, the provision was directed at closing a specific tax loophole—i.e., the conversion of potential ordinary dividend income into preferentially treated capital gains (often without substantial dilution of a shareholder's equity investment or control of the corporation).

Under Section 306(a)(2), an amount received by a shareholder from a corporation upon redemption of Section 306 stock shall be treated as a Section 301 distribution and taxable as a dividend to the extent of the corporation's earnings and profits *at the time of redemption*. If the distribution is in excess of such earnings and profits, the balance will be a return of capital to the extent of basis, and capital gains thereafter. On the other hand, if the Section 306 stock is sold or otherwise disposed of to a third party, ordinary dividend income will be realized to the extent that the proceeds would have been a dividend at *the time of the original distribution of the Section 306 stock*, if cash had been distributed in lieu of stock. Again, the balance will be first applied against the basis, with any excess being treated as capital gain. Thus, the date for determining the amount of earnings and profits resulting in dividend treatment differs between a redemption by the corporation and a sale to a third party.

Among the limited exceptions to the harsh rules of Section 306(a) is a complete termination of the shareholder's interest in the corporation. The apparent simplicity of this approach is often frustrated, or made impractical, because of the constructive ownership rules of Section 318(a), since most often Section 306 stock arises in a context of closely held, family corporations. It is most difficult, if not impossible, to avoid application of the attribution rules in this situation, since shares owned by other family members, trusts, etc., are deemed owned by the shareholder or his estate.

[1] 207 F 2d 462, CA–6 (1953), cert. den., 347 US 918 (1954). See also Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders, 10–1—10–14.

The limited waiver of family attribution is problematical as it applies to an estate, the entity most likely to desire a redemption by the corporation,[2] because of the requirement and time deadlines for making payment of the death duties and expenses of the decedent's estate, as well as the fact that few executors would make distributions to heirs prior to settlement of such obligation or effecting the requisite redemptions. Many are precluded by state law from so doing. Even though the heirs theoretically could have their stock redeemed without the same attribution of ownership problem, practically this cannot be accomplished.

Two other exceptions are of limited significance, i.e., the redemption in partial or complete liquidation under Section 306(b)(4). In context, it should be noted that the regulations refer to an isolated redemption of Section 306 stock by a minority shareholder as an example of a redemption qualifying for the "(b)(4)" exception. Regs. Sec. 1.306–2(b)(3). It should also be noted that his exception under Section 306(b)(4) is limited to transactions that in the opinion of the Treasury are not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax. Based on the experience of most practitioners, the likelihood of obtaining such clearance in advance is uncertain.[3] Additionally, there is substantial concern in arranging long-range family tax and estate plans when there is doubt about obtaining such Treasury clearance in advance and no safe harbor approach, such as Section 303, exists.

It should be recognized that for many years substantial use has been made of Section 306 stock as a tax planning device for owners of closely held family type businesses, either through a preferred stock recapitalization or a preferred stock dividend. The latter has been used frequently in many areas of the country because of simplicity from both a tax and legal point of view. The rationale is very simple: the need to provide for continuity of ownership, security for the elderly shareholder, incentive to the new and younger management (whether family members or outsiders), retention of a stock that is more easily valued, i.e., preferred versus common, are many of the reasons dictating use of Section 306 stock. Shareholders had the security that no untoward results would be occasioned by having created Section 306 stock, since the step-up in basis applicable to assets included in an estate would expunge the "Section 306 taint" under the law as it existed prior to the passage of the Tax Reform Act of 1976. Additionally, it should be noted that very few in the family corporation situation ever considered creation of Section 306 stock as a means for bailing out earnings at capital gains rates. This was the sophisticated tool for the shareholder of a listed corporation or a very large unlisted company. Since preferred stock of small, family owned enterprises realistically is not marketable (except to the corporation itself in a redemption) and as typical family corporations do not have the funds to redeem shares (and often little borrowing capacity, as well), the loophole was adequately closed by the Internal Revenue Code of 1954 in the passage of Section 306, as well as the tightening of Section 303 by the 1976 Tax Reform Act.

Section 303

Section 303 has a simple purpose and the statutory intent would appear to be clear. It was enacted as a relief measure to avoid ordinary dividend income treatment for the limited, if not isolated, one-time post-mortem distribution by a corporation that otherwise would be taxable as a dividend under Section 301. *Cf.* House Report No. 2319, 81st Cong., 2nd Session 1950 (reprinted 1950–2 CB 380, 427–8), reproduced in part below:

"(E) DISTRIBUTIONS IN AID OF DECEDENTS' ESTATES

"It has been brought to the attention of your committee that the problem of financing the estate tax is acute in the case of estates consisting largely of shares in a family corporation. The market for such shares is usually very limited, and it is frequently difficult, if not impossible, to dispose of a minority interest. If, therefore, the estate tax cannot be financed through the sale of the other assets in the estate, the executors will be forced to dispose of the family business. In

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[2] Crawford, 59 TC 830 (1973), nonacq. 1974–2 CB 5; Rickey, 77–1 USTC 9275 (DC La.).

[3] Rev. Proc. 72–9, 1972–1 C.B. 718, Sec. 4.01, states that rulings will not "ordinarily" be issued with respect to the applicability of Section 306(b)(4) to stock of a closely held corporation.

many cases the result will be the absorption of a family enterprise by larger competitors, thus tending to accentuate the degree of concentration of industry in this country.

"Two potential avenues of relief are available under existing law and regulations, but neither provides a truly satisfactory remedy, Section 822(a) of the Internal Revenue Code permits the Commissioner of Internal Revenue to extend the time for payment of the estate tax in cases of undue hardship for a period not in excess of 10 years.

"The other possible remedy exists because of a regulation which sets up an exception to the rule that the funds paid out through the redemption of the outstanding securities of a corporation out of accummulated earnings will be taxable as a dividend to the recipient. The regulation in question (Regulation 111, section 29.115-9) states that—

"A cancellation or redemption by a corporation of all of the stock of a particular shareholder, so that the shareholder ceases to be interested in the affairs of the corporation, does not effect a distribution of a taxable dividend.'

"While this regulation provides much needed relief in certain cases, it does not constitute a satisfactory remedy for the problem at issue here, since in order to qualify under the regulation the estate must dispose of its entire holdings in the family business. In most cases this will be tantamount to the withdrawal of the family from the business.

"Your committee is of the opinion that remedial action is desirable in order to prevent the enforced sale of the family businesses which are so vital and desirable an element in our system of free private enterprise. Therefore, section 20S of your committee's bill amends section 115(g) of the Internal Revenue Code so as to remove from the category of a taxable dividend payments made under certain carefully restricted circumstances in the redemption by the issuing corporation of a portion of its stock held by a decedent's estate.

"This statutory extension of the principle contained in the existing income tax regulations will provide an effective method of financing the payment of the tax when an estate consists primarly of stock in a closely held business, thus eliminating, in most cases, the need for disposing of the family's interest in the business. On the other hand the circumstances under which such relief is available are narrowly defined and will restrict relief to situations in which true hardship exists.

"The revenue loss resulting from bill will be small."

Obviously, Section 303 was intended to be paramount to all other Code provisions. Thus, this exception under Section 303 to dividend treatment on redemptions applies equally to shareholders with solely common stock as well as those who might have preferred stock, whether or not the preferred is subject to the "Section 306 taint." Upon the death of a shareholder of a closely held family type business, often Section 303 has been the only route available to provide for death tax liquidity needs. Although the installment payment rules under Section 6166 (now Sections 6166 and 6166A, based on the Tax Reform Act of 1976) have been provided to meet these needs, often the installments can only be paid through the net proceeds, after tax, of dividend distributions, or by effecting a redemption from the family company. As noted above, this may also result in dividend treatment unless their is a complete termination of interest in the corporation, provided the shares owned by others are not deemed owned by an estate under the attribution rules. Moreover, seldom is bank financing available for the death tax obligation and, if available, it is, as best, only a temporary solution.

Since redemptions typically closely follow the date of death, prior to 1977 they ordinarily resulted in no tax at all to the estate, since the step-up in basis equaled the redemption proceeds. On the other hand, if the distribution is treated as a dividend, the entire amount is ordinary income, since basis is not recognized in determining the amount of the dividend, but in essence disappears for that computational purpose (see Sections 301(c) and 316(a)).

Because of the bunching effect, if the proceeds of a redemption were treated as an ordinary dividend, very easily 60 to 70 percent of the proceeds would be taken in income tax with only the net 30 to 40 percent being available to pay the death tax liability and administration expenses. In fact, in high state tax areas, such as New York, the total income tax liability (U.S., state and city) can approach 90 percent.

Simplistically, if $200,000 were required for the death tax and administration expense requirements, and the effective overall income tax rate were 60

percent, it would take $500,000 (resulting in income tax of $300,000) to net the $200,000 of transfer tax requirements. The limited relief made available by Section 303 for those estates that are comprised primarily of a family business is necessary to avoid the dissipation of a family business built up over substantial years. As can be seen from Appendix A, the proposed changes have a significant impact on an estate of even $500,000, half of which is made up of Section 306 stock. Once an estate rises above $1,000,000 in value, assuming Section 303 tests could otherwise have been met with Section 306 stock, the entire amount of a family business interest will be dissipated in the first estate to pay for death duties and income tax resulting from the redemption to provide for such liquidity needs, even when a maximum marital deduction has been provided. Without a marital deduction, the entire Section 306 interest will be consumed even in an estate of $500,000.

Section 1023(h)—Carryover in basis

As part of the Tax Reform Act of 1976, the automatic step-up in basis rules were eliminated and, in lieu thereof, a carryover in basis approach, comparable to that in effect for lifetime gifts, was substituted. In the process of determining this new complex statutory change, a number of commentators have queried whether the "fresh-start" basis, and any other adjustment for that matter under the new carryover basis rules would apply to Section 306 stock.[4] However, no one considered that the new statutory framework for carryover in basis would result in the treatment of Section 306 stock in any different context than that of regular preferred stock or common stock with respect to the redemption rules under Section 303.

Section 3(a)(1) of the Technical Corrections Bill of 1977 would amend Section 306 by providing an increase to basis for the amount realized for the December 31, 1976 fair market value "fresh-start" adjustment. In fact, this basis adjustment, with respect to Section 306 stock that was distributed before January 1, 1977, may be illusory and of no consequence in most cases. This is based on an interpretation that the only time it would have significance is when the shareholder of Section 306 stock made a sale to an unrelated third party or had the corporation redeem his entire interest in the Section 306 stock (and other stock owned in the corporation, if any). Another possible interpretation is that the amount realized is reduced by basis, including "fresh-start" adjustment, for purposes of Section 301(c) as well as Section 306.

As noted above above, especially with respect to redemptions, the inability of a shareholder to do so without ordinary income resulting in typical in most Section 306 situations because of the attribution rules under Section 318 and the inability of an estate to avoid their impact even if all the shares it owns directly are redeemed. Moreover, the desire for continuity of ownership in the family company would be frustrated—contrary to the policy expressed in 1950 by Congress and reaffirmed in numerous sections of the Tax Reform Act of 1976.

If it is to be clear that the objective of Section 3(a)(1) is to be achieved by providing basis for the amount for the "fresh-start" adjustment as of December 31, 1976, it would appear necessary not only to provide this amendment to Section 306(a), but also to Section 301. The basis adjustment provided by the proposed amendment of Section 306 may be of little significance, since it seems meaningful only if the disposition is categorized as a sale. Thus the buyer must be someone other than the issuing corporation or a family member. In spite of the amendment to Section 306(a) by Section 3(a)(1) of the Tax Corrections Bill of 1977, distributions by corporations are still controlled by Section 301. The "fresh-start" basis adjustment would be more assured in redemptions only if Section 301(c) is also amended in a manner consistent with Section 306(a). Otherwise there is a possibility that the basis attributable to the preferred stock may be ignored and thus "lost" in the determination of the dividend income from the redemption.

The basis "lost" transfers to other stock, if any, owned by the redeeming shareholders. Regs. Sec. 1.306-1(b)(2), ex. 2 and 3. This provides only partial mitigation, since at best it will reduce capital gains of any remaining stock upon subsequent sale. At the worst, it will generate a capital loss of doubtful benefits in many cases. In fact, the "fresh-start" adjustment will have less significance as time takes its toll. Presumably the value of the preferred stock

[4] Cf. Newman and Kalder, Post-Mortem Stock Redemption Problems, 46 Journal of Taxation, 226 (April 1977); Abbin, Carryover Basis—Opening Pandora's Box, 116 Trusts and Estates 154 (1977).

will not vary greatly over the years, but the formula under Section 1023(h) will result in a diminishing "fresh-start" adjustment the longer the stock is held beyond December 31, 1976. If Section 303 applies, capital gains will be created for the difference. Without it, the difference will be ordinary income.

It is difficult to discern any Congressional intent to narrow its long standing policy of aiding family businesses' estate liquidity needs. In fact, the Tax Reform Act of 1976 provided additional liberalizations (except for the percentage tests and who is an allowable redeeming shareholder under Section 303). The only suggestion to be found is in the Conference Committee Report, that makes reference to the interrelationship of the "fresh-start" rules with respect to the transactions resulting in gain where all or part thereof would be treated as ordinary income.

It should be noted that with reference to Sections 1245, 1250 and comparable sections, taxpayers have realized prior tax reduction and these rules are effective merely to recoup such prior tax benefit. This is to be contrasted with Section 306 stock rules that are based on a statutory policy that ordinary income taxation may result, depending on the nature of the disposition, i.e., redemption or sale of part of the interest. However, where Section 306 stock is concerned, there has not been any prior tax benefit obtained through deduction or otherwise. Moreover, it is difficult to perceive why this brief reference by the Conference Committee with respect to regulations indicates a Congressional policy that Section 306 stock should no longer obtain the same safe harbor nondividend treatment on redemption under Section 303 that is available to other forms of stock interests, i.e., common stock and nontainted preferred stock. This intent is not evident from the words of the statute or any prior discussion in hearings that preceded the passage of the 1976 Tax Reform Act. As mentioned above, the bail out results are the same irrespective of the nature and type of stock interest. It is clear from the Congressional policy expressed in enacting the predecessor to this section in 1950 that the isolated redemption to obtain funds for estate liquidity purposes was to be provided special treatment. There appears to be no reason why this special relief for the family business should not be continued in spite of the enactment of carryover basis provisions. There is nothing inconsistent with these approaches existing concurrently.

Technical corrections bill of 1977—interrelationship of sections 303 and 306 (sec. 3(a)(2))

Much has been made by some commentators of intent evidenced by the provisions under Section 303(c)(3) and Regulations 1.202-2(d), where a post-death dividend or recapitalization into Section 306 stock is sanctioned as still qualifying under the relief provisions under Section 303. This treatment has been carried forward in Section 3(a)(2) of the Technical Corrections Bill of 1977 that amends Section 303(b)(5), precluding the eligibility of Section 306 stock for use in Section 303 purposes, except new stock meeting the requirements set forth in Section 303(c), if the stock was not Section 306 stock. This exception, allowlowing continued qualification for the relief provisions of Section 303 upon redemption, thus would continue to apply to post-death recapitalizations involving preferred stock and/or preferred stock dividends made on common stock subsequent to the date of decedent's death. It appears that this special relief measure has been inserted to allow redemptions to take place under Section 303 to provide for the death tax requirements without impinging on the relative voting rights of the common shareholders that would occur if the corporate redemption involved common stock only.

The liberalizing attitude of Congress in this area is evident from the legislative history provided in 1954, when Section 303 was expanded to provide additional consideration with respect to Section 306 stock after the death of the decedent as follows:

"Under subsection 303(c), your subcommittee has further expanded the application of existing law and section 303 of the House bill that if after the death of a decedent his estate receives stock whose basis is determined by reference to, or by allocation of, the basis of the stock which was included in the gross estate then section 303 will apply to a redemption of the new stock to the same extent section 303 would have applied to the redemption of the old stock, within the time limitation described in subsection (b)(1). This subsection represents an expansion of section 115(g)(3) of the 1939 Code, as well as section 303 of the House bill. This subsection applies notwithstanding the provisions of section 306." S. Rep. No. 1622, 83rd Cong., 2d Sess., p. 239.

Thus it is clear that under the law prior to the 1976 changes, Section 306 stock received by an estate as a dividend or from a post-death reorganization could

be redeemed subject to the special provisions of Section 303. The pre-1976 Tax Reform Act consideration of the need for this section and the dichotomy between pre-death and post-death receipt of Section 306 stock is directly and specifically recognized under Regulations 1.303-3(e) that state, "Section 306 stock ceases to be so classified if the basis of such stock is determined by reference to its fair market value on the date of the decedent-stockholder's death or the optional valuation date under Section 1014." It is submitted that because of the law as it existed prior to 1976 there was no need beyond this to clarify the status of Section 306 created prior to a decedent's death, since it, along with all other types of stock, automatically would, within the requisite tests, qualify for redemption under Section 303. Thus, silence in the Committee Reports and Section 303, including regulations thereunder, shoud not be taken to indicate lack of consideration of automatic qualification of "pre-death" Section 306 stock within Section 303. Rather, it was necessary for Congress specifically to address itself to the situation involving post-death creation, by dividend or recapitalization, of Section 306 stock. Otherwise, ordinary income would result upon redemption of such stock. As the Sen. Report No. 1622 states clearly, the intent was to expand the application of Section 303, so that Section 306 received post-death would be given the same treatment to which Section 306 stock received by a decedent during his lifetime automatically was entitled. Thus, the intent of Congress for over 22 years has been to state clearly that Section 303 prevails over Section 306 and any other application code sections.

It is ironic, indeed, that if the amendments to Section 303 and 306, suggested by the Tax Correction Bill of 1977 are effected, an estate that is the sole shareholder of a corporation with common stock may, with impunity, redeem to pay death tax transfer costs and expenses under Section 303 at the tax favored rates under Section 303 (including appropriate recognition of tax basis in reducing the taxable gain) while not changing its status as the sole voting shareholder, whereas the estate whose interest in a company is comprised solely of a less significant interest in the company's future—and essentially none in its economic growth—i.e., preferred stock that has Section 306 taint, is precluded from similar treatment.

In tracing the history of the intent of Congress over the period from 1959, this dichotomy never existed and the desire to preserve business ownership in the family group woud be perverted by such divergence in approach.

Summary

The proposed amendment to Section 303, under the Technical Corrections Bill of 1977, precluding use of Section 306 stock for relief provisions under Section 303, will result in a catastrophe to estates that are comprised of Section 306 stock that was created as much as 22 years ago under statutory safe harbor rules. This will be compounded by the fact that the basis step-up for "fresh-start" as of December 31, 1976, may apply in very few cases as an offset to the amount of gain realized. Because of the double tax impact, i.e., coverage of estate and inheritance taxes, administration expenses and the Federal and State income taxes, the funds required to discharge such liabilities often will require the redemption of the entire amount of closely held stock owned that would otherwise qualify under Section 303.

Little if anything will be left for the surviving spouse or family heirs. There is no rationale justifying this result under the 1976 Tax Reform Act, nor should there be under any subsequent consideration. It is to be acknowledged that qualifying common or preferred stock (not Section 306) that is redeemed under Section 303 is a legislatively sanctioned bail out. As a result of the carryover basis rules, obviously that bail out now will cause at least some capital gains tax. That increase can be accommodated; but to tax any redemption of preferred stock tainted under Section 306 many years ago in anticipation of at least qualification for the limited, isolated redemption relief provisions of Section 303 is retroactivity that is not called for either in the concept of fair play nor in the amount of cost to the Federal Fisc.

There has been little evidence that substantial benefit has been obtained from this section beyond that desired by Congress; likewise no untoward advantage has been taken of it.

It must be recognized that the source for liquidity requirements of an estate of any family type closely held company primarily is the company itself. Often it is difficult for that company to arrange an immediate cash redemption for the estate liquidity requirements; this will become practically impossible if, in addition to that tax, a substantially greater amount of income tax from the re-

demption also must be financed by the company. The end result would appear to be contrary to other policy aspects set forth in the 1976 Tax Reform Act, i.e., more favorable installment payments under Section 6166, the special valuation rules for farmland and other business real estate, amongst others. It obviously goes counter to stated government policy with respect to business concentration and desire to keep family businesses extant. For these reasons, Section 3(a)(2) of the Technical Corrections Bill of 1977 should be eliminated and Section (3)(a)(1) should be made applicable not only to Section 306(a)(3), but to Section 301(c) as well.

ADJUSTED GROSS ESTATE

[Assumptions: (1) Death occurs in 1977; (2) State inheritance tax equals Federal State tax credit; and (3) Other liquid assets are absorbed by debts, claims and administration expense]

	$500,000		$1,000,000		$2,000,000	
	Marital	No marital	Marital	No marital	Marital	No marital
A. Amount of sec. 306 stock	$250,000	$250,000	$500,000	$500,000	$1,000,000	$1,000,000
B. Unified transfer tax—Net of credit, 1977	40,800	125,800	125,800	315,800	315,800	750,800
C. Income tax on redemption to obtain funds for B	[1] 40,800	[2] 150,000	[2] 188,700	[3] 350,000	[3] 700,000	[3] 700,000
D. Balance of sec. 306 stock (A—(B and C))	178,400		185,500			
(a) Deficit in funding	NA	(25,800)	NA	(165,800)	(158,000)	(450,800)
Total taxes as percent of adjusted gross estate—1st estate	16.3	55.2	31.5	66.6	50.8	72.9
Percent of stock required for redemption—1st estate	[4] 16.3	100.0	[5] 62.9	100.0	100.0	100.0

[1] 50 percent effective tax rate assumed.
[2] 60 percent effective tax rate assumed.
[3] 70 percent effective tax rate assumed.
[4] 32.6 percent for combined estates.
[5] 100 percent for combined estates.

MAHER, MELOY & HANKENS,
Cherokee, Iowa, August 9, 1977.

Re: Tax Reform Act of 1976.

STAFF DIRECTOR,
Committee on Finance,
Washington, D.C.

DEAR SIR: The carryover basis rule contained in the above is not a workable solution to our tax mess—how can heirs administer the act when they and everyone else cannot understand nor make it work—kindly change.

Thank you.

R. STEPHEN HANKENS.

TE PASKE & EVANS,
Sioux Center, Iowa, August 10, 1977.

MICHAEL STERN,
Staff Director, Committee on Finance,
Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: I have been advised by the secretary of the Iowa State Bar Association that the portions of the Tax Reform Act of 1976 concerning the new carry-over-basis rules and gift in contemplation of death rule are the subject of reconsideration and investigation by Congress. I would strongly urge you to listen carefully to the testimony and other statements concerning these matters offered by attorneys practicing in rural Iowa and other experts in this area.

My immediate problems concern the carry-over-basis rule. As you well know, this rule was a product of Congressional concern about lost income tax revenue due to the favorable tax treatment available to those who held their property until death and passed it to their heirs through the state. The effect of this rule is to do away away with the so-called stepped-up basis for computing taxable gain for the heir or beneficiary upon a later disposition or sale of the asset.

Conversations with other attorneys indicate that there are primarily five objections to the carry-over-basis rule. These are as follows:

1. The carry-over-basis rule cannot be administered by the Internal Revenue Service effectively.

2. In many instances the person who could supply the information necessary to comply with the rules will be deceased.

3. The future recordkeeping required by the Act will be staggering to the lawyer.

4. Very few taxpayers will ever be capable of understanding the effect of the Act which seems to be the exact antithesis of an over-all announced goal of tax simplification.

5. It appears that any efforts on the part of Congress to preserve the family farm or small business by alleviating the burdens of the Federal Estate Tax are completely counterbalanced by the adverse income tax consequences encountered in any estate in which there are liquidity problems.

I wholeheartedly support any efforts on the part of Congress to simplify our tax structure. Rules such as carry-over-basis and the like serve only to frustrate that goal. Further, I, an attorney am ethically obliged to make legal services available to all those in need of them. Continued existence of this rule hinders me in the exercise of that duty in that too much of my time and energy will be devoted to ferreting out facts which in many circumstances are undiscoverable. As a reward for these extraordinary efforts. Congress proposes to impose sanctions and penalties upon me and my clients for our failure to deal with circumstances that are beyond our control. Accordingly, I most strenuously urge you to support legislation co-sponsored by Congressman Jim Leach retroactively striking the new carry-over-basis provisions.

Respectfully,

TERRY HUITINK.

CRAY, WALTER, CRAY, LOESCHEN & GODDARD,
Burlington, Iowa, August 9, 1977.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: We understand a bill has been or will be introduced in the House of Representatives by Congressmen Conabel, Johnson and Leach modifying or striking the "carry-over basis" as defined in the Tax Reform Act of 1976. This bill would also carry modifications, according to our understanding, with respect to the "special use" value of family farms and small business companies and the "freshstart" rule.

The members of our firm recommend that these rules of the Revenue Act of 1976 be substantially modified or stricken.

The record keeping and computations necessary to comply with these rules are proving, and will continue to prove a great burden on both taxpayers, tax consultants, accountants, and lawyers assisting taxpayers. The provisions of the Act imposing severe penalties for failure to provide the "carry-over basis" on estates to beneficiaries also seems most unjust and unfair and gives rise to a contingent liability on professional firms, including persons who assist in preparation of income tax return. For instance, how could persons and firms assisting in probate ever carry on their books an accurate statement of the contingent liabilities which may arise uder such provisions? Under similar circumstances, even an individual preparing tax returns for customers could have hanging over him contingent liabilities for many years.

With respect to the "cardy-over" rule, we find that many farmers and owners of residential property in our County of Des Moines have no records adequate to provide an adjusted basis for such beneficiaries in a decedent's Estate. This is for the reason that such properties may have been owned for so many years and records not available.

It also occurs to us that the provisions of the "fresh-start" or "carry-over" basis and treatment of the values of family farms, small businesses and estates is so complicated and the necessary elements for computations so completely elusive that we doubt if the provisions can be administered. The recapture of taxes for up to fifteen years is unreasonable.

We urge your Committee to look favorably upon reporting modification of the Reform Act of 1976 by eliminating the "fresh-start" or "carry-over" basis and "special use" provisions for arriving at the valuation of family farms and small businesses in the hands of Executors and beneficiaries of decedents.

In conclusion, it occurs to our firm that the Reform Act of 1976 has placed on the taxpayers aof this country such a difficult and complicated tax system that

the ordinary taxpayers is incapable of understanding or complying without professional assistance. It is also doubtful that the terms of the Act can be administered by the Internal Revenue Service.

Respectfully submitted,

GLENN F. CRAY.

NORELIUS, NORELIUS & GUSTAFSON,
Denison, Iowa, August 8, 1977.

Re carry-over-basis-rule.
Mr. MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR SIR: I want to voice my objection to the above Rule for the following reasons:

1. In just a short period of time since the Rule went into effect, we have learned of the almost impossible inability to get the information as to the purchase price, additions of capital improvements, depreciation taken, and in short, computing the adjusted basis in the hands of the decedent.

2. The impossible taks of keeping records required by the Rule and the notices to beneficiaries or persons acquiring the property.

3. I have tried to explain the Rule to clients who are acquiring property coming within the Rule, just how it works, so that they will know the tax consequences if the property is sold by them. I must admit I have difficulty in understanding the Rule, let alone trying to explain it to a layman.

Sincerely yours.

E. A. NORELIUS.

BECK, PAPPAJOHN & SHRIVER,
Mason City, Iowa, August 8, 1977.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: I am advised that your office is receiving written testimony and other objections pertaining to, among other matters, the carry-over-basis rule contained in the 1976 Tax Reform Act. Without enumerating in detail each of the deficiencies in such legislation as passed, I wish to state that it is the judgment of this writer and without exception the judgment of every other lawyer with whom I have visited concerning the legislation, that strict compliance with the requirements of the new carry-over-basis rule will in almost every case be an impossibility. I cannot believe that legislators voting in favor of the new carry-over-basis rule knew or understood the adverse consequences of additional time and expense being imposed on any taxpayer coming within the purview of the new rule. The time which has now passed since the enactment of such rule should have been sufficient for all legislators to now realize that the new carry-over-basis rule was a mistake in direct opposition to the announced goal of the 1976 Tax Reform Act of Tax Supplification.

I strongly urge that the new basis provisions contained in the carry-over-basis rule of the 1976 Tax Reform Act be retroactively stricken.

Very truly yours,

JAY M. SHRIVER.

FRUNDT, FRUNDT & JOHNSON,
Blue Earth, Minn., August 8, 1977.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
Dirsken Senate Office Building, Washington, D.C.

DEAR SIR: I wish to simply state my opinion concerning the new tax reform act of 1976 in hopes that the committee will give it some consideration when they consider the matter which we understand will be coming up in the near future.

Nearly all of the attorneys whom I have talked to, and it has been a substantial number, feel that the tax reform act of 1976 is going to prove an impossible burden upon the taxpayer, as well as upon the government.

We feel that there is substantial burden on the taxpayer in having to keep records of earnings and expenses in connection with the operation of each particular part or tract of real estate which he may own which may ultimately be broken down in smaller tracts, or become parts of larger tracts; and, particularly, with the problem of valuations at the date of death and the payment, or responsibility, of having to have the potential income tax liability on the increment in value of said real estate, and the determination of that value as it may have changed from January 1, 1977, to the date of death.

We feel that the income tax burden is completely unfair; that the taxpayer is supposedly paying, and should pay, for the increase in valuation as an inheritance tax matter, but not an income tax matter; and, that the principle of the old law is sound and the theory of it fair, but the principle of the new law is completely arbitrary and unreasonable and constitutes double taxation contrary to the constitution of the United States.

It is not for me at this time to go into a long detailed 25 page objection to the matter because I have faith that the matter is being duly aired by the people who are close to the committee and giving the testimony pertinent to the problem. However, I am certain that this measure is the most feared tax measure that we have ever faced in the history of our income tax since the time it was first passed back in 1913. It is going to cause litigation of a tremendous amount, and problems which are not going to be at all equally resolved as far as our various taxpayers are concerned, and those who can afford to pay for attorneys will end up paying substantially less tax than those who can't afford it. We feel that the tax itself is confiscatory and unfair, unreal, and unworkable, and we sincerely hope that the committee will appreciate the terrible burden this is putting on the taxpayer and do something to remedy the situation.

I assure you that in expressing this opinion I am expressing the opinion of every lawyer that I know of that has considered the matter, and the people themselves are very much upset about what our government is doing to them under the guise of tax reform. It is just getting too complicated to try to comply with the law any more. We beg you, therefore, to consider the matter very seriously and to, at least, eliminate the income tax aspects of the law and make the application of it, both income tax wise, and federal estate tax wise, much more simple and fair.

Very truly yours,

J. H. FRUNDT.

PICKENS, BARNES & ABERNATHY,
Cedar Rapids, Iowa, August 8, 1977.

Re Tax Reform Act of 1976.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
Dirksen Office Building, Washington, D.C.

DEAR MR. STERN: I understand there are some pending investigatory hearings to consider such topics as the "carry-over-basis rule" and other matters that were enacted in the Tax Reform Act of 1976. I would like to register some complaints as to the so called Tax Reform Act which was enacted last year.

I have practiced law for 21 years and do a considerable amount of tax work. I have been a member and a past president of the Cedar Rapids-Marion Area Estate Planning Council and although I may not be an expert in the field I certainly am experienced.

The Tax Reform Act of 1976, to a great extent, was not reform, it was change. I see no possible practicable way that the Internal Revenue Service will be able to administer the carry-over-basis rule over the period of time that it will apply and I have no idea how the taxpayer or his lawyer will be able to keep proper records to see that it is applied.

I have personally handled four tax audits this year in 1976 all relating to income tax. I have had courteous and prompt attention by the Internal Revenue Service agents with whom I have dealt. I have asked all of the agents whether they feel that the Internal Revenue Service will be able to administer the new Tax Reform Act and they all have confessed that they feel it will be virtually impossible. I am sure a great number of these ideas, even though politically

motivated, arise from noble beginnings. However, when they cannot be administered or enforced, they are virtually worthless.

There is something wrong with the tax system when the ordinary taxpayer who may be very competent to run and operate his business at a reasonable profit feels totally inadequate to prepare his tax return. This is what has developed in recent years. I hope these thoughts would be of some help to you in connection with the pending hearings.

Sincerely,

JAMES F. PICKENS.

CORNWALL & AVERY,
Spencer, Iowa., August 8, 1977.

Hon. MICHAEL STERN,
Staff Director, Committee on Finance,
Dirksen Office Building, Washington, D.C.

DEAR MR. STERN: It is our understanding that a bill has been or will be introduced in the House of Representatives to strike from Tax Reform Act of 1976 the provisions relating to the "carry-over-basis-Rule," and we are writing to urge that this bill be given serious consideration because, in our opinion, the present provision creates a situation and makes requirements that will be very difficult, if not impossible, for the taxpayer to perform or the Department to audit.

We urge that the provisions be eliminated entirely or at least changes be made so the regulation may be understood and workable by the taxpayer and the attorney or the tax consultant.

Respectfully submitted,

WILSON CORNWALL,
ALDEN D. AVERY,
TOM CORNWALL,
CHRISTOPHER A. BJORNSTAD,
STEPHEN F. AVERY,
Members of the Firm.

O'CONNOR, THOMAS, WRIGHT, HAMMER, BERTSCH & NORBY,
Dubuque, Iowa, August 9, 1977.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: It is my understanding that a bill has been, or soon will be, introduced in the House of Representatives by Representatives Conable and Johnson, and co-sponsored by other parties, relating to the "carry-over-basis rule" which was adopted as part of the tax reform bill of 1976. The "carry-over-basis rule" adopted in 1976 should be repealed and the property of deceased persons should be given a new basis which would be the value of the asset at the date of death. The "carry-over-basis rule" is objectionable for many reasons, including the following:

1. In many instances the person who could supply the information necessary to comply with the rule is the deceased;
2. The "carry-over-basis rule" cannot be effectively administered by the Internal Revenue Service or accurately used by lawyers in the collection of Federal Estate Taxes on estates of persons dying after December 31, 1976;
3. Very few taxpayers will ever be capable of understanding the effect of the Act, which seems to be entirely contrary to the announced goal of tax simplification;
4. The future record keeping required by the Act will be staggering to the lawyer.

I urgently and sincerely request that the new "carry-over-basis rule" be repealed and that we go back to the rule which was in force and effect prior to January 1, 1977.

Very truly yours,

E. MARSHALL THOMAS.

WILSON, BONNETT AND CHRISTENSEN,
Lenox, Iowa, August 5, 1977.

Re Tax Reform Act of 1976.

Senator DICK CLARK,
Washington, D.C.

Senator JOHN CULVER,
Washington, D.C.

Congressman TOM HARKIN,
Washington, D.C.

DEAR SIRS: As a general practitioner located in Southwest Iowa wherein we deal primarily with small businesses and family farm operations, I am greatly concerned about the affects of the 1976 tax reform act upon the administration of decedents estates.

At the present time under the new rules which have been enacted by Congress we have anything but a provision which will simplify or benefit our small businessman or small estate.

We can look at said tax bill and upon first impression it would appear that the increase and/or change from the $60,000 exemption to the unified credit would effectively reduce the total amount of Federal Estate Tax that would be due and owing from a small estate.

However, the other ramifications of said tax bill quite clearly and in my opinion negate any benefits that we have received from the lower federal estate tax on small estates. The stepped up cost basis and the very complicated procedure in attempting to determine cost basis which would be subjected to either Federal Estate tax or a capital gains tax at the time of an individual's death are almost impossible to compute.

The formula as such for computing the carry-over basis rule is almost totally incomprehensible and even if the general practitioner is able to satisfactorily master said matters it will be virtually impossible to explain said matters to lap people so that they can effectively understand what has taken place in the administration of an estate.

Not only do we have these particular problems but the very definitions under which we are to operate, which apply to those individuals who are allowed to use, "productivity value" for valuation purposes may not in fact be able to utilize the same unless the individual is completely debt free and the only child of a particular decedent and is in fact farming the land or operating the business. This is very narrow and it would appear to me somewhat deceptive provision which is really not what was intended in trying to provide relief to the family farm or small business operation.

It has become very apparent that the record keeping process will be almost a total impossibility as the very individual who could answer such questions will in fact be deceased. Further the legal responsibilities and exposure which any law firm will have to undertake in the administration of an Estate will, I am sure, increase the cost of administering said Estate as well as the over-all malpractice insurance premiums that will be charged to those individuals who handle administration of decedents estates. As you know this cost will not be absorbed by the practicing lawyer, but will in fact be passed on to those clients whom one represents at that particular time.

It seems to me that we could have had a tax bill implementing the unified credits rather than the estate tax exemption without all of the problems which are built into said bill as a result of the carry-over basis rule which will entail incomprehensible record keeping responsibilities which we presently have under this tax reform act.

I certainly would join with those individuals who are asking that the new basis provision for property be retroactively stricken from said tax reform act so that we might be able to provide the kind of service and needs of our clients in the administration of decedents estates.

In remain

Respectfully yours,

RICHARD L. WILSON.
RONALD D. BONNETT.
DAVID L. CHRISTENSEN.

MORRIS & ANDERSON,
Tama, Iowa, August 8, 1977.

MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: I am writing on behalf of all of the members of this firm relative to the investigation you are conducting concerning portions of the Tax Reform Act of 1976 and more specifically, the "Carry-over-basis Rule".

In general, of course, after the passage of more time, the general effect of this rule will have its impact on the tax payer and he will react badly in face of the stern tax consequences. From an administrative standpoint, however, the Rule is fraught with what will turn out to be impossible requirements on the ground level. I have been practicing law for twenty years and my firm has been deeply imbedded in preparing individual tax returns for farmers and small business men and I can say with great conviction that the average person does not have and does not maintain good records of any kind including financial and tax. Furthermore, tax matters are not something which is a commonly handled, discussed and knowledgeable area for the family. Normally, one individual in the family has the responsibility for preparing the family tax return and most generally, one spouse or the other has only the barest knowledge of the family tax situation much less what goes into preparing a tax return. Almost always, this tax information is not spread beyond the spouse. Consequently, to administer the "Carry-over-basis Rule" is going to be extremely difficult if not impossible because in a great many cases, the information necessary to comply with the rules will have been within the purview of the decedent and no one left surviving will have the faintest idea about the information necessary nor where to find it.

Furthermore, under the present requirements, the Act will make necessary an unprecedented and staggering amount of record keeping by someone. From experience, I can tell you that that record keeping will not be by the taxpayers themselves but their lawyers, accountants or taxpreparers. They will have to pay for that time and it will greatly increase their cost of tax preparation.

Finally, and perhaps most importantly, we doubt if any or at best very few tax payers will ever understand the effect of the Act. This being the case as in all things when people do not understand, it becomes a vexing subject and imposition and a contest to which they will never be reconciled. This makes for unhappy citizens, unhappy taxpayers and litigation all of which are to the detriment of our clients. It is to their detriment when they cannot understand and therefore do what is necessary to comply with the law as well as plan to live within it. Legislation which cannot be understood in general and which is burdensome to administer and enforce is poor legislation and it appears to me that irrespective of tax generation, the Tax Reform Act is imposing a great burden on the taxpayer from the standpoint of record keeping and tax preparation expense not to mention a practical impossibility to learn to live with. It is simply going to generate a great deal of unhappiness to the farmer and small businessman and that unhappiness is going to be reflected in their attitude toward their Government.

We strongly urge you and all those who are a part of your investigation to take the necessary action to rectify what appears to us to be a disastrous situation by retroactively striking the new basis provisions for property.

Respectfully yours,

BEN MORRIS,
Senior Partner.

ST. LOUIS COUNTY NATIONAL BANK,
Clayton, Mo., August 2, 1977.

Re: Investigatory Hearing of Subcommittee on Taxation and Debt Management Concerning Serious Estate and Gift Tax Problems Created by the Tax Reform Act of 1976.

To: Mr. Michael Stern, Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

From: Ronald H. Spicer, Assistant Trust Officer, St. Louis County Bank, Clayton, Mo.

CARRYOVER BASIS RULE

As an individual in charge of maintaining income tax cost records for the Trust Department of a Bank I would like to testify to the fact that the carryover basis rule is indeed a "administrative nightmare" for two basic reasons. It is so com-

plex only the most sophisticated tax lawyer or Trust Department could attempt to apply it, yet it will effect every heir of every estate. Secondly, the fundamental assumption that an executor will be able to determine the decedent's original cost basis for each asset is so farfetched that this law, without a doubt, will prove to be totally impractical and unworkable. For the moment I will assume tax laws have to be complex and will confine my comments to whether this law can be applied.

It is easy, I suppose, to assume that a taxpayer will have cost records for virtually all his assets in a convenient location such as a safe deposit box or desk drawer and all the executor has to do is put them in alphabetical order. Without being facetious, the real world does not work that way, at least it hasn't so far in my experience. The more typical state of a taxpayer's financial affairs as of the date of death is usually as follows.

Normally the deceased taxpayer, and his spouse if married, although being elderly do not anticipate his immediate death and have not purposefully arranged his cost records for the use of another party. If there is a spouse this problem may be lessened but if not we can only hope the executor or a family member looks in the right place and know what they see when they are looking at it. There may be several reasons they will never find what they are looking for.

The decedent may have never known or tried to obtain the cost basis himself. If he acquired the asset by gift or inheritance the donor or prior executor may have failed to notify him of his cost basis, and he may have failed to request this information before he sold the property and had an immediate need for it.

Even if the decedent had his original cost records at one time he may have unknowingly lost it or if he knew the records were missing he may have them committed to memory instead of bothering to write them down. It is surprising how many taxpayers recall exactly what price they paid and when but this knowledge often dies with them.

The decedent may have even intentionally discarded his cost records out of ignorance because he knew for a fact he would never sell the asset during his lifetime and he was advised all assets are stepped up to Federal Estate Tax values upon death. Unfortunately he received this advice before January 1, 1977.

Let us now go so far as to assume we have a sophisticated taxpayer who has all his cost records. Nothing will guarantee these papers will find their way into the hands of the executor after the taxpayer's death, unless perhaps they are in a safe deposit box. The question now becomes, can all U.S. taxpayers be educated to the fact these papers should be kept in such a safe place.

It is doubtful given situations where even the Will cannot be located.

In summary, the transmission of cost records of a decedent to his executor simply cannot be considered a routine matter. The lack of this information will result in the heirs being unable to determine their correct capital gain or loss; maintenance of cost records will become an inexact science.

Even the "fresh start" provision as of December 31, 1976, intended as a relief measure, poses further burdens to executors and heirs. The stepped up values on this day cannot be used by the heir if a capital loss would result, so the law in effect requires a dual set of cost records be kept for each asset acquired before that date. Also, can you imagine the confusion of an heir after an executor tells him he can use the December 31, 1976, value if the result is a gain, but if not he must use the original basis to determine loss, and he will have no gain or loss if his sales price is between December 31, 1976, value and original basis? This is stretching taxpayer compliance to the limit.

The law contains a provision that if the decedent's basis is unknown, the fair market value at the date of purchase, or approximate date of purchase, can be used. This relief is almost meaningless since it is very rare to know the date of purchase if you do not know the original cost in the first place. Possibly this section contemplates that stock certificate dates of transfer can be used. If so, the executor is first burdened with tracing stock dividends and splits through their adjustments (mutual fund and other dividend reinvestment plans are another matter) and then he can shift some burden to stockbrokers by requesting them to look up a quote for Coherent Radiation Corp. on February 19, 1959.

The computations above are only the beginning. Adjustments to basis must then be made for Federal and State estate taxes attributable to appreciation to date of death. Needless to say if the estate itself sells an asset before these taxes are determined, amended Fiduciary Income Tax Returns will be required.

These burdens of estate administration may well cause a family member to be reluctant to act as executor even though he is otherwise well qualified. For attor-

neys and banks who act as executors, the complexities of the law will require additional time expended and add another layer of expense which will be passed on to every estate and heir.

RECOMMENDATIONS

I urge your committee to recommend the carryover basis rule be repealed in its entirety. It is my opinion tax reform to close the loophole of appreciation to death is unworkable by any reference to the decedent's basis. The old law was simple and straightforward and should be retained.

RONALD H. SPICER.

SKELTON, TAINTOR & ABBOTT, P. A.,
ATTORNEYS AT LAW,
Lewiston, Maine, August 3, 1977.

Re Senate Finance Committee
Hearings, Technical
Corrections Bill of 1977

MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: This letter is submitted in response to the invitation to persons who wish to submit written testimony to the current Senate Finance Committee Hearings regarding the Tax Reform Act of 1976.

My only comment is that the Technical Corrections Bill of 1977, H.R. 6715, does not go far enough in solving the problem of independent trustees who serve as trustees of generation-skipping trusts. An effort has been made in § 3(n) of the Bill to clarify that an independent trustee will not be a beneficiary for purposes of the generation-skipping rules. However, the Bill is too narrow.

Essentially, the Bill would amend § 2613(e) of the Code by providing that an individual does not have an impermissible power in a trust if the individual is a trustee who has no interest in the trust, is not a related or subordinate trustee, and does not have any present or future power in the trust other than a power to dispose of the corpus of the trust or the income therefrom "to a beneficiary or a class of beneficiaries designated in the trust instrument." The quoted language is the problem. In most trust instruments, the trustee has the power to distribute to or for the benefit of beneficiaries of the trust. I therefore suggest that the language I have quoted be revised to read "to or for the benefit of a beneficiary or a class of beneficiaries designated in the trust instrument."

This is a simple change, but it could save a great number of trust instruments from falling within the generation-skipping rules in ways that the drafters of H.R. 6715 obviously intend that they should not.

Thank you very much for your consideration.

Very truly yours,

BRYAN M. DENCH.

ALLBEE, WILSON & ALLBEE,
ATTORNEYS AT LAW,
Muscatine, Iowa, August 4, 1977.

MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR SIR: I wish to voice my strong opposition to the intolerable burdens placed upon the taxpayers of the United States by the so called Tax Reform Act of 1976.

Need I say more?

There are not enough computers in the IRS to keep adequate records of the data the taxpayers, executors and their attorneys are required to accumulate and forward to the IRS under this Act. Storage and retrieval costs of data to be filed will be prohibitive and far exceed the taxes collectible as a result thereof.

A major portion of the tax basis data required to be reported under the act will not be available and can not be reported because the information will be held by persons who are deceased and their records, of course, will no doubt have long since disappeared. Congress may have forgotten that we have a transient population and transient people do not tend to keep a lot of records on hand for indefinite periods of time.

Attorneys, under the Act, are required to keep voluminous records in order to protect themselves and their taxpayer clients. Attorneys die—their records are not kept forever. If a taxpayer is deceased and the attorney is deceased, how can a descendant or successor taxpayer comply with the carry-over-basis rule?

Why not select an arbitrary carry-over-basis equal to 200 percent or some other arbitrary percentage of the taxpayer basis for unlisted securities and undepreciable personal property?

The existence of two carry-over-basis—one for determining capital gains and the other for determining capital loss—is ridiculous.

It would appear that in some situations a piece of property could have:

(*a*) A special use for Federal Estate tax purposes;
(*b*) A different value for state Inheritance tax purposes;
(*c*) A different value for state property tax purposes;
(*d*) A different value for taxes in the event of a sale, and
(*e*) Finally, a different value for depreciation purposes.

Note also, that if a special use value is used it could not be used for gift tax purposes. This, I submit, is too, too much.

Change the rates. Change the credits. But please—please simplify. Cut down record keeping requirements.

If you must redistribute the wealth—say so and do it in a straight forward manner. Don't try to accomplish it in a circuitous fashion.

Yours very truly,

ALLBEE, WILSON & ALLBEE,
HARVEY G. ALLBEE.

VINCENT E. JOHNSON,
ATTORNEY AT LAW,
Montezuma, Iowa, August 5, 1977.

Hon. JOHN CULVER,
U.S. Senate Building,
Washington, D.C.

DEAR MR. CULVER: The carryover basis rule for property as it exists under the 1976 Tax Reform Act should be stricken from the provisions of such act for the following reasons:

(1) The only way which this rule could be legally carried into effect would be for every living person to make an inventory of property interests owned as of January 1, 1977, and in so doing, making the required adjustments as required under the act. If the individual during his life does not prepare this information and leaves it to be done by those following him after death, no one can accurately reconstruct the information needed. Although I have advised many clients of this requirement, I am sure that none of them have complied, although we are now more than seven months past the effective date of the act. This is a natural, human trait and if we think it would be difficult now for recipients or successors in interest to reconstruct the information necessary following the death of a decedent, the task of doing this job one year, five years or ten years down the road would be impossible.

(2) It would be terrifically time consuming for the lawyer to meet the requirements of record keeping to comply with the law and furnish or make available to the executor on an acceptable basis the information the executor must have at the time of closing the estate and which the executor must report to the government to avoid penalty provided for in the act. I have not even been able to find a service, including trust department facilities at banks, who are prepared to assist on a present basis for computer preparation of values or who anticipate providing such service in the future.

(3) The party in interest, usually recipients of property, will never be able to understand the requirements nor will they be capable of doing the necessary computations on their own without the help of an accountant or lawyer, or both. The inability to understand it is bad enough and totally futile so far as actual taxpayer is concerned but cost to him will also be prohibitive.

It seems that for the above reasons and in addition probably many more, both from a technical and practical standpoint, this carryover basis rule should be stricken from the Tax Reform Act. The procedure necessary certainly takes away any element of simplification as it affects the practicing lawyer, accountant or the layman who has the actual duty under the act.

Yours respectfully,

VINCENT E. JOHNSON.

THE FIDELITY TRUST CO.,
Stamford, Conn., August 3, 1977.

Re Subcommittee on Taxation.

Hon. MICHAEL STERN,
Staff Director, Committee on Finance,
Dirksen Senate Office Building,
Washington, D.C.

DEAR MR. STERN: As Vice Chairman of the Trust Division of the Connecticut Bankers Association I am authorized to correspond with your committee to express our Association's view that section 1023 of the Tax Reform Act of 1976 entitled "Carryover Basis For Certain Property Acquired From A Decedent Dying After December 31, 1976" should be repealed.

To this end we have previously corresponded with each member of the Connecticut House of Representatives delegation to urge support for bills submitted for the purpose of repeal, viz., Representative Conable's bill H.R. 1563 and Representative Burleson's bill H.R. 2674. When Senator Helm's bill, S 1696 was introduced in the Senate we corresponded with Senators Ribicoff and Weicker to request their support for this measure. In this connection we enclose a copy of our July 21, 1977 letter to Senator Ribicoff and request your attention to the third paragraph wherein we summarize, briefly, our reasons for supporting repeal of the Section.

It is obvious that the enactment of section 1023 poses an almost impossible framework within which a professional fiduciary may function. In our view the only reason a massive objection from the general public has not occurred is that the complexities of the Section are too difficult for the average taxpayer to comprehend. The revenue to be realized from the changes is minimal and the costs of estate settlement and trust administration will escalate appreciably. It is our impression that the law generally favors early vesting of assets of an estate or trust. We fear that if Section 1023 is allowed to represent the tax law of the land protracted litigation and confusion will result. The section, as presently constituted, presuppose that accurate records are available from the date of acquisition of an asset. From our experience we may assure your committee that this is not a fact. Moreover, it is doubtful that adequate enforcement or policing by the Treasury Department is feasible without materially increasing the burgeoning Internal Revenue Service staff.

We include a copy of a letter received from Mr. Bozak of the Tax Department of Hartford National Bank and Trust Company covering this subject.

Before concluding we should mention that we believe that some constitutional issues are raised by the enactment of subsection (a) of Section 2035 of the Tax Reform Act, "Adjustments For Gifts Made Within 3 Years of Decedent's Death". In essence, this subsection provides that a gift made within three (3) years prior to a decedent's death is automatically included in the estate for tax purposes, irrespective of the donor's intent. We submit that the due process provisions of the Fifth Amendment may be violated by creating an artificial presumption which has no basis in fact. We defer in this area, however, to the members of the nation's bar associations who plan, no doubt, to address your Committee on this subject.

We shall observe with considerable interest your Committee's progress in reviewing these critical matters and we thank you for affording us the opportunity of expressing our grave concern.

Sincerely,

WALTER T. SULLIVAN,
Senior Vice President and Trust Officer.

THE FIDELITY TRUST CO.,
Stamford, Conn., July 21, 1977.

Re Senate Bill 1696 (Helms).

Hon. ABRAHAM A. RIBICOFF,
U.S. Senator, Connecticut,
Russell Senate Office Building,
Washington, D.C.

DEAR SENATOR RIBICOFF: We understand that Senator Jesse Helms of North Carolina has introduced the subject bill for the express purpose of repealing Section 1023 of the Tax Reform Act of 1976 entitled "Carryover Basis for Certain Property Acquired from a Decedent Dying After December 31, 1976".

On behalf of the Connecticut Bankers Association I am authorized to correspond with you to advise you that our Association requests that you support Senator Helms' measure. As you know, similar bills have been introduced in the House of Representatives, and we have corresponded with members of our Connecticut House delegation to request support in that body for the Conable Bill (H.R. 1563) and the Burleson Bill (H.R. 2674).

As you no doubt know, Section 1023 creates an extreme hardship upon Administrators and Executors who are now required to obtain detailed cost information for certain assets in decedents estates in order to inform legatees and devisees of the adjusted tax cost as of December 31, 1976. In most instances the details concerning original purchase prices are not available and the attendant administrative burdens in making death tax adjustments are extremely difficult. The fact that penalties are imposed by the Section for noncompliance merely serves to make the entire concept untenable. Truly, the complexities of the Section may result in fostering involuntary tax fraud.

We trust that you will be sympathetic to our position in this matter as we believe that repeal is in the interest of the general public.

Sincerely,

WALTER T. SULLIVAN,
Vice-Chairman, Trust Division,
Connecticut Bankers Association.

HARTFORD NATIONAL BANK AND TRUST CO.,
Hartford, Conn., August 1, 1977.

Mr. WALTER T. SULLIVAN,
Senior Vice President and Trust Officer,
Fidelity Trust Co.,
Stamford, Conn.

DEAR WALTER: I believe you want to know about the problems Connecticut Banks are encountering in complying with the carryover basis provisions of the Tax Reform Act of 1976.

1. *Tangible personal property:* Ascertaining the acquisition date and actual cost of jewelry, heirlooms, a coin or stamp collection acquired on a piecemeal basis is frequently virtually impossible.

2. *Real property:* Where a decedent had a residence at death which was one in a series of houses he or she purchased and sold, it is often difficult to determine the adjusted basis of the property. In many cases, we are unable to determine if major improvements were made to the property, which would affect the cost basis.

3. *Suspended basis:* Although the decedent's basis must be increased by estate taxes attributable to appreciation in property value, this information is not available until the estate tax return has been audited and accepted by the Internal Revenue Service and State Tax Departments. Final acceptance of the return can take from six months to two years from the date it was filed. Consequently any sales made during the administration of the estate will invariably require filing amended fiduciary income tax returns to reflect the adjustment to basis as a result of the audit.

Adjusting the tax costs of appreciated value assets in an estate now frequently will be a record-keeping chore. For example, increasingly people are purchasing stock through monthly and quarterly dividend reinvestment plans. Each purchase, even a fraction of a share, represents a separate asset for purposes of this adjustment. Also, coin and stamp collections usually appreciate in worth and each item must be adjusted.

Further, Executors now must establish two tax costs for each asset, one the basis for gain in event of a sale of the asset, the other the basis for loss. Each cost must be adjusted to reflect changes in estate tax assessments.

When assets are distributed to the beneficiaries, the Executor now must advise them that the asset's tax cost basis may change and any sales made by the beneficiaries may require amending their personal returns.

4. *Cost reconstruction:* Frequently, a decedent's cost records are not available. This necessitates tracing acquisition dates and costs through transfer agents or reconstructing costs based on certificate dates, a costly, time consuming process.

5. *Buy-sell agreements:* We foresee substantial litigation in this area in at-

tempting to establish them as "marketable securities" rather than property subject to the formula approach for determining the "fresh start" basis.

Corporate executors, with tax specialists who have access to tax and capital changes services, will be able to cope with these new responsibilities.

However, we believe the extensive record-keeping required by the carryover basis of the Internal Revenue Code runs counter to an executor's duty to administer and settle estates expeditiously. We also feel that the Congress did not intend this consequence when it legislated the estate tax changes.

We would appreciate, greatly, an opportunity to discuss this with you.

Sincerely,

——— ———.

LAW OFFICES OF EDWIN W. SALE,
Kankakee, Ill., July 19, 1977.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: With reference to the hearing scheduled for the Subcommittee on Taxation and Debt Management of the Senate Finance Committee, July 25, 1977, I would like to submit some comments similar to those I addressed to Representative Al Ullman, MC, by letter dated May 5, 1977. My references are to Sections 2032A, 6166 and 6166A. As members of the Subcommittee may know, in central Illinois, Iowa, Indiana, and Ohio land is going for farming purposes from $2,500 to $4,000 an acre, so that an owner of a mere half section of land can well be worth over $1,000,000. Generally, a half section of land is not considered sufficient to farm economically because of the cost of machinery, so that many farmers feel forced to buy more of this expensive land to justify their investment in the machinery. It is a very difficult position to be in.

Many of these owners, such as widows and retirees, either never have farmed the land as an operator or haven't farmed it for a long time, and unless they have a son or son-in-law who is farming the land for them, their estate does not get the benefits of the foregoing sections.

It is my supposition that the benefits of these sections were withheld from nonoperating farm owners on the assumption that a nonoperating owner holds his or her farm as an investment in the same manner as an investor in common stock, bonds or other securities and should therefore be liable for the same amount of tax on the regular estate tax closing date. This assumption, while seemingly logical, overlooks both the nature of 90 percent of all investments in farm land and the nature of the property. Investments in common stock, particularly, and bonds to a certain extent, are in the eyes of their owners basically temporary in nature. Stocks and bonds are bought and sold depending on such factors as price, company management, and mere need for cash.

Farms on the other hand may have been in the same family for over one hundred years and amount to a way of life as contrasted to an investment in securities, and this holds true even though the farmer and his wife retire and lease their land for farming purposes. A farm is as much a part of the fabric of its owner's life as is his house in town. Furthermore, the breaking up of a farm is an irretrievable event because small farms are simply not as efficient as larger farms.

I think the Congress was quite correct in recognizing that the radical increase in farm prices does not result from a normal market condition. Nonfarmer purchases of farm land, at present prices, are rare indeed, since the investor stands to make less than 1 percent on his investment in at least some years so that the Congress's worry that investors in farm land should not get a break as compared to investors in some other property is based on a nonexistent condition.

Purchases of farm land are being made by neighboring farmers 90 percent of the time and they justify their expensive investment in neighboring land by commingling its value with the price their grandfather paid for their original farm. Thus if they originally owned 200 acres which cost $200 an acre and they buy a neighboring 80 for $3,000 an acre, they figure their investment in the whole 280 is only $1,000 an acre. If they can net $100 an acre they figure they have a 10 per cent return, whereas on the higher priced 80 their return at $100 an acre would be a little over 3 per cent, which is certainly not worth considering by a buyer who owns no other land.

It is therefore my conclusion that it is grossly unfair to a farm family which has been in the business for a number of years to be denied the benefits of these

sections, simply because they are operating as landlords rather than directly. I am sure Congress will be amazed at the complicated legal methods which will be developed to entitle actually nonoperating farm owners to the benefits of these sections, unless their availability is drastically expanded.

Sincerely,

EDWIN W. SALE.

LAW OFFICES OF
EDWIN W. SALE,
Kankakee, Ill., August 3, 1977.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: On July 19, 1977, I directed a letter to you with reference to the hearing scheduled for the Subcommittee on Taxation and Debt Management of the Senate Finance Committee, July 25, 1977.

In that connection I enclose a photo copy of the last page of Kiplinger's Agricultural Letter of July 29, 1977, which bears out my contention that investments in land are made by farmers seeking to expand their holdings rather than by those who would be termed ordinary investors.

Sincerely,

EDWIN W. SALE.

Enclosure.

Demand for land is outrunning supply in major farming areas. And most of it comes from farmers who want to expand current operations. Some are willing to pay "almost anything" to pick up additional acreage that's close to their present holdings. Grab anything that's available.

Extra land at present prices isn't a bad buy for solid operators. Especially those farmers who own their present farms outright . . . or have a high percentage of equity. They have the means to carry the payments. And when cost of new land is averaged with old, the cost is reasonable.

New farm law might give land prices an extra kick. If legislation ties target prices to cost of production and land is included in figuring the costs, farm real estate prices would be riding a faster escalator.

Yours very truly,

THE KIPLINGER WASHINGTON EDITORS.

July 29, 1977.

EHRHARDT & GNAGY,
ATTORNEYS AT LAW,
Elkader, Iowa, August 4, 1977.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: May I voice my serious concern over the "carry-over-basis rule" and other problems under the 1976 Tax Reform Act.

The "carry-over-basis rule" is just impossible to properly follow and to carry out. I have practiced law in a small community all of my life, have done a large probate business and have done much income tax work. I know that our farmers just cannot and do not keep the kind of records that are required to comply with this law. Many farmers buy livestock, for instance, at various times during the year. When they sell this livestock they do not know if it was raised or purchased or if purchased, when and for how much. Then if the farmer is deceased the problem is much more greatly multiplied. Maybe his wife has been taking care of books but she does not know these various articles to which a basis should be affixed.

Beyond that, I don't see how Internal Revenue can possibly administer such a law. We already have estates that were opened after January 1, and can now be closed. I have written for forms or information on complying with this provision of the law and get no response from the Internal Revenue Service. I am fearful that the executor of an estate will necessarily have to be a commercial bank or other institution making a business of acting as an executor or a fiduciary. I have visited with several older lawyers and this provision is enough to make them think seriously about retirement from the practice of the law.

Then I am very concerned what to do about the small estate. Possibly a widow who holds everything in joint tenancy with her husband or maybe doesn't even

need an estate. How does she comply with giving notice to Internal Revenue on the basis of various articles of property? Certainly in the present day of endeavoring to simplify language this is impossibly difficult both for the practicing lawyer, the fiduciary, the heirs and the Internal Revenue Service. I strongly urge that appropriate steps be taken to correct or remove this problem.

Very truly yours,

L. J. EHRHARDT.

MORRIS L. ALLEN,
ATTORNEY AND COUNSELLOR,
Marion, Iowa, August 4, 1977.

Re "Carry-over-basis rule."

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: We wish to submit the following statement concerning the above matter, which we understand will come on for hearing this fall when Congress reconvenes.

1. The "carry-over-basis rule" is highly undesirable due to the fact that it will not be uniformly reported, computed or enforced due to the complexity of the situation.

2. The information necessary to report on the carry-over basis is frequently lost in antiquity and would be very unreliable, yet at the same time, persons using that information may not use it for many years in the future. It would be doubtful whether or not they would in fact have the information that was provided for them in 1977 for a sale of property in 1997.

3. This carry-over basis violates many of the aspects a good tax law should have in that it is not reasonably predictable, nor can the diligent and honest taxpayer prepare a return which is reasonably correct. A high percentage of the taxpayers desire to return information which is reasonably correct, however, on the "carry-over-basis rule," we would be making reports filled with conjecture, misinformation and unsubstantiated guesses.

The administrative burden to transfer basis of property from generation to generation would require an unreasonable amount of administration, both within the government and outside of the government.

4. Cooperation of the taxpayer with his attorney or accountant is likely to be poor due to the fact that the taxpayer would not understand the problem or be able to gather the information necessary for his attorney or tax accountant to comply with this.

Due to the above and foregoing, we respectfully request that the "carry-over-basis rule" be deleted and a better and more understandable method of raising revenue be created, if such a method is necessary in order to support the government.

Respectfully submitted.

MORRIS L. ALLEN.

NICOLA, MARSH & GUDBRANSON,
ATTORNEY AND COUNSELLORS,
Cleveland, Ohio, July 20, 1977.

Re hearing on estate and gift tax problem areas: Capital gain tax rule and/or carryover basis rule.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: May I suggest on behalf of every voting citizen who owns property that consideration be given for an inflation factor exemption in the computation of capital gain taxes. This could either be built into the capital gain tax provisions, or the basis of property provisions relating to capital gains. The factor could be computed by reference to Government tables printed annually.

May I further suggest that apart from the obvious equity involved, that the Government's own projected capital shortfall suggests that it is disastrous for our Government to collect large amounts of capital gain tax, much of which gain is illusory, substantial amounts of death taxes, both representing capital, and then expend this capital on current consumption.

Sincerely,

WERNER D. MUELLER.

THE AMERICAN COLLEGE OF PROBATE COUNSEL,
Los Angeles, Calif., August 1, 1977.

Hon. HARRY F. BYRD, Jr.,
Russell Senate Office Building,
Washington, D.C.

DEAR SENATOR BYRD: On behalf of the American College of Probate Counsel, I wish to congratulate you and your Senate Finance Subcommittee on Taxation and Debt Management for holding the much-needed July 25th hearing on estate and gift tax problems arising from the Tax Reform Act of 1976.

As you mentioned at the July 25th hearing, the latter constituted the first opportunity for lawyers specializing in estate planning and probate practice to express their views on the problems which the 1976 Act causes for the middle-class family, the farmer and the small businessman.

We endorse the testimony of the four distinguished panelists at the July 25th hearing as to the most unfortunate consequences of carryover basis. The American public has expressed a growing uneasiness over the extended time and substantial cost of probate, and we, as practitioners in this area of the law, are keenly aware that we have an obligation to do all we can to meet their concern. We also know from experience that the preparation and audit of the Federal estate tax return has been the main cause for this delay and expense. In three separate appearances before the House Ways and Means Committee and the Senate Finance Committee in the spring and summer of 1976, our College stressed the need for greater simplicity in the estate and gift tax laws so that estates could be settled quickly and expeditiously. In our position paper addressed to the members of the Joint Senate-House Conference Committee on H.R. 10612 (the Tax Reform Act of 1976) we warned of the "many serious problems that the College believes will be created in the administration of tax laws, the probate process and the transmission of wealth from one generation to the next, if certain policy changes are not made in the estate and gift tax reform proposals."

The Act did take one big step toward eliminating the Federal estate tax as the bottleneck in the probate process by providing a higher exemption in the form of a credit and an increased marital deduction so that for deaths after 1980, estates of married taxpayers up to $425,625 (the sum of the $175,625 exemption equivalent to the new credit and the $250,000 marital deduction) escape Federal estate tax entirely. Thus, the need to deal with the Federal estate tax no longer exists in administering most estates.

But, ironically, the carryover basis provisions of the 1976 Act constitute a giant step backwards from the goal of achieving inexpensive and expeditious probate; not just for the large estate, but for all estates with carryover basis property in excess of $60,000. Executors who formerly could rely on date of death values for the basis of assets in the hands of a decedent's estate or beneficiaries must now attempt to determine the acquisition date and cost of every asset except for $10,000 of tangible personal property (if the executor makes the section 1023(b) election). Moreover, this same information is required for all substantial improvements to carryover basis assets. In an era when recordkeeping has been inadequate to begin with and the records were often discarded after three years, who is going to know the cost of a home handed down by gift through one or more generations or the date of installation, and cost, of subsequently installed furnaces, air conditioning, porches, etc? It is true that section 1023(g) (3) provides that where decedent's basis is unknown, such basis shall be treated as being the fair market value of such property as of the approximate date of acquisition, but we must point out that such fair market value itself may be hard to determine, and, furthermore, the fiduciary will still be under pressure to determine the actual basis to see if it is greater than the assumed fair market value. All this examination of records, as well as the elaborate calculations required to determine the four separate adjustments to carryover basis provided by Section 1023 as to each carryover basis asset will greatly increase both the time and cost of probate for all estates, whether small, medium or large.

We should also like to stress another point made by the panel of expert witnesses on July 25th with respect to the adverse long-term effects of the carryover basis provisions of the 1976 Act. We are concerned that the sense of trust and confidence between the executor and the estate's beneficiaries will be greatly eroded, not only because the great complexty of these provisions will necessarily result in many errors in calculations, but also because changes in estate tax values on audit of the estate tax return will result in income tax deficiencies on returns because the income tax returns as filed cannot correctly show gain on

the sale by the estate or the beneficiary of carryover basis assets until final determination of the federal estate tax values. Furthermore, the executor will be put to an impossible task in having to decide who is to receive high-basis assets, who receives low-basis assets and who receives cash from the estate. Obviously, executors are going to be faced with a sharply higher number of court contests of their accountings and malpractice suits against their attorneys will also greatly increase. We predict that many individuals will hereafter refuse to serve as executors and the field will be increasingly dominated by banks and trust companies, a result which we do not believe to be healthy.

The panel of experts on July 25th aptly pointed out how the farmer and small businessman "had been had" by the Tax Reform Act. In many instances the Act negates prior estate planning centering around the use of section 306 preferred stock and buy-sell agreements, since the percentage requirements for qualification for a section 303 redemption of a decedent's stock have been toughened, section 306 stock no longer qualifies for section 303, and carryover basis will cause both capital gains tax and minimum tax on redemptions, which were not previously taxed this way. The additional tax often cannot be paid from the proceeds of the redemption. Moreover, the qualification and recapture provisions of section 2032A make a special valuation of farms at use value a mirage in most instances; thus the belief of both Congress and the farmers that the latters' burdens had been eased is erroneous. It is also important to keep in mind that section 3(i) of the Technical Corrections Bill of 1977 introduces a concept of "indirect retention" of ownership of stock of closely held business which will negate the traditional gifting of such stock, either outright or in trust, as part of the estate plan for a small businessman.

The American College of Probate Counsel is hopeful that at the very least some of the worst defects of carryover basis can be cured by way of amendments to the Technical Corrections Bill. We enclose for your consideration certain legislative proposals which are part of the Statement we will file with the House Ways and Means Committee on that Bill.

We respectfully request that this letter and attachment be made part of the written record of the hearing of your Subcommittee on July 25, 1977. Accordingly, we are sending five copies to Mr. Michael Stern, Staff Director of the Committee on Finance.

The American College of Probate Counsel stands ready to assist you and your Subcommittee on any legislation affecting estate and gift taxation. Arthur Peter, Jr., is our Washington representative (785-1234).

Very truly yours,

FRANK S. BERALL, *Chairman,*
Estate and Gift Tax Reform Committee,
American College of Probate Counsel.

PART II—SUGGESTIONS FOR ADDITIONAL AMENDMENTS

If the carryover basis concept is to remain in the law, we propose amendments (1) through (6) listed below:

(1) *Section 303 should certainly be amended so that the determination of the maximum amount of the redemption distribution takes into account all Federal and state income taxes attributable to gain on the redemption.*

(2) *Amend § 1212 to permit a capital loss carryover from a decedent to his estate and its beneficiaries in a manner similar to the concept of the pass through from an estate or trust of excess deductions under § 642(h).* Although under prior law a capital loss carryover expired with a decedent's death, the step in basis for any appreciated property held by the decedent prevented this loss of the carryover from being a hardship to the estate and its beneficiaries. Now that the decedent's basis for appreciated property is carried over after his death, it will be very advantageous to arrange deathbed sales of sufficient appreciated property to offset existing capital losses and capital loss carryovers from prior years. Obviously, in most cases it will not be possible to accomplish this just prior to death, and the loss of the capital loss carryover, combined with the carryover of the decedent's basis for capital gains purposes, results in unfair treatment in such cases. We recommend that the same treatment be given to existing capital loss carryovers at the death of the decedent that is now given to them upon the termination of an estate or trust under § 642(h).

(3) *Grandfather all assets of a decedent which were owned by him on December 31, 1976, so that they will be subject to the old rules and get the full step-up (or step-down) at death.* This amendment would, as to such assets,

eliminate the problems caused by inadequate records and would also remove the current unfair distinction between marketable securities and other assets of the decedent.

(4) *Amend Section 1023(c) to provide that the estate tax adjustment will be made at the top rather than average rate, and amend Section 691(c) so as to return to the prior rule that this deduction is determined by comparing the actual Federal estate tax with what it would have been without the Section 691 item of income in the gross estate.* The calculations under existing law are geared to the average estate tax payable by the estate rather than the top estate tax bracket, so that even the smallest change by I.R.S. in the valuation of estate assets will require a recomputation of the estate tax adjustment to cost basis and the Section 691(c) deduction, and thus spawn a myriad of protective claims for refund of income tax.

(5) *Section 1023(b)(3) should be amended to increase the $10,000 exclusion for tangible personal property to such a level that carryover basis would no longer be a problem for such assets in estate of persons other than collectors.* (Writers of home owner's insurance should be able to supply the correct figure.)

(6) *Section 1023(d) should be amended to increase the minimum amount for carryover basis properties from $60,000 to $175,625.* The $175,625 figure is the amount of the exemption equivalent to the full amount of unified credit available in 1981 and subsequent years, and it would appear logical to eliminate the complexities of carryover basis for all estates up to the same amount as will be exempt from Federal estate tax.

PETTIT, EVERS & MARTIN,
ATTORNEYS AT LAW,
San Francisco, Calif., August 3, 1977.

Re Hearings on Estate Tax Impact of Tax Reform Act of 1976.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: The following comments pertain to the Orphan's Exclusion added by Act Section 2007(a).

I believe that the Exclusion is a praiseworthy concept, but that the restrictions imposed on gifts in trust severely diminish the usefulness of the Exclusion, and are unnecessarily cumbersome.

Section 2057(c) provides that the deduction is allowed only if the gift fulfills the requirements of Section 2056(b). A literal reading of Section 2057 suggests that if the gift is in trust, the minor must be given mandatory income rights as well as a general power of appointment.

In my experience as an estate planner, most clients would prefer to place gifts to children in a "pot" trust until the youngest child reaches the age of majority, giving the Trustee discretion to distribute income as he deems appropriate. To qualify a gift for the Orphan's Exclusion, I have been forced to create a separate trust for that gift, which provides for mandatory income rights and a general power of appointment. It is not only difficult for clients to understand the rationale behind such a trust, but it increases the cost and complexity of will drafting.

Essentially I believe that the restriction set forth in Section 2057(c) should be eliminated. I can see no congressional purpose which would be frustrated by allowing the Orphan's Exclusion for a gift to a pot trust for the benefit of all the decedent's children.

Very truly yours,

PETTIT, EVERS & MARTIN,
THOMAS R. BENNETT.

LAW OFFICE OF
KUBICEK, NOVAK, KUBICEK & KUBICEK,
Cedar Rapids, Iowa, August 5, 1977.

Re Carry-over-basis rule, Tax Reform Act of 1976.

Hon. MICHAEL T. BLOUIN,
U.S. Representative, House Office Building, Washington, D.C.

DEAR MIKE: As you probably know by now, members of the Iowa State Bar Association who do any probate work are extremely agitated by portions of the above Tax Reform Act and especially the carry-over-basis rule. I feel qualified to

speak out since I have attended four in-depth seminars concerning the Tax Reform Act, am a Fellow of the American College of Probate Counsel, and my specialty is real estate and probate matters.

Yet in spite of this experience and training, I feel extremely uncomfortable with the new law which in many areas appears to have been passed without much thought or preparation. One of these areas is the carry-over-basis rule, being new Code Section 1023. This portion of the law is so bad that I doubt it is enforceable.

Would you please use your influence to seek a repeal of this provision.

Very truly yours,

THEODORE L. KUBICEK.

AMERICAN NATIONAL BANK AND TRUST CO.,
Danville, Va., July 28, 1977.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: As you know, the Congress recently overhauled the income, estate, and gift tax rules in a major fashion thus resulting in the "revolutionary" Tax Reform Act of 1976.

Much has been written about this massive document and we administrators are confronted with trying to understand and explain it to the public but more importantly to comply with the new laws.

One area that should either be repealed or greatly simplified concerns the *New Carryover Basis on Property.* The concept may be great in theory but speaking as an administrator with fifteen years of banking experience, it will be most difficult if not impossible to administer. My peers share this same view and we would appreciate your assistance and support in this area.

With appreciation and kindest regards.

Very truly yours,

E. BUDGE KENT, Jr.,
Vice President and Trust Officer.

DUKEMINIER AND WILBOURNE,
CERTIFIED PUBLIC ACCOUNTANTS,
West Point, Miss., July 16, 1977.

Re estate and gift tax problems.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR SIR: I am writing in regard to the carryover basis rule. I do not think this part of the code can be administered as the person who would know the answers to his basis in property is dead and in most cases no other person can give the information. How many people who have owned a home for 40 or 50 years know what their basis in their home is?

As to the relief for farmers and small businessmen, I don't see how this will help. Most farms are left to widows and then to children. The law states that you must continue to farm the land. In most cases the widow will have to rent the land out and if the land went to children only one child usually stays on the farm as it is not large enough for more than one family to live on it.

Both of the above seem to be a poor law.

Sincerely yours,

GEORGE DUKEMINIER.

LAW OFFICES OF
HAFFKE & HAFFKE,
Fort Morgan, Colo., August 4, 1977.

Re The Tax Reform Act of 1976.

MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR SIR: This is being submitted in quintuplet as written testimony relating to the repeal or substantial amendment of the estate and gift tax provisions of the captioned act. During my over forty years in the practice of law, progression of taxation under the Internal Revenue Code from a reasonable raising of reve-

nue for justifiable and essential governmental functions to a method of confiscation to enslave and make individuals dependent upon autocrats of government has been appalling. Never was it within any thinking person's contemplation that it could attain a vortex such as the Tax Reform Act of 1976, the effect of which can only be described as sequestration only to be expected of tyrants or despots.

There may be many concepts as to the purposes and methods of taxation but it was a politically avowed purpose to maintain vigorous, productive and financially sound family farms and small businesses. Certainly, I hope, it was not the intent to destroy them. However, the application of the estate and gift tax provisions of the 1976 act provides a textbook case of how the power to tax is the power to destroy.

From my experience in handling the affairs of individuals, farmers, ranchers and small business owners, I can only conclude that the 1976 act is inimical to the professed objectives. (Counterproductive in bureaucrateese). If not changed, it will be an administrative nightmare for both the government and those attempting to comply and rapidly erode and destroy the base from which tax revenues flow.

When the $60,000 estate tax exemption was established three to four decades ago, rarely would there have been any need for the filing of an estate tax return on the estate of a decedent owning at the time of his death, (1) a 320-acre irrigated or midwestern general crop farm, a 1280-acre nonirrigated western wheat farm, or a 4000-acre livestock ranch, all with adequate equipment to effectively operate the same; or (2) a thriving independent retail mercantile, grocery, automobile, appliance or other merchandising or service business; or, (3) a home, as a wage earner, having some life insurance, savings and stocks or bonds, and if an estate tax return was required, the tax would have been very nominal.

Now the same type of ownership, although not capable of furnishing any greater service or producing any more product, has an inflated price, (so called market value) ten to twenty times what it was thirty years ago. What was then a forty or fifty thousand dollar farm, ranch, estate or small business with equipment, may now inflatedly be priced from four hundred to six hundred thousand very less valuable dollars. The predatory inflation was resulting in the extortion and destruction of continued individual family farms and small business ownership under the estate and gift tax provisions of the Internal Revenue Code before the so called "Reform Act of 1976". The reform that was essential and required was to exempt the capital values of the family farms, ranches, small businesses and estates from all estate, gift or other death taxes.

Another vicious aspect of the act of 1976 is the carry over basis rules. These rules compound the fiction that there is some income that should be taxed when a capital item is sold, exchanged or passed to another at an inflated price or value over the cost or basis of the transferor or decedent. The perpetuation of this fallacious concept can only result in the eventual ownership of practically all property by gigantic corporate conglomerates or the government with the individuals becoming serfs subject to the whim or caprice or remote bureaucratic or corporate dictators.

Mainly it has been the fiscal policies of government, i.e., spending funds which were not in hand and borrowing or printing money to make up the deficits, that has caused the escalating and destructive inflation. A family farm or ranch with operating equipment that could be, and was, acquired or sold for $50,000 or $60,000 in 1940 to 1945 is, because of inflationary prices, now considered worth $300,000 to $500,000 although it can still only produce substantially the same amount of crops, livestock or food, currently bringing lower prices than thirty years ago. The same ratio applies to small businesses and homeowners. In the intervening thirty to forty years, the persons who have been able to acquire family farms, ranches, small business and homes have only been able to pay for them after first paying exorbitant and burdensome income taxes. That they have them is only because of great industry, frugality and thrift through the joint efforts of spouses and their children.

It is mandatory that there be some indexing of exemptions and rates of taxation to correlate with the rates of inflation. Long or short term gains on capital assets is a fiction. The price at which a capital item is sold or traded, always reflects the cost of a replacement of a like item in the current market. If the seller elects to take dollars instead, the number of dollars will relate to their purchasing power in bringing a like return as that of the capital item sold. Any money received will either be spent for living, invested in some other item or deposited in a bank or savings institution where it will be available for

loans to others. The greater such deposits are, the lower the interest or cost of such loans will be.

With no disrespect to the solons, one cannot but wonder, if they did not understand what they wrought when they passed the act, whether they will understand when anyone tries to explain what needs to be done to rectify the havoc they have created. Most desirable would be to repeal the estate and gift tax provisions enacted by the 1976 act and reinstate the estate and gift tax laws as they were before the 1976 act was enacted but with these amendments: (1) Raise the estate tax exemption from $60,000.00 to $500,000.00 and the gift tax lifetime exemption from $30,000.00 to $250,000.00, (2) Direct that only one-half of the value of properties and assets held by a husband and wife as joint tenants or as tenants by the entirety be included as assets in the estate of the first to die irrespective of whom furnished the funds, and (3) Declare that an annual $3,000.00 gift per donor/per donee is exempt and never shall be considered as made in contemplation of death.

If this is not within the realm of reasonable expectation, although within the realm of reason, then the following minimum amendments should be made, to-wit:

1. Remove all carry-over basis rules and attempts to tax what are denominated as gains and clearly state that the basis in the hands of the estate, trust, heirs, recipients or other beneficiaries of all assets and property that passed from a decedent is that of the values at which each was included for purposes of computing death taxes (Federal and State estate and inheritance taxes);

2. Insert an estate tax exemption of $300,000.00 before the imposition of the combined estate and gift tax rates and credits, e.g., if a person dies with assets (including any called back gifts) valued at $500,000.00, the first $300,000.00 would be exempt and the tax and credits would be applied as to the $200,000.00 exceeding the exemption;

3. Maintain the $3,000.00 per donor/per donee annual gift tax exclusion and declare that any such gift shall not be called back for estate tax purposes nor be considered as having been made in contemplation of death; and,

4. Exempt the first $500,000.00 of any trust established by any decedent for any beneficiary from the application of the skip generation trust provisions.

Respectfully submitted,

EARL W. HAFFKE.

ROSS B. HUTTON,
ATTORNEY AT LAW,
Alta, Iowa, August 4, 1977.

Re: The Tax Reform Act of 1976—written testimony.

MICHAEL STERN,
Staff Director,
Committee on Finance, Dirksen Senate Office Building,
Washington, D.C.

SIRS: The income tax basis should be the same as the estate tax basis, like it was under the former laws, and the carryover basis, and the "Fresh Start" basis, and all the other adjustments put into the new reform act should be voided and retroactively stricken from the law.

As this new law is set up, it would take a Philadelphia lawyer with a major in calculus to even find through it and try to comply with it, and I.R.S. will never be able to hire enough experts to police such a law. Why penalize the taxpayer and why do it in the name of "reform" and try and kid him that you are helping him?

If the carryover basis is the same basis as the one used for the estate tax, the government will still end up getting the money and the taxpayers who opt to have their farms valued at the lower values because the farm family is in the business and does so qualify will be "nailed" at any later rate when the farm may be sold, as they will have a lower cost basis, and thus a larger capital gain.

Why talk about simplifying laws without ever doing it?

Let's amaze the taxpayer by throwing out the garbage part of this new law.

Yours truly,

ROSS B. HUTTON.

P.S. I have been a tax preparer and tax practitioner for over 30 years and am still actively so engaged. This new law is so complicated that it even affects small estates that pay no Federal Estate Tax, because it forces them to figure their new carryover basis, for each item of the estate, and to send a copy to the government and to the heirs, making an intolerable burden, oftentimes for a widow who is the sole heir and owes no taxes.

LAW OFFICE,
DAVID K. GILMORE,
Walnut Creek, Calif., August 2, 1977.

Re Estate and Gift Tax Problems of TRA 1976.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: My tax service says that you represent a subcommittee considering the above problems and will accept advice from the public. I have been practicing law in California for 42 years, concentrating in probate and estate planning law. I have sought to master the 1976 Tax Reform Act and, so far, have had something like a dozen opportunities to apply it in planning, and a half dozen opportunities to apply it to the estates of persons dying this year.

As a whole it works quite well, but I find that the carryover basis rule for determining capital gain on sale not only offends my sense of fairness, but in most cases involves research totally beyond the ability of my widows to carry out.

Change, if you must, the rates of death tax or of capital gain tax, but don't make us go back of the value at the date of death to determine the tax on the sale of assets owned at death. Life is too short for such endeavors.

Respectfully submitted,

D. K. GILMORE.

PETTIT, EVERS & MARTIN,
ATTORNEYS AT LAW,
San Francisco, Calif., August 3, 1977.

Re Hearings on Estate Tax Impact of Tax Reform Act of 1976.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: The following comments pertain to the Orphan's Exclusion added by Act Section 2007(a).

I believe that the Exclusion is a praiseworthy concept, but that the restrictions imposed on gifts in trust severely diminish the usefulness of the Exclusion, and are unnecessarily cumbersome.

Section 2057(c) provides that the deduction is allowed only if the gift fulfills the requirements of Section 2056(b). A literal reading of Section 2057 suggests that if the gift is in trust, the minor must be given mandatory income rights as well as a general power of appointment.

In my experience as an estate planner, most clients would prefer to place gifts to children in a "pot" trust until the youngest child reaches the age of majority, giving the Trustee discretion to distribute income as he deems appropriate. To qualify a gift for the Orphan's Exclusion, I have been forced to create a separate trust for that gift, which provides for mandatory income rights and a general power of appointment. It is not only difficult for clients to understand the rationale behind such a trust, but it increases the cost and complexity of will drafting.

Essentially I believe that the restriction set forth in Section 2057(c) should be eliminated. I can see no congressional purpose which would be frustrated by allowing the Orphan's Exclusion for a gift to a pot trust for the benefit of all the decedent's children.

Very truly yours,

PETTIT, EVERS & MARTIN,
THOMAS R. BENNETT.

THOMPSON & KITTOE,
CERTIFIED PUBLIC ACCOUNTANTS,
Seattle, Wash., August 2, 1977.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: This letter is being written in response to an article published in the July 14, 1977 issue of the Research Institute of America's Federal Tax Coordinator 2d (Weekly Alert) in which it states that persons who have

estate tax problems arising from the Tax Reform Act of 1976 especially those affecting the average estate and estates containing interests in small or closely-held businesses should contact your office.

I am deeply concerned about the possible interpretation by the Internal Revenue Service of the new law which deals with the election to extend the payment of estate tax attributable to a farm or other closely-held business for up to 15 years.

The IRS has ruled that for purposes of the automatic *ten-year* extension, mere management of rental property, such as a shopping center, does not constitute a *trade or business*. It is my belief that this ruling is not only arbitrary and unfair, but does not now reflect the intent of C··gress. I believe the IRS will rule in the same manner in regard to the 15-year e 'on.

The stated purpose of the deferred payment ' .ion is to lessen the need for forced sales in order to pay estate taxes. If ...s is the "real" purpose, why should closely-held businesses which deal with income producing properties, be treated differently than closely-held businesses which produce "business" income?

Below is a passage from the April 1977 Federal Tax Coordinator 2d in which the writer quotes the ruling of the IRS on the 10-year election as follows:

"The election was not intended to protect continued management of income producing properties or to permit deferral of the tax merely because the payment of the tax might make necessary the sale of income-producing assets, except where they formed a part of an active enterprise producing business income rather than income solely from the ownership of property."

If this is the position of the IRS on the new election, I must question their reasoning.

The 15-year election should be available to all farmers and small businessmen regardless of the type of business or source of income where the breaking up of the business to pay estate taxes would work a serious economic hardship upon that business and indirectly affect the spouse of the deceased who is usually uninitiated in the operations of the business.

In conclusion, I would like to state that I believe that the IRS tries (and succeeds) in makin too many exceptions to general rules. Their stand on who can qualify for the ten-year extension is only one example of many which point to the unfairness which results from their biased decisions. I hope that Senator Byrd's Subcommittee issues definitive rules allowing the estates of owners of small or closely-held businesses to avail themselves of the deferred payment election.

Very truly yours,

THOMPSON & KITTOE,
B. K. KITTOE.

DOYLE & MIDEY.
ATTORNEYS AND COUNSELORS AT LAW,
Seneca Falls, N.Y., August 8, 1976.

Re Subcommittee on Taxation and Debt Management—Senate Finance Committee, Tax Reform Act of 1976.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
Dirksen Senate Office Building,
Washington, D.C.

DEAR MR. STERN: I received notice informing me of the public hearing to be held shortly with respect to estate and gift problems encountered by farmers and small businessmen as a result of the Tax Reform Act of 1976. I am an attorney engaged in a small town practice in Seneca Falls, New York and a substantial part of my time is devoted to probate and estate tax matters.

It so happened that a few days after the Tax Reform Act of 1976 went into effect this office was retained to represent the executor of the estate of a farmer who died shortly after January 1. Since that time I have collected the assets of the estate and before the year is up I hope to wind up its administration. The estate has not presented many conceptual problems with the significant exception of those created by the Tax Reform Act of 1976.

My first problem is a practical one. The federal estate tax return is due in September, yet I have been wholly unable to obtain a copy of the new forms I need to file. It seems to me that if Congress enacts sweeping tax reforms it should make an equal bureaucratic commitment to allow the Internal Revenue

Service the additional personnel and money needed to inform the general public of the changes and to supply the required forms.

My single largest concern is the carryover basis rules and the practical problems involved in applying them to this estate. As you know, a fiduciary is now required to furnish all beneficiaries with the decedent's cost basis for items received from the estate. A significant asset of the estate I am handling is the family farm and homestead. The decedent acquired his farm in 1932 from his father for a sum of money (of which there is no record), an annuity of $40.00 a month, the lifetime use of a dwelling house and garage, a promise to furnish "firewood for one-cook stove and also wood for use in first party's (father's) furnace during the fall and spring" and also a promise to furnish two quarts of milk per day and sufficient fruit from the farm for the father's use. Over the last 40 years innumerable improvements to the farm have been made for which virtually no records are available, and the executor, who is the decedent's son, tells me he cannot possibly reconstruct the decedent's cost basis for the property. My problem is relatively minor in this case because the decedent died close to the effective date of the Reform Act and his basis is nearly the same as the fair market value at death, but I foresee similar situations in the future in which it will be absolutely impossible to approximate a farmer's cost basis or to estimate the capital gains tax to be paid by his estate should the farm be sold.

I am opposed to the carryover basis rules in principle because of the tax penalty which they impose upon future generations. What the government has given with a general decrease in estate taxes it will take away with a vengeance as the effect of the capital gains provisions of the new law become apparent. Moreover, this problem will be even more troublesome for widows and children who have to sell assets to raise cash if the Carter Administration makes good on its promise to close the capital gains "loophole". Taxes necessarily complicate our lives but it seems to me that death is an event which should wipe the slate clean and provide a platform from which a family's financial affairs can be renewed with certainty and predictability.

As I have indicated, I am also concerned over the practical implications for a fiduciary who is required under *penalty of law* to furnish each beneficiary with a cost basis for all the assets distributed by him. As in the estate which I am now handling, this can be an impossible task to perform.

As you can see, I strongly favor the repeal of the carryover basis rules and favor a return to the former stepped up basis concept. I sincerely hope that these observations will have some effect in this regard upon the committee's deliberations and that the result will be a more equitable and simplified estate tax.

Very truly yours,

DOYLE & MIDEY,
CALVIN A. BRAINARD.

STATEMENT OF ERWIN N. GRISWOLD

My name is Erwin N. Griswold. I am domiciled in Belmont, Massachusetts, but for the past ten years have been resident in Washington, D.C., where I am now practicing law.

From 1929 to 1934, I worked for the Federal Government, in the Solicitor General's office. From 1934 until 1937, I was a member of the faculty of the Harvard Law School, and was Dean of that school from 1946 until 1967. In 1967, by appointment of President Johnson, I became Solicitor General of the United States. I held that office until June, 1973, when I retired.

Early in 1913, at the age of eight, I spent a period in the hospital when my appendix was removed. People brought me stamps and it was then that I began to collect stamps. At first it was simply a boyhood hobby. As I became older, though, I followed the stamp market closely, and was impressed with the fact that stamps can be a sound investment. I became well acquainted with the factors which make some stamps good investments, while others are not. I bought stamps from dealers and at auctions. This continued for a number of years, in a modest way, until there was an important change in the circumstances of my life.

In 1939, thirty-eight years ago, my wife had a serious case of infantile paralysis. She is completely paralyzed from the waist down. She is able to get about with crutches and braces, and with the use of a wheelchair. She does remarkably well, but she is severely handicapped. At the time of her illness, I was thirty-five and she was thirty-four, and we had two small children. I had heavy medical expenses, far exceeding my salary at the Harvard Law School. (As a matter of

fact, it was my wife's case which led Randolph E. Paul, then General Counsel of the Treasury, to recommend to the Congress the adoption of the deduction for extraordinary medical expenses, now found in § 213 of the 1954 Code. I have never received any benefit from that deduction, since my wife's major medical expenses preceded the adoption of that provision.)

After my wife came home, my great concern was that there should be adequate provision to see that she was taken care of in the event that I was no longer here. I took out additional life insurance, and I tried to save and to make productive investments. Over the years, I invested more and more in stamps. There were two special reasons for this, apart from their investment potential: (1) they do not produce current income, and (2) they present almost no problem of conflict of interest.

Even as a law professor, I was concerned about possible conflicts of interest. This became even more important in later years when I was in Government service. In 1961, I was appointed a member of the United States Commission on Civil Rights by President Kennedy. I resigned this office in 1967, but then held the office of Solicitor General for nearly six years. Thus, I held federal office from 1961 to 1973, a period of twelve consecutive years. Particularly while I was Solicitor General, the ownership of shares in corporations, or, indeed, the ownership of investment real estate, could frequently have raised conflict of interest questions. Consequently, I invested more and more in stamps. This had long since ceased to be a hobby. The stamps were kept in a safe deposit box. They have continued to be good investments, even when the market for securities has declined. Making adequate provision for my wife remained a primary concern for me, but as I was able to accumulate more and more, the pressure I felt about seeing that my wife would be properly cared for was slowly reduced.

No one else in my family is interested in stamps. It was always my expectation that my executor would sell the stamps, and I have left instructions with him about dealers who might be used for that purpose. I fully understood the value of the stamps would be included in my gross estate at the time of my death, and that was all right with me. I figured that there would be no problem about valuing them, because they would be sold shortly after my death.

One of the things that has given me great concern in connection with my efforts to provide for my wife has been ever-increasing inflation. Anything else that I have done has suffered from inflation. The insurance that I took out forty years and more ago served well for a while, but its purchasing power now is considerably reduced. Some municipal bonds which I purchased, as a part of the plan to avoid conflicts of interest, are worth less than I paid for them. It is, of course, wholly appropriate that there should be an estate tax on the value of the stamps. But it is not really, as a practical matter, double taxation to add an income tax, too, when the increment in value is, to a considerable extent, simply a reflection of the inflation which has occurred over the past twenty or twenty-five years?

In the fall of 1976, with little warning, and no public hearings on this matter, the estate tax provisions of the Tax Reform Act of 1976 were enacted, including the provision for carry-over basis. With respect to securities, this provided a new start on January 1, 1977. With respect to other property, though, it becomes necessary to determine the cost, and there is a complicated allocation of the increment over cost. I have made no count, but in my case, I would guess at least ten thousand items, probably more, will be involved in this process, bought at different times for various prices, some times as single items, but often in groups for an unallocated lump sum, with the groups often broken up and re-arranged. Moreover, for the most part, I have few, if any, records. Some of these stamps were bought as long as sixty years ago. (Part of the money which I earned as a pageboy in the East Cleveland Public Library while I was in high school was used to buy stamps.) These early purchases do not aggregate a great deal, but beginning in the 1930s, I bought more actively. I kept no detailed record of these purchases. I did not think it was necessary, since I had no expectation of selling the stamps while I lived, and thought that the date of death value would be the relevant figure if they were sold after I died. To some extent, I suppose that I can reconstruct the cost of some of the items by using figures on my checkstubs, if I can find my checkstubs back over a period of thirty or forty years. That will be very difficult for me to do, and it could, at best, cover only a portion of the items.

Even if the records could be put together, the computations would be extraordinarily complicated. For each item, a cost and a date would have to be determined, then a sale price, which may require an allocation if all the stamps should

be sold in a single lot, or in several lots. That allocation would require valuing each item, so as to determine the portion of the sale price allocable to each item. Then a gain would have to be determined for each item, and the resulting gain would have to be allocated over the period from the date of acquisition to the date of death. As I have said, there are at least ten thousand items, probably more. It would be very difficult for me to do this. It will be virtually impossible for my executor to do it.

I have worked in the field of taxation most of my life. I have argued many federal taxation cases for the Government before the Supreme Court. I fully understand what Justice Holmes meant when he said that "Taxes are what I pay for civilization." And I have no objection to paying my proper share. Somehow or other, though, I have not been able to escape the feeling that I have been caught rather badly, and that the effect of the change of the law in 1976, as applied to me, may be unfair, and beyond the contemplation of Congress when the carry-over basis provision was so hastily enacted.

Like many others, my basic purpose has been to see that my wife is properly provided for. This is not altogether easy in her case. She is already considerably handicapped, and her condition may become worse in later years. From some experience I have had, I know that if she should require around-the-clock attendants, it will be hard to keep the cost below $50,000 a year. If that should last for ten or twelve years, or more, the aggregate could be considerable.

My basic objective was to provide for my wife. I thought I had found a way to do this, and at the same time minimize conflicts of interest in my academic and government work. This was seeming to work out well until the fall of 1976. Now, the practical problem confronting me is a very serious one.

Could the carry-over basis, if it is to be used, be made applicable to property *acquired* after the enactment of the 1976 Act? Gain 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. I know of the proposal that there be an optional valuation method which uses a percentage figure for determining increase in value after January 1, 1977. But the percentage suggested is too high. And this method is unfair as to property held for a long time before 1977. Thus, the figure mentioned is eight percent, which is to be compounded. That would mean that if death occurs ten years after January 1, 1977, virtually the whole increment would be treated as having occurred after January 1, 1977. This is unrealistic when it is clear that much of the gain arose prior to that date. Surely a lower percentage should be used, and some way should be worked out to apply it in such a way that all of the pre-1977 gain will not soon be wiped out.

There is an appeal, I know, in the carry-over basis idea. But, it may be a matter of carrying things to a dryly logical extreme. In view of the persistent inflation, it may be that the Federal Government gets its appropriate share when it takes an estate tax from a decedent's estate. To apply an income tax, too, on the gain which passes with the property and as a part of the property at the time of death, may be more than is appropriate. And the difficulties are especially great in a situation where there is no feasible way to establish the cost basis of much of the property involved.

Though these facts are necessarily highly personal, I present them for consideration by the Committee in the hope that they will show a concrete exampe of unforeseen consequences of the legislation enacated in 1976, and may lead the Committee to develop amending legislation which is more workable and more fair as a part of the over-all system of federal taxation.

JOHN GRIFFIN,
BUSINESS & TAX CONSULTANT.
Fullerton, Calif., August 1, 1977.

MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR SIR: Many tax practitioners in Southern California, myself included are virtually concerned with a requirement of one estate tax area of the 1976 Tax Reform Act. This is code Section 1023.

Our collective interpretation of that section 1023 is basically this: Whether a decedent's gross estate is subject to estate taxes or not, there are certain additional new filing requirements. The executor of the estate is charged with

the responsibility of furnishing the Treasury and the beneficiaries with a listing of the "carryover basis property" and the correct basis for each such property. We have read where Treasury regulations are forthcoming that will spell out the procedure. To my knowledge these Treasury regulations are not yet available.

Because we have clients who are affectd by this new code section and also that there are penalties attached, it is necessary that clarification be made available to us.

What form is to be used? What office of the Treasury Department receives this information? What is the time limit before penalties are assessed?

I realize that the 1976 Tax Reform Act has placed a heavy burden on your shoulder, but so that we may comply, any clarification that your committee can supply will be greatly appreciated.

Thank you.

JOHN GRIFFIN.

STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION

We appreciate this opportunity to submit Farm Bureau's comments on problems arising from the gift and estate tax revisions made by the Tax Reform Act of 1976.

Farm Bureau members have been actively involved in the past several years in seeking reform of the federal gift and estate tax law. Some measure of gift and estate tax relief was achieved for many of our members in the Tax Reform Act of 1976; however, taxes were increased for some farm and ranch estates and some difficulties are beginning to surface.

We wish to preface our comments and recommendations with a reminder that, at this time, we have had relatively little experience with the new gift and estate tax law. With many rules and regulations still pending and only a small number of our member families having had first-hand experience with the new law, it is difficult to assess the impact of the changes on farmers and ranchers.

The most common concern, by far, of farm and ranch families relates to the change which requires the use of a carryover basis for property acquired from a decedent in lieu of the previous practice of permitting the basis of such property to be stepped up to its fair market value at date of the decedent's death. This provision is especially hard on farmers and ranchers because the long holding period typical of farm property often results in substantial "gains" which represent an adjustment to inflation rather than an increase in real wealth.

The carryover basis imposes an excessive, and most unfair, burden on executors and heirs in cases where a decedent failed to keep adequate records or to leave such records where they can be found.

Farm Bureau will continue to urge repeal of the carryover basis.

The special provision allowing executors of the estates of owners of farms and other closely held businesses to value real property on the basis of its use as a farm or closely held business rather than its fair market value has created some difficulties. Some farmers and ranchers appear to be reluctant to allow the U.S. government to hold liens on their property as provided in the special use valuation section of the Tax Reform Act of 1976. This reluctance, coupled with the numerous rules and qualifications associated with the special use valuation, may severely limit the number of those who will decide to avail themselves of this section of the new law.

The repeal of the "contemplation of death" feature of the old law has created difficulties. While the old provision resulted in some litigation, it was generally accepted that an accidental or unexpected death would not affect a gift made within the previous three years. The current law includes in the estate all gifts made within three years of death, except those shielded by the annual exclusion, and requires reappraisal of such gifts at the time of death. Farmers and ranchers do not understand why the appraisal made the year the gift was made should not be allowed to stand.

Farm and ranch families also have a number of concerns which may, in part, reflect a lack of understanding of complicated legal provisions and which certainly indicate a need for IRS to publish an understandable explanation of the current law as it applies to farm estates. For example:

1. The increase in the marital deduction provided by the Tax Reform Act of 1976 has been well publicized and is widely understood. There is, however, a concern that the revised marital deduction may lull some taxpayers into a false sense of security. In many cases the objective of the farmowner is to pass his business on to his children; and the marital deduction merely postpones the estate tax until the death of the surviving spouse, at which time the children are faced with payment of the tax. We believe the marital deduction should be explained and publicized as a means of postponing estate taxes and not as a cure-all for estate tax problems.

2. The elimination of the specific $30,000 lifetime exemption for gifts is viewed by many Farm Bureau members as having an inhibiting effect on efforts to pass interests in farms and ranches to succeeding generations.

We believe this Committee should continue to explore the impact of the Tax Reform Act of 1976 on farmers and ranchers and take remedial action where necessary.

We respectfully request that our statement be made a part of the hearing record.

PAUL J. DUNN,
Tiffin, Ohio, July 22, 1977.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: In accord with your press release of July 1, 1977 announcing that Senator Byrd's Subcommittee on Taxation would be pleased to receive written testimony from persons who wish to submit statements for the record concerning "estate tax problems arising from the Tax Reform Act of 1976, especially those affecting the average estate and estates containing interests in small closely held businesses", I wish to submit the following terse and simplistic comment.

The bookkeeping requirements, needless complexity and terrible confusion created by the Tax Reform Act of 1976 probably ranks it as one of the most ill-conceived and vicious pieces of legislation that ever emanated from the halls of the Congress of the United States.

Thank you.

Sincerely,

PAUL J. DUNN.

JOINT STATEMENT OF NATIONAL LIVESTOCK TAX COMMITTEE, AMERICAN NATIONAL CATTLEMEN'S ASSOCIATION, NATIONAL LIVESTOCK FEEDERS ASSOCIATION, AND NATIONAL WOOL GROWERS ASSOCIATION

SUMMARY

1. *Carryover Basis Should be Repealed.* Carryover basis creates problems of compliance and administration which are onerous and will result in additional expense. It also can have an adverse effect on the traditional method of administering estates and will increase the cost of transferring property at death. Further, carryover basis will result in the imposition of higher taxes; and where an estate has to sell property to pay death taxes or administration expenses, a double tax burden will result. Many family farm and ranch operations may not be able to pay this added tax without liquidating the business.

2. *Farm Land Valuation Provision Should Be Amended.*

a. *$500,000 Limitation Should be Eliminated.* The $500,000 limitation rule serves to restrict the intended benefits of the farm valuation provision because of increases in the size of family farm and ranch operations and in the value of farm land. Other restrictions contained in the farm valuation provision are sufficient to restrict its availability to estates of family operated farms and ranches.

b. *15 Year Recapture Period is Too Long and Should Either Be Significantly Reduced or a Viable Alternative to Recapture Adopted.* A recapture period much shorter than 15 years would be sufficient to deter speculation and provide continuation of the family farm operation without unfairly restricting the agricultural activities of the surviving family members and causing possible title and loan problems. In the alternative, a workable substitute to recapture might be adopted.

c. *Material Participation Requirement Will Cause Problems and Should be Deleted in Favor of a More Feasible Test.* Material participation can result in the imposition of self-employment tax on earnings from a farm business and reduce the amount of social security benefits in certain cases. Accordingly, a more suitable test should be devised.

d. *Provisions in Technical Amendments Bill (H.R. 6715) Concerning Farm Land Valuation Rule Should be Adopted.*

3. *As Indicated in Recent Internal Revenue Service Release, Tax Liens for Recapture Tax and Extended Payment of Estate Tax Provision Should Be Given Such Status So As Not to Impede Flow of Vital Credit to Surviving Family Members of Deceased Farmer or Rancher.*

4. *To Provide Equality of Treatment With Other Capital Assets, Cattle and Horses Held for Draft, Breeding, Dairy or Sporting Purposes Which are Sold by the Estate or Heirs of a Deceased Farmer or Rancher Should be Considered to Have Been Held by the Estate or Heirs for the Applicable Period Required for Long-Term Capital Gains Treatment.*

JOINT STATEMENT

INTRODUCTION

Formed in 1942, the National Livestock Tax Committee (NLTC) is sponsored by a number of national, breed and state livestock associations throughout the country and has as its purpose maintaining and assuring equity and equality in the fields of federal income, gift and estate taxation for the entire livestock industry.

Representing over 300,000 cattlemen throughout the nation, the American National Cattlemen's Association (ANCA) is a voluntary, nonprofit, nonpolitical organization.

The National Livestock Feeders Association (NFLA), a nonprofit, voluntary, nonpolitical organization, has a membership composed of stockmen residing in 20 states with the largest concentration in the north central part of the country.

The National Wool Growers Association (NWGA), a voluntary, nonprofit, nonpolitical organization, represents 22 state and regional organizations encompassing a 25 state area, where 90 percent of the nation's lambs and wool are produced.

NLTC, ANCA, NLFA, and NWGA speak for the entire red meat animal industry in the nation. In addition, NLTC represents dairy and horse organizations.

In 1976, as well as in prior years, representatives of NLTC, ANCA, NLFA, and NWGA appeared before the Senate Finance Committee to testify on the subject of estate and gift taxation as it affected farm and ranch operations. See Statement dated March 22, 1976.

I

OVERVIEW—ESTATE AND GIFT TAX PROVISIONS OF 1976 TAX REFORM ACT

A. BENEFICIAL PROVISIONS—FEDERAL ESTATE VALUATION OF FARMLAND AND EXTENDED TIME WITHIN WHICH TO PAY FEDERAL ESTATE TAXES

In joint testimony presented to the Senate Finance Committee in 1976, NLTC, ANCA, NLFA, and NWGA pointed out that the existence and continuation of farm and ranch operations were seriously threatened by the federal estate tax. A strong plea was made for the immediate enactment of remedial legislation which would permit the federal estate tax valuation of farm and ranch land based upon such land's earning capacity or productivity for agricultural purposes. Among other changes urged was the critical need for more flexibility and time for farm and ranch estates to pay the escalating federal estate taxes.

The 1976 Tax Reform Act (TRA) contained provisions permitting the executor of a deceased rancher's estate, if certain requirements are met, to elect (a) to value farm land and improvements for federal estate tax purposes based upon the land's use for agricultural purposes and (b) to pay the federal estate tax applicable to the farm or ranch over a period of up to 15 years following the rancher's death with only interest payable during the first 5 years and then principal and interest for the remaining 10 years. While both of these provisions should be beneficial and help reduce the illiquidity and related problems previously faced by farm and ranch estates, certain amendments are needed in

order to make these provisions confer the advantages intended for perpetuating the family farm and ranch.

B. MOST HARMFUL PROVISIONS—CARRYOVER BASIS

For farm and ranch estates, as well as other estates, the most detrimental provision of the 1976 TRA is the one relating to carryover basis. NLTC, ANCA, NLFA and NWGA opposed such provision in their joint statement filed in 1976 with the Senate Finance Committee and continue to object to the inclusion of such provision in the federal tax laws. Besides causing complexity in both compliance and administration, carryover basis will have a particularly deleterious effect on farm and ranch operations because of the additional tax burden it will impose on such operations.

II

CARRYOVER BASIS SHOULD BE REPEALED

Since passage of the 1976 TRA, there has been a groundswell of opposition to the carryover basis provision. NLTC, ANCA, NLFA, and NWGA support and strongly urge repeal of the carryover basis provision. Because of its complexity, carryover basis will be extremely difficult to comply with as well as to administer. Additionally, carryover basis will increase the tax burden and compound the illiquidity of estates of farmers, ranchers and other family business operators which have to sell property in order to raise sufficient cash to pay death taxes and administration expenses.

A. COMPLEXITY OF CARRYOVER BASIS CREATES PROBLEMS OF COMPLIANCE AND ADMINISTRATION WHICH ARE ONEROUS AND 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 4 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 trust officer with the First National Bank of Denver. This computation form which represents over 100 hours of research shows that there are *61* 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 7 additional computations which may be necessary in order to determine the figures to insert in some of the steps indicated on the computation form.

That sophisticated and expensive computers will be required to compute the correct basis figures under the carryover basis provisions is clearly apparent. Even then, computation of carryover basis 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 1930's or 1940's is going to be difficult at best and in some cases a virtual impossibility, especially for family farm and ranch estates where the farm and ranch have usually been held for a great number of years. 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 decedent acquired such property may be more illusionary than helpful. In the case of farm and ranch properties acquired in different segments and at various times over many years, such calculation will be burdensome. Moreover, any fair market value so determined can be expected to be examined and question by the Internal Revenue Service, resulting in additional and further controversy and expense.

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, with a ceiling of $2,500 on total penalties which may be assessed.

Executors will face additional burdens under carryover basis in distributing property to a decedent's heirs and as a consequence face the prospect of litigation involving such distributions. If their heirs of a decedent do not all receive property of equal value having the same income tax basis, which is a virtual impossibility especially 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. Distrust and family inharmony will be the natural consequences of this situation caused 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. A concomitant cost will also likely be incurred by the Internal Revenue Service in administering this provision. The result will be to increase the cost of transferring property at death and requiring more federal revenue to be spent in administering this complex and unnecessary provision.

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. 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 and ranches, 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 undesireable and harmful provision.

B. CARRYOVER BASIS CREATES ADDITIONAL TAX BURDENS

Estates which are not subject to the payment of federal estates taxes because of various deductions and credits may nevertheless have to pay higher income taxes as a result of carryover basis if property is sold by the estate or the heirs. The amount of such tax is increased in many cases where capital gains are involved because of the tightening of the minimum tax provisions under the 1976 TRA. In other cases, there will be a pyramiding of federal taxes under the carryover basis provision.

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 1977 leaving an estate valued at $545,000 to a son. Most of the estate consists of corn and beans which were raised in 1977. 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 has 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, however, there is not as much liquidity available to pay death taxes and administration expenses on the death of a farmer or rancher largely because of the amount of farm or ranch land owned by the decedent. Where this occurs, the farmer's estate may be required to sell some of the land to pay death taxes, even when the impact of such taxes may be ameliorated by the special farm use valuation and extended tax payment provisions. Such sale of farm land 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 land plus a federal estate tax on the land's value. Because the income tax basis of farm land is traditionally low reflecting the number of years it has been held, the amount of the capital gains can be quite high. The result is a capital gains tax at death (made worse by the more stringent minimum tax rule) in addition to the federal estate tax. The estates of many farmers and ranchers may not be able to bear this double tax burden which could mean the liquidation of the family farm or ranch. With the need to maintain a sound and productive agricultural system to provide the country with adequate supplies of food and fibre, carryover basis can strike a lethal blow to this desired goal.

While not affecting farmers and ranchers as much as other persons, there is a lock-in problem caused by carryover basis. Carryover basis will tend to freeze assets within estates because the heirs may not be able to afford to sell them and pay the tax which would result. Some comment has been made that

this will cause an impediment to the free flow of capital and have an aderyse effect on the economic structure of our country.

Whether forced to sell farm property to pay death taxes and administration expenses or whether sales occur in the regular and normal marketing of farm crops and livestock following the death of a farmer or rancher, there will now be more tax to pay because of carryover basis. The strain this added tax burden will place on many family farms and ranches could result in liquidation of the operation. For this reason, it is respectfully submitted that carryover basis is unwise both as a tax and as an economic policy.

III

AMENDMENTS NEEDED TO FARM LAND VALUATION PROVISION

The stated congressional purpose for the provision in the 1976 TRA permitting farm land and improvements to be valued for federal estate tax purposes based upon agricultural use was "to encourage the continued use of property for farming . . ." by members of the deceased farmer's family. H.R. Rep. No. 94-1380, 94th Cong., 2nd Sess. 22 (1976). NLTC, ANCA, NLFA and NWGA feel that this stated purpose can best be achieved if certain amendments are made to the farm land valuation provision.

A. $500,000 LIMITATION SHOULD BE ELIMINATED

Under the 1976 TRA, the special use valuation cannot reduce the fair market value of the farm land by more than $500,000. No reason is given for this limitation in the committee reports. It is the position of the NLTC, ANCA, NLFA and NWGA that this limitation is contrary to the stated Congressional purpose of providing much needed estate tax relief to family farms and ranches and encouraging the family ownership and operation of farms and ranches.

By imposing a $500,000 limitation on this valuation provision, the benefits of this provision are significantly limited. With the growth in size of family owned agricultural operations and the historic pattern of increasing farm land values, the $500,000 limitation severely and unnecessarily restricts the intended beneficial effect of this special valuation provision.

U.S. Department of Agriculture figures reveal that farm land values continue to increase at a rapid rate. For just the period from November, 1975 to November, 1976, farm land values increased on an average nationally of 17 percent with some states in the midwest reporting increases as high as 41 percent. See *Farm Real Estate Market Developments*, U.S.D.A. (CD81-Jan. 1977). Recent reports from the U.S. Department of Agriculture reveal that the average value of farm land on a per acre basis rose from $390 in February, 1976 to $456 in February, 1977 and that the value of farm land is expected to continue to rise another 8 percent to 10 percent during 1977. Of all farm land purchases the U.S. Department of Agriculture noted that the majority of them related to farm enlargements whereby farmers bought adjoining or nearby land to add to their existing holdings.

Families are expanding the size of their farming operations to justify new expensive equipment which is needed in today's modern agricultural practice. This expansion helps lower the per unit cost of production and thereby increase the revenues and ultimate profitability of the operation. With these increases in land holdings, family farms are growing in value at a rapid pace.

To encourage the continued vitality and growth of family farms and to avoid the forced liquidation caused in past years by escalating federal estate taxes, the $500,000 limitation should be eliminated from the farm use valuation. This $500,000 limitation is counter productive to the purpose of the farm use valuation provision which is to promote farming operations by family units and permit the transfer of farms to surviving family members without the imposition of burdensome estate taxes that could result in a forced liquidation. As farm land values continue to grow, the $500,000 limitation will needlessly and unjustifiably restrict the benefits of the farm land valuation provision.

Sufficient restrictions are presently contained in the farm land valuation provision to limit the benefits of the provision to estates of family operated farms and ranches. Thus, the $500,000 limitation serves no useful purpose and is in fact detrimental to estates of deceased farmers and ranchers.

For the foregoing reasons, NLTC, ANCA, NLFA and NWGA respectfully urge the elimination of the $500,000 limitation.

B. 15-YEAR RECAPTURE PERIOD IS TOO LONG

In proposing adoption of the farm land valuation provision, NLTC, ANCA, NLFA, and NWGA supported a recapture period of 5 years following the death of a farmer or rancher so as to eliminate possible speculation and to promote continuation of the land in agricultural production by the surviving family members. However, it is felt that the 15-year recapture period presently provided in the farm land valuation provision is too long and is not needed.

Since the avowed Congressional purpose for the recapture provision is to assure that the surviving family members use the farm land for agricultural purposes for a "reasonable period of time after the decedent's death", it is submitted that a period significantly shorter than 15 years would be a more reasonable time. Further, the surviving family members for economic and business reasons may find it prudent to sell a portion of the farm or ranch land and buy additional land in another area. For example, during drought conditions, such as presently being experienced, it can be necessary to sell some land and acquire other land in another region affected by the drought. Under the 1976 TRA, such sales of land within a 15-year period would result in triggering recapture.

An additional problem with the 15-year recapture period is that the lien placed on the farm land during this extended period could cause title and possible loan problems. There is less likelihood of this being a problem if a shorter recapture period applied or if an acceptable alternative to the recapture approach were found.

The Senate Finance Committee bill in 1976 contained a farm land valuation provision which specified a full recapture for 2 years following the deceased farmer or rancher's death with a scaled down recapture for the next 8 years. Such a recapture rule would be more equitable and beneficial.

In support of a shorter recapture period or a viable alternative to recapture, NLTC, ANCA, NLFA and NWGA strongly feel that a 15 year recapture period is too long, is not needed to deter speculation or retention in the family of the farm land and continuation of the family operation, would unfairly tie the hands of the surviving family members in disposing of the land for legitimate business reasons and could cause title and loan problems.

C. THE MATERIAL PARTICIPATION REQUIREMENT WILL CAUSE PROBLEMS AND SHOULD BE DELETED IN FAVOR OF A MORE FEASIBLE TEST

The 1976 TRA states that the farm land valuation provision will not be available unless there has been material participation in the farm operation by the decedent or a member of his family in 5 out of 8 years immediately preceding the decedent's death. A similar requirement is applied to the qualified heir who inherits the farm. The qualified heir or a member of his family must, during the 15 year recapture period, materially participate in the operation of the farm during 5 years of any 8-year period or else the recapture provisions will apply. "Whether or not there has been material participation by an individual . . . is to be determined in a manner similar to the manner in which material participation is determined for purposes of the tax on self-employment income with respect to the production of agricultural or horticultural commodities." H.R. Rep. No. 94–1380, 94th Cong. 2nd Sess. 23 (1976).

A major problem with this material participation requirement is the adverse effect it can have on farmers and ranchers who do not "materially participate" in the operation of all or a significant portion of their farm or ranch business because to do so would subject them to self-employment tax on the earnings from the business and also might reduce the amount of social security benefits to which they would otherwise be entitled. The effect of this is that the material participation requirement of the farm land valuation provision counters the amendments made prior to 1976 to the social security and self-employment tax provisions where absence of material participation caused a beneficial result and where some operations were conducted so that there would not be material participation. The result is that farmers and ranchers will be forced to decide whether they want the benefits of farm land valuation for their estates or whether they would rather receive social security benefits and not be subject to self-employment tax during their lifetimes. It seems unfair to force this choice on farmers and ranchers and certainly this was not the intent of the farm land valuation provision.

It is understood that the intended purpose of the material participation requirement was to restrict the benefits of farm use valuation to those situations where

there was active involvement in the farm business as opposed to holding farm land passively for investment purposes.

In order to allow estates of farmers and ranchers who are retired or who may lease some or all of their farm land to be able to use the farm land valuation provision without subjecting the farmers and ranchers to loss of their social security benefits or to imposition of self-employment tax, it is suggested that another test should be substituted for that of material participation. NLTC, ANCA, NLFA, and NWGA would welcome the opportunity to work with the Senate Finance Committee and with the staff of the Joint Committee on Taxation in developing an alternative test which would be both viable and equitable.

D. TECHNICAL AMENDMENTS IN H.R. 6715 CONCERNING FARM LAND VALUATION PROVISION SHOULD BE ADOPTED

The Technical, Clerical and Conforming Amendments Bill (H.R. 6715) introduced in the House of Representatives and referred to the Ways and Means Committee contained a number of amendments concerning the farm land valuation provision. NLTC, ANCA, NFLA and NWGA support and endorse these technical amendments.

(1) Farm land valuation provision applies only to property passing to qualified heir

To clarify any possible misunderstanding, the Technical Amendments Bill specifies that the farm land valuation provision will apply only to the extent that farm land passes to qualified heirs.

(2) Use of special use valuation property to satisfy pecuniary bequest

Clarification is made in the Technical Amendments Bill that land valued under the farm use valuation provision can, like other property, be used to satisfy a pecuniary bequest without causing the recognition of capital gain to the estate, except for any appreciation occurring after the decedent's date of death. The bill further states that, under the farm land valuation provision, property will be considered to have been acquired from or to have passed from a decedent if it is acquired by any person from the estate in satisfaction of a pecuniary bequest.

(3) Treatment of community property under farm land valuation provision

It is made clear by the Technical Amendments Bill that the farm land valuation provision applies to community property in the same manner as property owned by a decedent in an individual capacity.

(4) Filing of bond by qualified heir to obtain release from personal liability on recapture tax

Under the Technical Amendments Bill, a qualified heir is discharged from personal liability for the recapture tax if the heir furnishes a bond for the amount of the recapture tax.

IV

Tax Liens for Recapture Tax and Extended Estate Tax Payment Provision Must Not Impede Credit Sources of Surviving Family Members

Tax liens on farm and ranch property are provided under the 1976 TRA when the farm land valuation provision or extended payment of estate tax provision is elected by the executor of a deceased farmer or rancher's estate. In the case of the farm land valuation provision, the amount of the lien is equal to the recapture tax. With respect to the extended payment provision, the lien amount is the deferred tax plus interest on the amount of the deferred tax.

Priority of these tax liens is spelled out in the 1976 TRA where it is specified that such liens are subordinate to certain liens relating to the construction or improvement of real property or the raising or harvesting of farm crops or the raising of livestock or other animals, regardless of whether these liens come into existence before or after the date of tax lien filing. An Internal Revenue Service Release (IR-1823) issued on June 2, 1977 appears to confirm this interpretation of the 1976 TRA.

NLTC, ANCA, NLFA, and NWGA are very pleased with this Release and the fact that the Internal Revenue Service has recognized this lien priority problem since it is vitally important that a continuing line of credit be available to the surviving family members of a deceased farmer or rancher. It is presumed that

the regulations, to be issued in the future, will give the same interpretation to this lien priority matter. Should problems develop in the interpretation or application of these regulations, then NLTC, ANCA, NLFA, and NWGA will seek adoption of appropriate amendatory legislation which will treat the lien priority issue in such manner so as to permit the extension of vitally needed credit to the surviving members of the farm family.

NLTC, ANCA, NLFA, and NWGA support the provision of the Technical Amendments Bill which provides that the amount of the extended payment lien is equal to the amount of deferred taxes plus the aggregate amount of interest payable over the first 4 years of the deferral period.

V

Cattle and Horses Held for Draft, Breeding, Dairy or Sporting Purposes Which Are Sold by the Estate or Heirs Should Quality for Capital Gains Treatment Even if Holding Period Less Than 24 Months

Prior to the 1976 TRA, a capital asset acquired or passing from a decedent was considered to have been held by the estate or heirs for the period required for long-term capital gains treatment. No conforming amendment was made to this provision by the 1976 TRA. As a result, the previously mentioned Technical Amendments Bill, which is presently pending in the House Ways and Means Committee, contains a provision which specifies that a capital asset which is carryover basis property is to be considered to have been held by the estate or heir for the applicable period required for long-term capital gains treatment. (In 1977, this holding period requirement is 9 months or longer and in 1978 and subsequent years it is one year or longer.) Unfortunately, neither the law prior to the 1976 TRA nor the Technical Amendments Bill accords similar capital asset and gains treatment to cattle and horses held for draft, breeding or dairy purposes.

Under present law, cattle and horses used for draft, breeding, dairy or sporting purposes do not qualify for capital gains treatment unless held for 24 months or more. To provide equality of treatment with other capital assets, NLTC, ANCA, NLFA, and NWGA urge that the tax laws be amended to permit the estate or heirs of a deceased farmer or rancher holding such cattle or horses to be considered to have held such cattle or horses for the 24-month period in order that the proceeds from their sale will qualify as long-term capital gains. Such amendment would also serve to benefit the estate or heirs of a deceased farmer or rancher in the orderly marketing of such livestock which would appear to be in keeping with the general purpose and intent of Congress in originally adopting this provision prior to the 1976 TRA.

VI

Conclusion

It is respectfully requested that the foregoing proposed amendments to the 1976 TRA and the tax laws be seriously considered. NLTC, ANCA, NLFA, and NWGA would be pleased, as they have in the past, to work with the Senate Finance Committee and with the staff of the Joint Committee on Taxation with respect to these proposed amendments.

National Livestock Tax Committee.
American National Cattlemen's Association.
National Livestock Feeders Association.
National Wool Growers Association.

Law Offices of Moehle, Reardon, Smith & Day, Ltd.,
Washington, Ill., July 15, 1977.

Mr. Michael Stern,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

Dear Mr. Stern: This letter will contain my testimony to be presented to the Senate Finance Committee, Subcommittee on Taxation and Debt Management, concerning the 1976 Tax Reform Act. I am certain others will discuss the technical aspects of the Tax Reform Act. My few comments will relate to the average taxpayer residing in a small community in central Illinois.

1. *Carry-over basis.* The complicated and non-workable provisions to establish carry-over basis imposes a burden on taxpayers which is not comprehended. Taxpayers will not be able to compile the necessary information to compute the carry-over basis on all assets.

2. *Generation skipping transfers and orphan exemption.* These two provisions are new. Their complexity and newness will work to the disadvantage of the average taxpayer.

3. *Special valuation rules for farms and closely held businesses.* The rules are so complicated and unmanageable that the average taxpayer will not be able to take advantage of them. The advantages, if any, of the special rules will go to taxpayers represented by highly skilled consultants. The average taxpayer will not get any advantage.

4. *Cost of estate planning and tax reporting.* Expert estate planners and expert CPAs will collect huge fees to assist taxpayers in tax avoidance. The average taxpayer who worked all his life to pay for 200 acres of farmland or accumulate a small business will not plan tax avoidance because either (a) he believes he cannot afford it, or (b) he has faith in his government that he will get the same fair treatment as all other taxpayers.

The Tax Reform Act of 1976 will be a moneymaker for specialists in estate planning and tax avoidance. It will also create a huge burden of red tape, bureaucracy, conflicting rules and regulations, enforcement problems and tax problems rendering it largely unworkable for the next decade. If Congress wants to do a fair job of reforming tax laws, more time, study and expert advice should be sought, chiefly outside of staff committee members.

Regards,

MELVIN O. MOEHLE.

LAW OFFICES PRAY, PRICE, WILLIAMS AND RUSSELL,
Long Beach, Calif., July 29, 1977.

Re Hearing of Senator Byrd's Subcommittee on Taxation July 25, 1977.

MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Building, Washington, D.C.

GENTLEMEN: The following is my proposed testimony for the hearing submitted in accordance with the press release of July 1st inviting statements.

STATEMENT

From a considerable practice in probate and tax work, the undersigned is of the opinion that the carry-over basis is going to be completely unworkable in practice in the following respects.

The "carry over" of the cost basis for capital gains tax from the decedent to the heir or distributee requires each of the latter to note and be interested in the potential capital gain liability in each individual asset and to demand division and distribution of assets in a way that will not settle such distributee with an undue and perhaps unfair tax burden. Particularly, those in higher tax brackets want assets distributed which do not carry a potential tax liability or if they get them they want the assets divided in such a way as to take account of that tax liability.

On the other hand, agreement among the heirs as to any scheme for division on distribution would seem to run the risk of a realization making capital gains tax immediately due.

The only alternative is to give each an undivided interest in and to each asset. The greater the number of heirs and the greater the number of asset items, the more complicated and impossible this alternative becomes.

At present I have an estate of a testator who died January 13, shortly after the new law became effective, who leaves five heirs and about twenty-five different issues of securities. The mathematics in determining what the potential capital gains situation as to each of these securities and what effect it will have on the brothers and sisters who are entitled to share equally in the estate under the Will but who have different personal tax pictures is going to more than exhaust the capabilities of any computer to which we have access and this really isn't a complicated estate at all.

The foregoing relates only to the single problem of how the estate will be divided up in order to make distribution. It has absolutely nothing to do with the problem the Executor has in trying to get together the cost basis and passing that information on to the heirs. Where January 13, 1977 is the date of death, the problem isn't too bad for securities but this estate has real property which decedent developed himself in the 1930's and one piece developed around 1939 that has been sold from the estate for $85,000.00. Because the date of death is so close to the effective date of the statute, the problem is somewhat

minimized but it is extremely difficult after 40 years to come up with records which will establish the cost basis particularly when there probably weren't any to begin with and for a long time there was no particular reason to keep them.

The implications of the "carry over basis" in actual practice lead this practitioner to the conclusion it is going to be completely unworkable. The problems we have are going to be duplicated in every case by the Internal Revenue agents called upon to review and audit the tax returns.

Yours very truly,

WILLIAM C. PRICE.

DANE, HOWE & BROWN,
Boston, Mass., July 27, 1977.

Re Subcommittee on Taxation and Debt Management Tax Reform Act of 1976.

MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR SIR: As a lawyer with more than twenty-five years experience dealing with individual taxpayers in estate settlement and related federal tax areas, I am one whose practice may grow by reason of the increasing complexity of the Code; yet I earnestly recommend to the subcommittee that it consider the following propositions:

1. The self-assessing tax system of the United States is a national asset of incalculable value.
2. The general acceptance of the system by the citizenry is seriously threatened by the ever-growing complexity of revenue laws touching upon individuals and households.
3. Any significant loss of citizen support for the system would have profound and adverse effects.
4. The Tax Reform Act of 1976 introduced sophisticated "perfecting" changes having great appeal to theoreticians; but many of its provisions purport to require individuals to establish and maintain transaction records wholly beyond their effective capacity to comply, and they are threatened in that regard with such burdensome expenses (not to mention penalties) as to alienate them in large numbers. They include citizens of good will and high education whose present dismay can be expected to spread as the new burdens are perceived more widely. Dismay can become contempt, and contempt can result in a broad hostility which the country cannot afford to risk.
5. The subcommittee, the Senate Finance Committee and the Congress in general should move to undo the damage threatened by the 1976 Act and should evaluate all revenue proposals touching upon households by inquiring whether they will invigorate or further damage respect for law in general and the self-assessing system in particular. Feasibility is the thing, and the stakes are enormous.

Yours very truly,

JERRY M. BROWN.

STATEMENT OF THOMAS WRIGGINS III, ATTORNEY AT LAW, ROCKFORD, ILL.

Section 2057(a); "Allowance of Deduction.—For Purposes of the Tax Imposed by Section 2001, if—

(1) The decedent does not have a surviving spouse, and

(2) The decedent is survived by a minor child who, immediately after the death of the decedent, has no known parent,

then the value of the taxable estate shall be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property which passes or has passed from the decedent to such child, but only to the extent that such interest is included in determining the value of the gross estate".

This particular section of the 1976 Tax Reform Act, as evidenced by the Committee Report of the House Ways and Means Committee, was designed to provide assets of $5,000 per year per orphaned child for each year that child was less than 21 years of age.

While the section does not impose the will of Congress upon the dispositive intent of the parent, it provides a form of incentive by removing the burden of transfer taxation upon funds made available to such orphaned children.

While reviewing the impact of this Exclusion for Orphans in my practice of estate planning, I experienced some difficulty with the wording of the law, specifically with the absence of definition of the words "surviving" and "survived" as used in the section.

Survival of one parent over the other, in its most basic form is one of medical diagnosis which can often approach split second timing. This situation most often occurs in cases of accidental common disaster where both parents die simultaneously. State law, whether using the Uniform Simultaneous Death Act, or specifically drafted language has created the situation where both parents are deemed to have survived the other. This legally created but medically impossible situation works well under the Internal Revenue Code if we are to regard the definition of "survival" in the Code as the same as structured by State law. While the Courts have universally forced the Internal Revenue Service to look to State law, the point remains that if there is a question, the taxpaper or the Service is forced to turn to the Courts for resolution.

To my knowledge, all states which have statutes dealing with simultaneous death will not impose the statutory definition of survival upon a testator who has evidenced some other intention by specifically providing for the contingency in his will or living trust. One of the reasons a testator might want to waive the statutory definition is to insure that his assets will pass under his spouse's dispositional instructions. Another technique used in estate planning is to provide that a spouse's survival must exceed a certain number of days before the decedent's executor or trustee can regard the surviving spouse as a recipient under the decedent's will or trust. A good reason for his approach is to prevent delay in transfer of assets through a subsequent estate, or to prevent additional transfer taxes by inflating the estate of the second decedent with the assets of the first.

Whatever the reasons for the variation, the fact is that there are three possible definitions of "survival"; medical, statutory and specified. The question is; which one did Congress intend?

An example of the possible frustration of Congressional intent might serve well here to show the results of lack of definition.

Husband and wife have separate wills naming each other as primary beneficiaries of each other's estate. The secondary beneficiary is a remainderman trust for the children which terminates to each child upon his reaching 21 years of age. Husband has a gross estate of $300,000 and the wife has a gross estate of $20,000. They have two small children ages 2 and 5. Husband and wife also provide in their wills that no person shall be deemed to survive the decedent unless he or she lives more than 30 days beyond the decedents date of death. Husband and wife are involved in an automobile accident, husband is killed, wife dies 8 days later.

Under the terms of the husband's will, wife is not a survivor because she did not live the requisite 30 days. Husband's assets therefore go to the children's trust. Does the husband's estate get to use the Orphan's Exclusion?

At ages 2 and 5, the total available exclusion could be: 21—2=19×$5,000=$95,000+21—5=16×$5,000=$80,000 for a total of $175,000. This is a significant amount when combined with the husband's Unified Credit exemption equivalent of $120,667 (1977). In this example, with only $5,000 deductible expenses (funeral, lawyers fees, etc.) the children would substantially receive their father's estate without any reduction for Federal Estate Tax if the Orphan's Exclusion were applied. If the Orphan's Exclusion were not allowed, the husband's estate would have to pay approximately $56,100 in Federal Estate Taxes. This significant amount of tax is entirely dependent upon the definition of survival under the facts of this example. Medically, the wife survived the husband by 8 days. State law supports the testator's instructions which (in this case) dictate that the wife did not survive as a beneficiary of the husband's estate.

If the Congressional language were interpreted to mean medical survival, the children would receive the father's property, but no Orphan's Exclusion would be available since the children were not orphaned by their father, but by their mother who died 8 days later.

I do not feel that Congress should specify what constitutes survival. I do think, however, that Congress should eliminate potential and possibly costly controversy by defining "survival" as paralled to the definition applicable under the jurisdictional state law or specified provision dealing with survivorship evidencing the testator's intentions in his will, living trusts, deeds or contracts of insurance.

With this in mind, may I recommend that the following amendment be made to Section 2057(d) Definitions by adding at the end thereof the following definition—

"(4) Surviving (Spouse and Minor Child).—Survivorship of the decedent's spouse and minor children shall be determined as a medical fact unless state law of competant jurisdiction otherwise provides, or unless the decedent's will, living trust, deed or contract of insurance specifically defines what shall constitute survivorship for the purpose of distribution of decedents property."

LAW OFFICES OF YOUNG, CLEMENT AND RIVERS,
Charleston, S.C., July 19, 1977.

Re Hearing, July 25, 1977, of Subcommittee on Taxation and Debt Management.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: Enclosed please find a portion of a paper which I recently wrote as a requirement for a Master's Degree in Taxation at the University of Florida concerning new Internal Revenue Code Section 2032A and its relation to timberland. (This material represents pages 10 through 35 of such paper, excluding footnotes.)

I would like to submit this material to the Subcommittee on Taxation and Debt Management for use in the Subcommittee's deliberations on the Estate and Gift Tax problems created for small farmers by the Tax Reform Act of 1976. This portion of my paper deals specifically with problems created and questions raised by IRC § 2032A when applied to timberland holdings in the estate of a decedent. The primary questions which I see at this time are: (1) whether standing timber is to be considered part of the "qualified real property" for valuation purposes, and (2) the activity to be required of a timberland holder in meeting the "material participation" test of § 2032A.

I thank you for your acceptance of this material.

Sincerely,

T. HEYWARD CARTER, Jr.

Enclosure.

C. GENERAL PROBLEMS AND PITFALLS

While Section 2032A will undoubtedly prove to be a boon for those estates which happen to fit precisely within its confines, it is expected that for the majority of estates containing real property which may be "qualified", election of the statute will be made with reservations both as to its availability and as to its actual benefits. Hopefully, many of the definitional, administrative and substantive questions raised by the statute will be dealt with in forthcoming Treasury regulations. Certain conceptual aspects of the statute and its interrelation with other provisions of the Internal Revenue Code, however, raise problems which may require further statutory guidance.

A basic question regarding use of Section 2032A in connection with qualified timberland is whether standing timber was intended to be included within the term "real property" as such term is used by the statute. Treasury regulations direct that for purposes of valuing the gross estate, "growing crops must generally be itemized and the value of each item separately returned." This itemization of "growing crops" apart from the land supporting them and together with personal property suggests that the Treasury regards growing crops as personalty for purposes of the estate tax.

Two questions immediately arise: First, is standing timber also to be regarded as a "growing crop" for federal estate purposes? Secondly, if standing timber is not included within the definition of a "growing crop", is it to be regarded as realty or personalty for federal estate purposes? There is no specific federal statutory answer to these questions, and therefore resort must be made to local law for a determination of the Common law status of timber as real or personal property.

Generally, under common law, a "crop" is an annual product of the soil, requiring cultivation by man. Standing timber is not normally held to be a crop under common law, as it is considered a natural product of the earth, not requiring annual cultivation. Furthermore, the general American rule is that timber is a part of the realty, until severed from the soil; when so severed, however, it becomes personalty. Thus, under local law, timber standing upon land which is Section 2032A qualified real property will itself generally be a part of such real property. It follows, therefore, that under common law principles such standing

timber should be combined with the land which supports it in computing the value of the real property as a whole for determination of the value of the gross estate under Section 2031, and for determination of the use value of such real property under Section 2032A.

The use valuation methods provided by Section 2032A, real property, even though as a matter of basic property law standing timber is an integral part of real property.

One of the prime "costs" of electing Section 2032A is the possibility of recapture of the estate tax originally avoided by application of the Section. Because of the fifteen year lien and recapture lurk within Section 2032A, the executor or estate planner considering using the statute to reduce federal estate taxes should attempt to learn what use will most likely be made of the qualified timberland after the decedent's death. Any expressions of intent by the client cannot, of course, be relied upon with certainty, but it may become clear that the existing qualified use will be ceased within a ten to fifteen year period (as, for example, where encroaching development may soon raise acreage fair market values to a level too high for heirs or devisees to resist), or that it is likely that qualified timber growing operations will continue on the property for the foreseeable future. If it is obvious that the property will very shortly be sold to a non-family member for development or other purposes, there is seemingly little advantage in electing Section 2032A, only to have the additional tax become due through recapture at an early date. On the other hand, if it is likely that the property will continue to "qualify" under Section 2032A for a number of years, it would normally be advantageous to elect Section 2032A in the hopes of avoiding some or all of the additional tax through waiting the required ten to fifteen year period.

In attempting to determine whether recapture might be avoided during the fifteen year period following the decedent's death, the practitioner should note that cessation of the qualified use can occur other than by sale or exchange of the qualified property to a non-family member or by the voluntary decision of the qualified heir to cease using the property for the qualified use. The statute provides no exceptions to the "cessation of qualified use" in the case of an ordinarily non-taxable event; as a result, a Section 1031 tax-free exchange or a Section 1033 involuntary conversion of the qualified real property will normally trigger recapture to the extent to which the interest in the property is affected, just as in the case of a voluntary sale or exchange.

Congress did, however, provide a means of relief for the heir who faces recapture of the additional tax which is triggered by an involuntary conversion of the qualified real property. The House Ways and Means Committee Report states that the "recapture provision is to apply not only if the qualified real property is sold (or exchanged in a taxable transaction) to non-family members, but also where the property is disposed of to non-family members in a tax-free exchange (under Section 1031), or where the property is disposed of under an involuntary conversion, rollover, or similar transaction (which is nontaxable by reason of Section 1033 or 1034). *The preceding sentence does not apply to an involuntary conversion or condemnation if the proceeds are reinvested in the real property which originally qualified for special use valuation.*"

Under present statutory language, recapture upon cessation of qualified use may thus be avoided only if the cessation is due to "involuntary conversion or condemnation" and if the proceeds therefrom are reinvested in the remaining qualified real property. If all of the qualified property is taken by involuntary conversion or condemnation, there remains no "safe" property in which to reinvest the proceeds and the heir is liable for the full amount of the additional tax due. It would seem that the heir who is involuntarily subject to the full additional tax would merit a means of escaping or deferring that tax as much as or more than the heir who involuntarily becomes liable for only a portion of such tax. Neither the statute nor the committee report, however, allows escape from the additional tax when the entire tract of qualified real property has been involuntarily converted. Amendment of the statute to provide that reinvestment of the proceeds of involuntary conversion or condemnation in real property which is "similar or related in service or use to the property so converted" or in real property "of a like kind" would allow continued avoidance of the additional tax seems in order.

A more troublesome aspect of the lien and recapture provisions of the statute is the question of whether such provisions are intended to apply to standing timber as a part of the land constituting the qualified real property. As noted above, although the general common law rule is that standing timber is a part of the realty, Section 2032A seems to exclude standing timber from the definition

of qualified real property for use valuation purposes. If such exclusion is applied to the lien and recapture provisions of the statute, it follows that the Section 6324B lien would not apply to timber standing upon the qualified real property. It further follows that any disposition of such timber, by sale, involuntary conversion, or otherwise would not trigger recapture of any part of the additional tax. Consistency in the exclusion of standing timber from the definition of qualified real property throughout Section 2032A both provides equitable treatment for the heir and protects the government's interest, for disposition of the timber would not normally significantly affect the value of the land to which the trees are attached. If, however, the government takes the position that, for purposes of the lien, standing timber will be treated as part of the qualified real property, the heir will be in a restricted position indeed. Even if a harvest of such timber is dictated by the forestry plan or principles under which the heir operates the qualified real property, any disposition of part or all of such timber, whether voluntary or not, will constitute a partial disposition of qualified real property, triggering partial recapture of the additional tax. On the other hand, reforesting of portions of the qualified land after the decedent's death will serve to increase the government's security for payment of the lien, as will the mere "passive" maturity of young trees existing at the date of death.

Exclusion of standing timber from the definition of qualified real property for valuation purposes and inclusion of such timber for lien and recapture purposes would constitute overreaching by the Treasury, putting severe restrictions on the heir's operation of the timberland in accordance with sound forestry principles without the countervailing necessity for additional lien protection. It is doubtful that such an approach was intended by Congress, and it is hoped that it will not be adopted by the Treasury.

A further aspect of the recapture and lien provisions of the statute is that a sale, exchange or other disposition of the qualified property by one qualified heir to another qualified heir does not trigger recapture, but rather substitutes the transferee heir for the transferor for recapture and lien purposes. Such transfer of liability along with title takes place even though full value shall have been paid for the qualified real property by the transferee-heir. This situation would at first seem to put a qualified heir wishing to buy out other qualified heirs to take over management of the qualified real property at a disadvantage vis-a-vis the non-family buyer who pays the fair market value and takes the property free of the estate tax lien. The informed transferor-heir will, however, realize that transfer of his interest in the property to a non-family member will trigger recapture of the additional tax ascribed to his share (and thus due by him), while transfer to another qualified heir will involve no such personal recapture liability. As a result, he should be willing to reduce the sales price to the purchasing qualified heir and the non-family purchaser would thus be on an even footing as regards price.

A major problem with election of Section 2032A may arise not from the statute itself but from one of its supposed beneficiaries—the surviving spouse. Consider the case of a decedent who has left to his wife the maximum amount which will qualify for the Section 2056 marital deduction, and whose adjusted gross estate for purposes of computing such marital deduction is $1,000,000. Under Section 2056 the widow's share will be $500,000, or "50 percent of the value of the adjusted gross estate . . .". However, if Section 2032A is properly elected, the value of the qualified real property will be decreased, in turn decreasing the value of the adjusted gross estate and, thus, the value of the widow's share as computed under Section 2056.

In the event that the widow has been left no interest in the qualified real property, her consent is not required for use of Section 2032A, and the adjusted gross estate, along with the marital deduction, may accordingly be shrunk by consent of only those heirs who do receive an interest in the qualifying property, regardless of the wishes of the widow. In the more usual case, the widow will receive an interest in the qualified real property, either by will or under local intestacy laws, or by an in-kind distribution in satisfaction of a pecuniary bequest. If such is the case, consent of the surviving spouse, along with the consent of all others who receive an interest in the qualified real property, is required for application of Section 2032A—consent which such spouse may understandably be reluctant to give. In the pre-death planning situation it may be possible either to structure composition of the gross estate and/or disposition of its assets so that the surviving spouse will receive no interet in the qualifying real prop ty, or, if she is to receive an interest in such property, to arrange matters s that she is amply provided for whether or not her share of the estate

is reduced by election of Section 2032A. Pre-death planning also allows the testator and the estate planner to discuss the situation with the spouse, explaining to her the tax advantage to the estate (and to the "family") of the statute.

Any estate plan which includes election of Section 2032A should also attempt to satisfy the desires of the spouse, so that her later consent to utilization of the statute is assured. Certainly the chances for gaining the consent of the spouse to use of Section 2032A will be greater if she has been made to feel that her interests were as much a factor in the estate planning process as were tax saving considerations, than if she is presented after her husband's death with the proposition that she should decrease her share of the estate in order to make use of a tax "loophole" of little or no pecuniary advantage to her.

Even if the spouse does not receive an interest in the qualified real property and her consent to the application of Section 2032A is thus not required, or if she does receive an interest and agrees to election of the statute, a further problem arises from the interplay of Sections 2056 and 2032A: Once Section 2032A has been elected, how might the cessation of qualified use of the qualified real property within the fifteen year period, and the resulting recapture of the additional tax, affect the value of the adjusted gross estate for purposes of Chapter 11 and, thus, for determining the spouse's marital deduction share?

Imagine that Section 2032A is applied to the adjusted gross estate with a value of $1,000,000 cited in the example above. The adjusted gross estate for purposes of computing the marital deduction has thus become $600,000, and the spouse has received $300,000 as her share of the estate. Five years later there is a sale of all of the qualifying real property to a non-family member, causing cessation of qualified use of the property and triggering recapture of the entire additional tax due. At this point, does the fact that the actual estate tax due is now being figured and collected on the basis of the value of the adjusted gross estate as determined without regard to Section 2032A (*i.e.*, the fair market value of $1,000,000) mean that for purposes of Section 2056 the adjusted value of the gross estate has suddenly become $1,000,000 instead of $600,000? If so, the surviving spouse's marital deduction share is now $500,000 instead of the $300,000 which she received upon election of Section 232A and subsequent settlement of the estate. If the Section 2031 fair market value test governs the value of the decedent's gross estate after a "recapture event" has taken place, the surviving spouse's share is thus $500,000. From whence will her additional $200,000 come, and who is to be liable for its payment?

The statute provides no answers to such questions. Because of its silence, it is reasonable to assume that the possibility of an additional "lurking marital deduction share," ready to spring up full grown upon the cessation of qualified use, was not considered by Congress. It is reasonable to assume further that if such a possibility was not so considered, it was because Congress intended that once Section 2032A is utilized in figuring the value of the gross estate for the purposes of Chapter 11, including the value of the adjusted gross estate for Section 2056 marital deduction purposes, the value of the gross estate as determined with regard to Section 2032A becomes the only value of the gross estate for federal tax purposes. Thus, although the traditional Section 2031 fair market valuation might be later referred to for the purpose of figuring an additional tax due, such a valuation is, after the election and application of Section 2032A, purely theoretical and for computational purposes only.

This reasoning is not contradicted by the language of the statute itself, which provides that once Section 2032A is elected and the necessary agreement filed, "for purposes of (Chapter 11), the value of qualified real property shall be its value for the use under which it qualifies, under subsection (b), as qualified real property." The use value of qualified real property is thus designated as the value of such property for purposes of chapter 11, and not as a "tentative" or "contingent" value, to remain in effect until some recapture event should cause it to be suddenly replaced *nunc pro tunc* by Section 2031 fair market value.

The problem is certainly arguable and can be expected to be dealt with in future regulations, and, possibly even before such regulations are promulgated, by the courts. However, further problems will not be avoided by either a ruling that upon cessation of qualified use Section 2032A use valuation is replaced by Section 2031 fair market value notions, or by a ruling that once Section 2032A is properly elected it alone finally determines the value of qualified property and thus of the gross estate. In the former instance, if the value of the gross estate is retroactively increased upon cessation of a qualified use, some provisions must be made for payment of the additional share due the surviving spouse, and some-

one must be held liable for such payment. On the other hand, if it is determined that the lower Section 2032A use value is the final value of the qualified real property for estate tax purposes, the surviving spouse can be expected to be less amenable to its use, and in situations where it is elected it may have unexpected detrimental economic effects to such spouse.

Another problem which will often arise in connection with the surviving spouse is satisfaction of a pecuniary bequest with an interest in the qualified real property, a transaction giving rise to one of the greatest (and least conspicuous) hazards of electing Section 2032A. Consider new Section 1040(a), which provides that if the executor satisfies a pecuniary bequest with appreciated carryover basis property (*i.e.*, property in which the heirs take the decedent's basis, as provided by Section 1023), gain on the exchange shall be recognized "to the extent that on the date of such exchange, the fair market value of such property exceeds the value of such property for purposes of Chapter 11."

Section 1040 was introduced into the Code in TRA '76 in order to mollify the effect of new Section 1023 upon the "*Kenan* gain" doctrine. However, if Section 2032A is elected and Section 1040 comes into play because of the disposition of qualified real property in satisfaction of a pecuniary bequest, Section 1040 applies to a Chapter 11 value for the real property which has been reduced through the application of Section 2032A. Thus, Section 2032A and Section 1040 together cause an automatic taxable gain to the estate in an amount at least equal to the Section 2032A reduction in value for estate tax purposes.

It is obvious that the drafters of Section 1040 did not have Section 2032A in mind when pegging the gain to be recognized to the estate to the "value of such property for purposes of Chapter 11," for such a drastic result could not have been intended. Until statutory amendment or regulations except valuation under Section 2032A from the literal language of Section 1040A, however, election of Section 2032A by an executor who may have to satisfy a pecuniary bequest in a fixed amount with qualified real property should only be made after a thorough review of the potential tax consequences involved to the estate and, thus, to the beneficiaries.

II. Using the Statute

A. Basic Requirements

1. Activity

Although the requirements for application of Section 2032A may initially seem rather straight-forward, the estate planner or executor attempting to determine its usefulness in connection with timberland held by the client will soon discover that three of the tests which must be met are so vague as to present serious problems in determining whether the relief offered by the statute is in fact available.

The first of these tests, the two-pronged percentage requirement, deals with valuation of the land vis-a-vis valuation of the entire estate. The second and third tests, those of "qualified use" and "material participation", involve problems of definition. The statute implies the necessity of some degree of activity in relation to the land in question for both the "qualified use" and the "material participation" tests, but in neither case does it give more than a hint as to the required extent or nature of such activity where timberland is involved.

"Qualified use" as regards timberland is rather broadly defined in the statute. Future regulations can be expected to indicate what activities the Treasury feels are encompassed by the phrase "preparation... of trees for market." Without the aid of such regulations, however, the phrase would seem to include any activity from seeding to shipping, and would certainly include the four specified activities of planting, cultivating, caring for, or cutting of trees. What the statute leaves unclear is the extent of activity required before the service will recognize that "woodland" is being used for "farming purposes"—*i.e.*, for the planting, cultivating, caring for, cutting or otherwise preparing of trees for market.

The additional question as to what extent a "hybrid" or dual use of the qualified real property might affect qualification under one or more of the requirement tests is likewise unanswered by the statute. If, for example, a tract of real property included in the estate supports in part growing timber and in part an operating farm, will the activities of the farming operation, and the participation therein by the decedent and his heirs, be ascribed to the timberland for purposes of meeting the "qualified use" and "material participation" tests? Likewise, will the value of the timbered portion of the tract be aggregated with the value of the farmland for purposes of meeting the percentage value tests, even

though no active management of the timberland might have been undertaken by the decedent?

While it seems likely that all real property which is used for some qualifying use or uses might be lumped together in order to meet the 50 percent and 25 percent tests, it is less certain that the activity and material participation attributed to one tract or portion of a tract will serve to qualify all tracts, or the entire "hybrid" tract, when the "qualified use" and "material participation" requirements are applied against the aggregate of the real property for which qualification is sought. The question becomes even nicer when the same area is used simultaneously for two or more different purposes, each of which would meet some of the requirements of Section 2032A(b), but no one of which alone would meet all of such requirements.

Until the necessary regulations are promulgated, the estate planner's judgment as to what Congress may have intended is his only authority. Legislative history of the statute provides a guidepost which may be of some assistance in determining its scope and in predicting the direction which future regulations may take, but the light shed by such history on the issue of timberland as "qualified" property is, at best, rather weak.

The legislative history of the statute reveals that while estate tax relief to the "family farmer" was of wide concern during the evolution of TRA '76, the "family farmer" was generally viewed in traditional terms—that is, as a unit for production of annual crops and/or livestock. The inclusion of timberland in H.R. 10612 seems to have been more of a Congressional afterthought than a thoroughly considered decision, and, therefore, most available information as to what activities will cause the service to view a "farm" as being used for farming purposes is of little value where timberland is concerned. The statute directs itself to the traditional farm operation, where constant activity is necessary in the planting, cultivating or harvesting of crops, or in the caring for livestock. In the case of timber growing, where long periods of inactivity are often the rule, the question of the extent and nature of required activity becomes more important and more difficult to answer.

It is certain that Congress intended that application of Section 2032A to timberland should depend on some sort of bona fide timber growing activity. Fears were expressed during the evolution of the Bill that the statute might be abused in the case of timberland in two ways: (1) by individuals who saw in its valuation provisions sufficient advantages as an estate tax shelter to make it worthwhile to buy and hold timberland as a major estate asset, and (2) by those who might happen to own timberland as an incidental or purely investment asset, perhaps making infrequent casual sales or cuttings, but whose holdings and participation in tree-farming activities did not merit the relief provisions of the statute.

Various proposals for prevention of abuse by those seeking an estate tax shelter were advanced during the course of the hearings, the most frequently proffered being incorporated into the statute as the holding period requirement and the recapture provision.

The degree of timber-growing activity required to make Section 2032A available is not dealt with in the statute, but discussions of the problem during the Congressional hearings, the exclusion of clearly inactive land uses from the final bill, and the vague allusions to "material participation" in the statute itself, all indicate clearly that something more than the casual ownership of wooded land is required to bring such land under Section 2032A.

There is little doubt that the "qualified use" test of Section 2032A will be satisfied as to those whose chief source of income is derived from the personal active management and cutting of family owned timberland. Timberland owners who are not personally involved in the direct management of such timberland may expect the Service to require proof from their executors that such timberland was in fact being used for active "farming purposes" during the required period. Legislative history indicates that the burden of proof will be considerably easier to satisfy if the timberland is being managed according to a professionally drawn management plan.

2. Material participation

The third test for qualification involves the extent of participation by the owner in management of the farming operations. Like the legislative history of the statute, its relevance to timberland is slight, but its use in connection with traditional farming operations may, by inference, prove helpful in attempting to predict what the Service will require.

While the statute purports to define the term "material participation", in actuality it merely makes a cryptic reference to use of the term in Code Section 1402(a)(1), abdicating any real definition to the regulations. The reference to Section 1402(a)(1) is somewhat confusing from the start, for in that section, which deals with net earnings from self-employment, the term "material participation" is used only in connection with income derived from farm rentals. Relating the treatment of "material participation" under the Section 1402(a) timberland operations strains the imagination and makes hazardous any predictions as to what future regulations might require in the case of timberland.

As with the "qualified use" test, woodland owned by an individual who personally operates an active timber-growing business will probably meet the "material participation" test with relative ease. Timberland owned by one not personally active in its management or income production will surely be subject to closer scrutiny. Probably the majority of privately held timber tracts fall into this latter category. Such tracts are typically held in a family for long periods, often passing through one or more generations before completion of a crop.

Harvests may or may not be carried out under a long-term management plan, and in most cases the active conduct of management and harvesting operations will be carried out under the supervision of an independent forester employed by the landowner or with the advice of a government or other consulting forester. In this type of situation, the "material participation" guidelines of the present regulations to Section 1402(a) offer little information as to what will be required of the owner of timberland for the purposes of Section 2032A material participation.

Four basic levels of owner activity can be imagined in connection with the operation of timber producing land: (1) owner (a) plants, (b) cultivates, (c) cares for, and (d) cuts the timber himself; (2) owner personally engages in one or more, but not all, of activities (a), (b), (c) and (d), but employs another (typically a professional forester) to perform the remaining activities; (3) owner performs none of the operations himself, but hires a manager or independent forester to manage the land; (4) owner leases the land to another for the production of timber.

If the timberland meets the "qualified use" test, relating to the level of activity involved in the timber-growing operations, it will in most cases meet the "material participation" test in situation number 1 above, where all activities are in fact performed by the owner. The land is not rented and none of the necessary activities are performed by any party other than the owner; in this situation Section 1402(a)(1) and the accompanying regulations are largely irrelevant.

In situation number 4, above, the land is timber-growing property rented to another, a situation analogous to that dealt with in Section 1402(a)(1). The regulations in this case may be somewhat relevant insofar as rental property is involved, but again a rather strained inference must be made in applying principles connected with an active farming operation to the more passive type of operation involved in woodland management. In addition, rental of privately held timber-growing tracts, in contrast to farm-rental or share-cropping arrangements, is an infrequent practice in most areas of the country. Situations 2 and 3, however, best describe the typical operations of a small woodlot owner. As to such situations, the use of the term "material participation" in Section 1402(a)(1) has little relevance, and the present regulations thereto offer almost no guidance as to how the phrase may come to be defined in respect to timber-producing land held by the owner and managed in whole or in part by another.

The present regulations to Section 1402(a)(1) provide that services performed by the employee or agent of the landowner are considered to be services performed by the owner or tenant in determining whether the "material participation" test has been satisfied. That principle, a reflection of prior rulings and case law, would seem to encompass situations number 2 and 3, where management and/or operation of the timberland is handled by the employee or agent of the owner. The regulation does not, however, reflect a relatively recent statutory amendment which directs that the activities of an employee or agent of the owner will no longer be treated as the owner's activities for purposes of determining "material participation" in connection with Section 1402(a)(1).

In light of the actual practices of most small woodlot owners, it would be unduly restrictive and unrealistic for the Treasury to require that activities which constitute material participation of the owner must be performed by the owner personally, and not by an agent, such as an independent forester. Such a requirement would eliminate a large, if not the major portion of private timber-

land holdings from the aegis of Section 2032A and would run counter to the intent of Congress in including woodland in the statute.

Considering that it is the expressed intent of Congress to provide a measure of estate tax relief to owners of privately held timberland, a ruling by the Treasury that would in effect deny such relief to a large number of such owners would be untenable. The estate planner whose client holds timberland which is under the management of a professional forester or other competent manager should be able to use Section 2032A without the fear that the irrelevant "material participation" notions of Section 1402(a)(1) will be blindly applied in the case of woodlands. However, until the Treasury indicates that the different nature and needs of timber as opposed to farm operations will be recognized by appropriate regulations, such confidence cannot be justified.

FRANKFORT, IND., *July 18, 1977.*

Re Tax Reform Act of 1976 Hearings.

Mr. MICHAEL STERN,
Staff Director, Committee of Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: I wish to submit the following written testimony to be used at the hearings to be held on Monday, July 25 in connection with the new Federal Estate Tax Law.

I first wish to object to the inflexibility of the rule which denies maximum marital deductions in pre-1977 wills for a period of two years. Many pre-1977 wills provided that the marital deduction gift to the wife should be "the maximum marital deduction allowed under the Federal Estate Tax Law in existence at the time of my death". In other words, the testator foresaw that the marital deduction might be increased and provided that the gift should be of a size to take full advantage of the increase. The inflexible rules laid down in the new Act do not recognize the clear intent of these clauses to apply the new maximum marital deduction. The purpose of the two year delay was so that testators would not have maximum marital deduction gifts increased against their intent automatically by the new law. However, where the will has already provided for the increased gift in the event of an increase in the deduction, the two year delay serves no purpose and serves to defeat the clearly expressed intent of the testator and cheats the wife out of a gift which is rightfully hers.

Testators are dying without having had a chance, or notice or knowledge, to change their wills and their wives are losing the increased gift and the increased tax saving because of this arbitrary limitation. The Act should be amended that where the will expressly provide for the increased marital deduction gift based on the law in effect at the time of death, the new maximum marital deduction should be allowed. There was a purpose to the two year delay—to preserve integrity of preexisting wills—but where the testator in his will provides otherwise, the two year delay deserves no purpose and should be repealed in those cases.

Now a word as to carry-over basis. This provision was obviously designed to destroy the middle-class quickly and the wealthier class of property owners more slowly but just as surely. I recently attended a seminar at Indiana University, Bloomington, Indiana, on the new Estate Tax Law including carry-over basis. This is especially vicious where the estate must sell property in order to pay taxes. It is very easy for the combined capital gains tax and federal estate tax to exceed the value of the property. In other words the property is to be confiscated. And this is using capital gains rates. President Carter has proposed that capital gains rates be abolished and all sales of property taxed at the full income tax rate. This will speed the confiscation of private property in America. Take, for example, a decedent estate in the Federal Estate Tax 50 per cent bracket and also in the Federal Income Tax 50 per cent bracket having to sell a piece of property to pay the Federal Estate Tax. Let us suppose that the property has zero basis, possibly a gift, or possibly something that was acquired at little value but which grew in value. The Federal Estate Tax would take half the sale price and the Federal Income Tax would take the other half of the sale price.

It was the consensus at the Indiana University Seminar that although owners of securities could survive, perhaps selling half-three fourths—etc. of the securities to pay the taxes and keeping the remainder, family farms and family owned businesses will be wiped out because there is no such thing as keeping

a piece of a small business or piece of a farm. You either have it or you don't. The result of the Tax Reform Act of 1976, in a couple of generations, will result in all businesses and all the farms being sold to large corporations for the purpose of raising the taxes which will be levied by, a (1) the increased federal estate tax levy, (2) the carry-over basis, and (3) the new 100 per cent capital gains tax. A person will be able to own shares in a large corporation but he will no longer be able to build, own and transmit his own family farm and small business.

Very truly yours,

ROBERT BRACKEN.

P.S.—Either Congress intended to destroy the family farm and the family owned small business, or else Congress has no conception of the values and taxes involved. In Indiana an economic family farm is somewhere between 300 and 500 acres. Good farmland is selling up to $4,000 an acre so that a 300-acre farm in this area would go into the Federal Estate Tax return at $1,200,000. (This is just plain farmland—not industrial sites or shopping center land.) I believe you can see that this farm would have to be sold in order to pay the Federal Estate Tax. The cruelest thing about this is that these values are not true values but inflation values. The Federal Income Tax and Federal Estate Tax laws have never been indexed to allow for inflation. Yesterdays poor farmer is todays millionaire according to present tax law and yet he's still the same hard-working guy with the same 300 to 500 acres under the plow. If you are trying to wipe him out, as some people feel you are, you are going to get the job done and soon.

NEW HOLLAND, PA., *July 19, 1977.*

MIKE STERN,
Dirksen Senate Office Building,
Washington, D.C.

Subject: For investigatory hearing set on estate and gift tax problem areas.

The problem I'd like to point out is the preferential farm valuation for estate tax purposes under code section 2032A should also be available under the gift tax law. Your remarks to this problem would be appreciated.

Thank you,

JOHN M. SENSENIG.

JENNER & BLOCK,
Chicago, Ill.

Hon. ADLAI E. STEVENSON,
Russell Senate Office Building,
Washington, D.C.

DEAR SIR: Your consideration is requested in a matter of the utmost importance to many of our clients who are the shareholders of small, family held corporations. For years, our clients have relied on Section 303 of the Internal Revenue Code, a relief provision designed to ameliorate estate liquidity problems, in planning for the payment of their estate taxes. The Tax Reform Act of 1976, Public Law 94-455, left unclear whether Section 303 would continue to apply to certain preferred stock redemptions to which it had previously been applicable. Section 3(a)(2) of the Technical Corrections Bill of 1977, H.R. 6715, on which hearings are scheduled to begin in July, 1977, attempts to clarify the uncertainty by denying use of the relief provision in those cases. This proposed restriction on the availability of Section 303 is without logic or equity and is not jusitfied by any tax considerations.

SUMMARY OF THE ISSUE

Section 303 allows capital gains treatment for property received in certain redemptions of stock received from a decedent. Section 306 prescribes divided treatment for property received in certain redemptions of "section 306 stock." Prior to the Tax Reform Act of 1976, there was never a problem in determining which section took priority when both applied because "section 306 stock" did not retain its character as such after the shareholder's death and would thus not normally be used in a Section 303 redemption. The sections overlapped in only one narrow case, and the Treasury Regulations clearly state that, in that case, Section 303 will apply. Amendments to the Code in the Tax Reform Act of 1976, however, brought stock received from a decedent, which had been "section 306 stock" in the decedent's hands, within the literal definition of

"section 306 stock" and thus created a new case to which both sections could be applicable without specifying which section was to take priority. Section 3(a)(2) of the Technical Corrections Bill of 1977 would clarify this issue by amending Section 303 to state explicitly that its provisions will not apply to a distribution in redemption of "section 306 stock." Because section 303 is intended to provide relief for the liquidity problems of estates consisting in significant part of the stock of closely held corporations, the use of "section 306 stock" in a Section 303 redemption presents no greater tax avoidance opportunities than are available by the redemption of other types of stock. Moreover, the redemption of "section 306 stock" in a Section 303 redemption is often advantageous for business reasons. For these reasons, Section 3(a)(2) of the Technical Corrections Bill of 1977 should not be enacted into law. Rather, the Internal Revenue Code should be amended to provide explicitly that Section 303 will apply to a redemption of "section 306 stock" to the extent that the conditions of Section 303 are met. Suggested language for a statute which will accomplish this result is attached as Exhibit A.

DISCUSSIONS

Section 303 provides that a distribution of property to a shareholder in redemption of stock which is included in the gross estate of a decendent for Federal estate tax purposes shall be treated as full payment in exchange for the stock redeemed in an amount not to exceed specified death taxes and expenses of the decedent, to the extent that certain conditions are met. The legislative history of the Internal Revnue Code of 1954 indicates that the purpose of Section 303 is to provide relief to the shareholders of family held corporations. The estates of such shareholders were often forced to sell large blocks of the company stock to pay estate taxes. By allowing capital gains treatment of the distribution received in a redemption of the stock by the company, Congress gave such estates an alternative to selling the company stock to a third party in order to obtain funds to pay estate taves. Without this relief measure, a redemption by the company was often not feasible because the proceeds would be subject to ordinary income treatment, and great sums of cash would have to be drained from the company to allow the estate to pay both the income tax and the estate tax. The House Report prepared to accompany the 1954 Code summarizes the purpose of Section 303: "This treatment furthers your committee's policy of preventing the forced sale of family held businesses to large corporate enterprises solely because of the combined impact of estate and income taxes." House Report No. 1337, 83d Cong., 2d Sess. 36 (1954).

Congress recently reaffirmed this objective. In House Report No. 1380, 94th Cong., 2d Sess. 30 (1976), prepared to accompany the bill which, as finally enacted, became the Tax Reform Act of 1976, the Ways and Means Committee reviewed Section 303 and the various provisions which allow an extension of time for paying death taxes, and found them inadequate to deal with the problems faced by estates of principal shareholders of closely held corporations. The report states:

The present provisions have proved inadequate to deal with the liquidity problems experienced by estates in which a substantial portion of the assets consist of a closely held business or other illiquid assets. In many cases the executor is forced to sell a decedent's interest in a farm or other closely held business in order to pay the estate tax. This may occur even when the estate qualifies for the 10 year extension provided for closely held business. In these cases, it may take several years before a business can regain sufficient financial strength to generate enough cash to pay estate taxes after the loss of one of its principal owners.

Included in the relief measures which Congress enacted as a part of the Tax Reform Act of 1976 to remedy this problem was an amendment to Section 303 extending the period during which a redemption of company stock from the estate will qualify for favored tax treatment. Section 303(b)(1)(C).

Section 306 was first enacted as a part of the Internal Revenue Code of 1954. It was intended to prevent a "bailout" of corporate earnings at capital gains rates through the sale or redemption of preferred stock. Certain preferred stock which was susceptible to this abuse was labeled "section 306 stock" and the proceeds of certain dispositions of such stock were made subject to dividend treatment rather than exchange treatment.

Prior to the Tax Reform Act of 1976 "section 306 stock" did not retain its character as such after the death of the shareholder. Section 306(c) defines "section

306 stock" to include stock received in certain transactions and stock the basis of which is determined by reference to the basis of "section 306 stock." Because the basis of stock received from a decedent was not determined with reference to the basis of the stock in the decedent's hands, it did not fit within the definition of "section 306 stock" and was thus unquestionably exempt from the treatment prescribed for a redemption of "section 306 stock."

The only case existing prior to the Tax Reform Act of 1976 in which both Section 303 and Section 306 would apply to a redemption of stock occurred where "section 306 stock" was distributed after the death of a decedent and then redeemed in a transaction which qualified under Section 303 with respect to the decedent's estate. Regulations Section 1.303(2)(d) specifically provides that, in this case, Section 303 will take priority (emphasis supplied):

If stock includible in determining the value of the gross estate of a decedent is exchanged for new stock, the basis of which is determined by reference to the basis of the old stock, the redemption of the new stock will be treated the same under section 303 as the redemption of the old stock would have been. Thus, section 303 shall apply with respect to a distribution in redemption of stock received by the estate of a decedent (1) in connection with a reorganization under section 368, (2) in a distribution or exchange under section 355 (or so much of section 356 as relates to section 355), (3) in an exchange under section 1036 or (4) in a distribution to which section 305(a) applies. *Similarly, a distribution in redemption of stock will qualify under section 303, notwithstanding the fact that the stock redeemed is section 306 stock to the extent that the conditions of section 303 are met.*

The legislative history of Section 303 also addresses the case in which the new stock is "section 306 stock" and states that Section 303 has priority over Section 306. Senate Report 1622, 83d Cong., 2 Sess. 239 (1954), prepared by the Senate Finance Committee to accompany the House of Representatives' bill which, as finally enacted, became the Internal Revenue Code of 1954, states (emphasis supplied):

Under subsection (c), your subcommittee has further expanded the application of existing law and section 303 of the House bill that if after the death of a decedent his estate receives stock whose basis is determined by reference to, or by allocation of, the basis of the stock which was included in the gross estate, then section 303 will apply to a redemption of the new stock, to the same extent section 303 would have applied to the redemption of the old stock, within the time limitations described in subsection (b)(1). This subsection represents an expansion of section 115(g)(3) of the 1939 code, as well as section 303 of the House bill. *This subsection applies notwithstanding the provisions of section 306.*

When Congress amended the rules for determining the basis of property acquired from a decedent in the Tax Reform Act of 1976, it created, perhaps inadvertently,[1] a new case to which both Section 303 and Section 306 would be applicable. Under new Section 1023 of the Code, added by the Tax Reform Act, the basis of stock of a closely held corporation acquired from a decedent dying after December 31, 1976 will be determined by reference to the basis of the stock in the hands of the decedent before his death. If the stock was "section 306 stock" in the hands of the decedent before his death, it may be "section 306 stock" in the hands of a shareholder after the decedent's death, because its basis is determined by reference to the basis of "section 306 stock" and will thus come within the literal definition of "section 306 stock".

Neither the statute nor the legislative history of the Tax Reform Act of 1976 indicates whether Section 303 or Section 306 should take priority when "section 306 stock" received from a decedent is redeemed in a transaction which otherwise qualifies under Section 303. Section (3)(a)(2) of the Technical Corrections Bill of 1977, H.R. 6715, (the "Bill") would determine this issue by excluding a redemption of "section 306 stock" from treatment under Section 303, unless the stock was distributed after the decedent's death. The proposed section states in full:

(2) *Clarification that section 306 stock cannot be used for section 303 purposes.*—Subsection (b) of section 303 (relating to distributions in redemption of stock to pay death taxes) is amended by adding at the end thereof the following new paragraph:

"(5) *Section 306 stock ineligible.*—Subsection (a) shall not apply to any distribution in redemption of section 306 stock. The preceding sentence shall not ap-

[1] Nothing in the legislative history of the Tax Reform Act of 1976 indicates that Congress was aware that by changing the basis rule for property received from a decedent Congress was also changing the rule that stock lost its "section 306 taint" on the death of the shareholder.

ply to new stock which meets the requirements of paragraphs (1), (2), and (3) of subsection (c) if the old stock was not section 306 stock."

(3) *Effective date.*—The amendments made by this subsection shall apply to the estates of decedents dying after December 31, 1976.

The description of the Technical Corrections Bill of 1977 prepared for the use of the Committee on Ways and Means by the Staff of the Joint Committee on Taxation does not explain the reason for disallowing the use of "section 306 stock" distributed prior to the shareholder's death in a Section 303 redemption. The description of Section 3(a)(2) of the Bill states in full (page 19):

Redemptions of Certain Preferred Stock to Pay Death Taxes (sec. 3(a)(2) of the bill and sec. 303 of the Code).

In certain cases, a distribution in redemption of stock to pay death taxes is treated as an amount realized from the sale or exchange of a capital asset rather than as dividend income. However, special rules are provided to prevent the "bailout" of dividends as capital gains upon a sale or redemption of preferred stock distributed to shareholders as "section 306 stock."

Under the carryover basis provisions added by the 1976 Act, this special rule applies to section 306 stock in the hads of the heirs of the distributee shareholder. As a result, it is presently unclear whether the provision extending capital gains treatment for redemptions to pay death taxes overrides the preferred stock bailout provision in the case where section 306 stock is redeemed from the estate or heirs.

The bill would make it clear that capital gains treatment under the redemption provision is not generally available for section 306 stock. As under present law, an exception to this rule would apply to preferred stock received by a decedent's estate in a reorganization if the stock is in substitution for common stock which was eligible for capital gains treatment in a redemption to pay death taxes.

The inequitable result accomplished by the proposed amendment is most likely caused by a confusion of the basic purposes of Section 306 and Section 303. Section 306, as applied to a redemption, is intended to prevent a withdrawal of cash from a corporation by a shareholder without a corresponding diminution in the shareholder's equity interest in the corporation. Section 303 is intended to provide an estate with a means of raising cash to pay estate taxes other than selling company stock to third parties. Section 303 has never required an estate to relinquish a portion of its equity interest in the company as a condition of favored tax treatment. For example, if a decedent's estate owns 100% of a company's outstanding common stock, a redemption of common stock from the estate will qualify for treatment under Section 303 if the other requirements of the section are met, notwithstanding that the estate will continue to own 100% of the company's outstanding common stock after the redemption. Because a diminution of equity interest is not required for a redemption of common stock to qualify under Section 303, the fact that a diminution of equity interest will not occur in a redemption of "section 306 stock" presents no justification for its disqualification from treatment under Section 303.

Furthermore, the use of "section 306 stock" in a Section 303 redemption is a necessary business planning tool, which the Bill would deny without good reason. For example, it often occurs that two or three individuals own the controlling interests in a company and each individual desires his interest to remain in his family after his death. Under the law as it existed prior to the Tax Reform Act of 1976, the company could issue preferred stock, which would be "section 306 stock," to the shareholders during their lifetimes and agree to effect a redemption of so much of the "section 306 stock" as would qualify under Section 303 upon each of their deaths. In this manner, when a shareholder dies, his estate would not be forced to relinquish its equity interest in the corporation in order to raise the cash to pay death taxes. This is precisely the relief Section 303 is intended to provide. Under the proposed amendment contained in the Bill, the deceased shareholder's estate may be forced to dispose of part or all of its common stock to pay death taxes and would thus not be able to distribute the decedent's equity interest intact to his family. The relative equity interests of the respective families would be determined by the order of death of the principal shareholders. Congress certainly has no interest in effecting such haphazard results. There is no justification for denying Section 303 relief in this situation, where equity interests are split among two or more shareholders, while allowing the sole shareholder of a company to qualify for treatment under Section 303 and pass his equity interest intact to his heirs.

Furthermore, there is no logical justification for denying treatment under Section 303 to a redemption of "section 306 stock" received in a pre-death distri-

bution while allowing relief for a redemption of "section 306 stock" distributed after death. The opportunity to "bail-out" earnings and profits which Section 306 is intended to prevent, is present in the case where "section 306 stock" is distributed after the decedent's death, but present law and Section 3(a)(2) of the Bill state that Section 303 treatment is nevertheless extended to a qualifying redemption of such stock. Indeed, the possibility of an earnings "bail-out" would appear more likely where the "section 306 stock" is issued after death than before. If a distribution of "section 306 stock" is planned to occur after the death of a decedent, the shareholders can more readily avail themselves of the opportunity to "bail-out" earnings because the exact dollar value of the stock redeemable under Section 303 will then be known. A corporation may issue only as much "section 306 stock" as will be redeemable under Section 303 and then effect the redemption, thus making no substantive change in the capital structure of the corporation. If the "section 306 stock" is issued before the decedent's death, the amount of stock that will be redeemable under Section 303 can only be estimated. If more preferred stock is issued than can be redeemed under Section 303, the unredeemed stock will remain a part of the capital structure of the corporation, or must be redeemed in a transatcion which will result in dividend treatment unless an exception is available under Section 306(b). If less preferred stock is issued than can be redeemed under Section 303, then full advantage cannot be taken of the favored tax treatment provided under Section 303 without redeeming stock which previously formed a part of the corporation's capital structure. Despite the opportunity for a "bail-out" of earnings and profits through a post-death distribution of "section 306 stock," Congress and the Treasury have stated that Section 303 shall take priority. A pre-death distribution of "section 306 stock," through which a "bail-out" cannot be as easily accomplished, should be accorded even treatment by applying Section 303 notwithstanding that the stock redeemed is "section 306 stock."

Those of our clients who will be penalized by the proposed amendment to Section 303 are the owners of family held corporations who have devoted their lifetimes to building their businesses. Since the enactment of Section 303, they have relied on its provisions to enable them to pass control of their businesses to their sons and daughters after they die. If Section 3(a)(2) of the Bill is enacted, we will be hard pressed to explain to them why Congress has chosen to deny them the relief afforded others by Section 303. It makes little sense now, simply because of some changes in property basis rules, to override a longstanding policy which enables the ownership of small corporations to be retained in the family after a shareholder's death. We hope that you will give this matter your serious attention, and that you will make every effort to see that Section 3(a)(2) of the Technical Corrections Bill of 1977 does not become law. We further hope that you will work for inclusion in the Bill of language similar to the attached sample which will specifically allow the use of "Section 306 stock" in a redemption which qualifies for treatment under Section 303.

Sincerely,

ADDIS E. HULL.

AMERICAN SOCIETY OF FARM MANAGERS AND RURAL APPRAISERS, INC.,
Denver, Colo., June 24, 1977.

Hon. AL ULLMAN,
Chairman, Ways and Means Committee,
House of Representatives, Washington, D.C.

DEAR MR. ULLMAN: Members of The American Society of Farm Managers and Rural Appraisers, in their professional capacity, manage more than 30,000,000 acres of farmland in the United States for estates, guardianships, trust and other types of clients. We in the Society are concerned about the potential impact of the special use valuation provision of the Tax Reform Act of 1976 as it may affect our membership's clientele and their families.

Special use valuation provides that material participation is determined in the manner that is used for determining the tax on self-employment income under Code Section 1402(a)(1). At the request of the Society's Executive Council, an analysis of the concept of material participation as it relates to special use valuation was prepared. The analysis was written by our special counsel, Jack Arthur Kirby, a member of the Philadelphia Bar Association.

A copy of the analysis is enclosed. It is sent to acquaint you with our concern over the interpretation of the concept. Our special counsel has submitted the

analysis to individuals in the Treasury Department and the Internal Revenue Service for their respective considerations relative to the promulgation of the final regulations.

The preface of the analysis, we believe, succinctly sets forth the position of The American Society of Farm Managers and Rural Appraisers. It is our belief that special use valuation will enhance the goal of preservation of the "family farm" once the concept of material participation is explicit. The membership of the Society, more than 2,100 in number, believes your concern towards the establishment of a workable, definition of the concept of material participation will ensure that the "family farm" remains in the family.

Sincerely,

JAMES R. HUTCHINSON, AFM, ARA,
President, the American Society of Farm Managers & Rural Appraisers, Inc.
CARL O. NORBERG, CAE,
Executive Vice President.

Enclosure.

AN ANALYSIS OF THE CONCEPT OF MATERIAL PARTICIPATION AS IT PERTAINS TO SPECIAL USE VALUATION, BY JACK ARTHUR KIRBY, ROSEMONT, PA.

PREFACE

This analysis is concerned with the concept of material participation as it pertains to Section 2032A of the Tax Reform Act of 1976. It is intended to provide considerations toward the establishment of workable and equitable guidelines in the interpretation of that section of the Act.

The analysis is divided into five sections, which are

1. Goals of the Tax Reform Act of 1976;
2. Introduction of material participation;
3. Legislative history;
4. Application to section 2032A; and
5. Conclusion.

The analysis reveals a significant diversity of interpretation of Congressional intent of the concept of material participation. Commencing with the legislative history, the theory is espoused that material participation as contemplated by the Act of August 1, 1956, ch. 836, Sec. 104(c)(2), 70 Stat. 824–25 can be achieved in various ways; that is, landowner can materially participate in the operation of his or her farm when the fact is established that there is periodic advice or consultation and periodic inspection of the production activities. Further, the legislative history states that if a landowner established the fact that he or she provided a substantial portion of the machinery, implements or livestock used in the production of the commodities or, that he or she furnished, or advanced, or assumed financial responsibility for, a substantial part of the expense involved in the production of the commodities, the degree of participation contemplated by the amendment will be met.

The analysis suggests that the Internal Revenue Service and the Treasury Department require all of the above criteria to be satisfied in order to meet the requirement. The judiciary tends to take a less restrictive interpretation. Query-which interpretation should prevail?

Modern society has attained substantial technological advancements since the material participation concept came into existence in 1956. The business of agricultural production today requires, and demands, multi-faceted operations. There are the bookkeeping and accounting aspects, the repair and maintenance of machinery and implements, the actual production activities, the marketing of the commodities and the livestock, the managerial activities, and so forth. Farmers today are agricultural businessmen operating a complex and risky business. Various tasks in the phases of the production and management of a working farm often are handled by different individuals engaged in the overall operation. Today, prudent farming activities necessitate a division of labor.

The objective sought by the analysis is a workable definition of the concept of material participation which, to the extent possible, is applicable to the farming community. The goal of preserving the "family farm" is meritorious. Section 2032A is a significant step towards it achievement.

The judiciary has held and the Internal Revenue Service and the Treasury Department appear to be in concurrence that actual physical participation by the landowner is not required to meet the material participation requirement.

The judiciary has held and present Treasury Regulation 1.1402(a)-4 (5) and (6) parallels its holding that material participation can be achieved via an agent or employee of the landowner. Public Law 93-368 provides, however, that material participation is determined without regard to any activities of an agent of such owner or tenant. The interpretation of this enactment is that if a farm owner does no participate in the farm operation and has completely turned over the management of his land to an agent, such as a professional farm management company, the activities of the agent or tenant are not attributable to the owner in determining material participation. Does this mean that the individual farmer who engages a professional farm management company, whatever the reason, must forego the benefit of special use valuation? A literal interpretation suggests that he would have to forego such benefit. If preservation of the "family farm" is an objective, it is conceivable that Public Law 93-368 defeats it. To hold that a farmer cannot satisfy the material participation requirement through an agent, such as a professional farm management company, is tantamount to suggesting that a principal is not responsible for the acts of his agents under the basic principles of agency law. As previously noted, modern farming is a complex multi-faceted business. It requires large amounts of capital, machinery, implements, and, of course, the land. All of which are expensive and costly to maintain. Such contribution by an owner or tenant should be sufficient to establish material participation.

At times, the engagement of a professional farm management company may be the most prudent decision a farmer can make for himself, his family and, perhaps, his agricultural community. The farmer may be elderly, the accounting required for tax purposes and prudent management may be beyond his experience, or the technical expertise offered by the farm management company may be invaluable to increase production. However, he will think twice if he is to lose the potential benefit of special use valuation. Therefore, is there a workable definition of the concept of material participation which may be acceptable to the Congress, the Internal Revenue Service, the Treasury Department and the Judiciary? It is believed there is. It is suggested that the term "material participation" shall include within its meaning—

(A) activities by a qualified heir, or any member of his family, similar to "material participation" as determined under paragraph (1) of section 1402(a) (relating to net earnings from self employment); or

(B) activity in which the qualified heir, or any member of his family, is at risk (within the meaning of section 465(b)) with regard to the qualified real property and whose annual beneficial interest in the qualified real property is dependent upon the fruits of a use for farm purposes of such qualified real property, whether or not the qualified heir, or any member of his family, directly manages such qualified use.

GOALS OF THE TAX REFORM ACT OF 1976

Public Law 94-455 became effective October 4, 1976. Known as the Tax Reform Act of 1976, this legislation introduced one of the most comprehensive tax reforms since the enactment of the Internal Revenue Code of 1954. The Act is intended to achieve six major goals: (1) to improve the equity of the tax system; (2) to modify certain deductions and credits, increase the standard deduction, redraft complex revisions, and delete provisions which are little used or obsolete; (3) to extend fiscal stimulus; (4) to encourage capital formation; (5) to improve administration of tax laws and strengthen taxpayers' rights; and (6) to provide relief for small to medium-sized estates in estate and gift taxes and eliminate tax avoidance possibilities.[1]

INTRODUCTION OF MATERIAL PARTICIPATION

In light of these goals and with recognition of their individual and collective merit, selected sections of the Act and of the Code are analyzed herein insofar as farming activities are concerned. In the past when the owner of a farm died, the value of the land for estate tax purposes was its potential highest and best use. Such valuation meant that the value of the farm for estate tax purposes could exceed its "true" value as an operational farm. The income, actual and potential, to be derived from the farming activities could be substantially below the value of the land if used for other than agricultural or horticultural production. Highest and best use valuation often forced the heirs to sell all or part of

[1] General Explanation of the Tax Reform Act of 1976, Staff of Joint Committee on Taxation, Dec. 20, 1976, at page 1.

the land in order to pay the taxes at the owner's death. Intending to eliminate speculative valuation of farmland at inflated prices and to reduce the imposition of higher estate taxes, Congress enacted Section 2032A. This provision permits the executor of an estate involving land devoted to farming or closely held businesses to elect special-use valuation.

Qualification for special-use valuation is contingent upon meeting certain requirements prescribed in the provision. Among these requirements is material participation. On the surface, material participation seems relatively easy to define. However, the concept is elusive. The Internal Revenue Service, the Treasury Department, and the courts have attempted definitions for more than two decades without total agreement.

LEGISLATIVE HISTORY

Prior to 1956 it does not appear that the concept of material participation existed in the eyes of the law. For the year 1955 and earlier, any income received by a farm landlord under a sharefarming or similar lease arrangement constituted rental income from real estate regardless of the degree of paticipation by the farm landlord. In 1956, the Congress, recognizing that under many such arrangements the owner, i.e., the landlord, *may* take an active part in the farming operation, create the concept of material participation (emphasis added). Self-employed farmers were therefore brought within the coverage of social security. As an amendment to the Social Security Act, the Act of August 1, 1956, ch. 836, Sec. 104(c)(2), 70 Stat. 824–25 provided that a farm landlord's net income from the shareleasing of his farm may be considered as net earnings from self-employment if two major tests are met:

(A) Such income must be derived under an arrangement between the owner and the tenant which provides that the tenant shall produce agricultural or horticultural commodities on the land and that there shall be material participation by the owner in such production or the management of such production; *and*

(B) There must in fact be such material participation by the owner (emphasis added).

In an attempt to understand what Congress meant by the words "material participation," reference is made to the legislative history as found in United States Code Congressional and Administrative News, Volume 3, 1956, at pages 3882–3884 and at pages 3914–3915. The history is summarized as follows:

Status of share farmers.—Both the House and the Committees approved bills to clarify the status under old-age and survivors insurance of individuals who operate farms under farm-sharing arrangements made with the owners or tenants of these farms. In specifying that these individuals are self-employed and not employees for purposes of old-age and survivors insurance coverage, the bill gives statutory recognition to the interpretation being followed in administering the present law.

Your committee believes that this statutory recognition is necessary to dispel doubt as to the intent of the Congress since persons operate farms under a share-farming arrangement with the owner or tenant have some characteristics of employees and some characteristics of self-employed persons. For example, in some instances the landowner may direct the share farmer to nearly the same extent, on an overall basis, as he does individuals who are clearly employees. On the other hand, share farmers participate directly in the risk of farming, their return from the undertaking is dependent upon the amount of the crop or livestock produced. The provisions of the bill would remove any doubt as to whether the services performed by the share farmer are rendered as a employee or as a self-employed person by statutorily defining such service to be self-employment. This definition is believed to be consistent with the actual relationship existing under share-farming arrangements in the majority of cases.

Landowners participating in production.—Under this amendment, it is contemplated that the owner or tenant of land used in connection with the production of agricultural or horticultural commodities must participate to a material degree in the management decisions or physical work relating to such activities in order for income derived therefrom to be classified as net earning from self-employment.

Share-farm arrangements.—The committee is of the opinion that in any case in which the owner or tenant establishes the fact that he periodically advises or consults with such other individuals as to the production of the commodities and also establishes the fact that he periodically inspects the production activities on the land he will have presented strong evidence of the existence of the degree

of participation contemplated by the amendment. If the owner or tenant also establishes the fact that he furnishes a substantial portion of the machinery, implements, and livestock used in the production of the commodities or that he furnishes, or advances, or assumes financial responsibility for a substantial part of the expense (other than labor expense) involved in the production of the commodities, the committee feels that he will have established the existence of the degree of participation contemplated by the amendment.

APPLICATION TO SECTION 2032A

The Report of the Committee on Ways and Means, U.S. House of Representatives, 94th Congress, 2nd session, Report No. 94-1380 suggests that material participation by an individual in farm operations or closely held businesses is to be determined in a manner similar to the manner in which material participation is determined for purposes of the tax on self-employment income with respect to the production of agricultural or horticultural commodities under present law. Code Section 1402(a)(1) defines net earnings from self-employment. In subparagraph (1) thereof, it provides that "... (t)here shall be excluded rentals from real estate and personal property leased with the real estate (including such rentals paid in crop shares) together with the deductions attributable thereto, unless such rentals are received in the course of a trade or business as a real estate dealer except that the preceding provisions of this paragraph shall not apply to any income derived by the owner or tenant of land if (A) such income is derived under an arrangement, between the owner or tenant and another individual, which provides that such other individual shall produce agricultural commodities (including livestock, bees, poultry, and fur-bearing animals and wildlife) on such land, and that there shall be material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) in the production or the management of the production of such agricultural or horticultural commodities, and (B) there is material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) with respect to any such agricultural or horticultural commodity."[2]

The law unquestionably precludes the mere passive rental of the farmland as a means of meeting the material participation requirement. Likewise, it suggests that a normal sharecropping alone does not meet the requirement. It requires that the owner or tenant must participate to a material degree. The extent and the degree to which an individual owner or tenant is required to participate has been the subject of litigation for twenty years. At present, therefore, reliance must be placed on existing law, regulations, rulings, and judicial interpretation.

Present Treasury Regulation 1.1402(a)-4, subparagraphs (2)-(6) inclusive thereof, discusses the requirements which must be met if an arrangement is entered into between the owner or the tenant and another individual. Subparagraph (2) provides that if rental income received by an owner or tenant is to be treated as includible farm rental income for purposes of Section 1402(a)(1), the income must be derived pursuant to a sharefarming or other rental arrangement which contemplates material participation by the owner or the tenant in the production or the management of production of the commodities. Subparagraph (3) concerns the definitions of the words "production" and "management." The word "production," in essence, relates to physical work in producing such commodities. It further adds that "... i(f) under the arrangement it is understood that the owner or tenant is to engage periodically in physical work to a degree which is not material in and of itself and, in addition, to furnish a substantial portion of the machinery, implements and livestock to be used in the production of the commodities or to furnish or advance funds or assume financial responsibility for a substantial part of the expense involved in the production of the commodities, the arrangement will be treated as contemplating material participation of the owner or tenant in the production of such commodities."[3]

Regarding the term "management of production," the regulation provides that it refers to "...(s)ervices performed in making managerial decisions relating to the production, such as when to plant, cultivate, dust, spray, or harvest the crop, and includes advising or consulting, making decisions as to matters such as rotation of crops, the type of crops to be grown, the type of livestock

[2] Section 1402(a)(1).
[3] Treasury Regulation 1.1402(a)-4.

to be raised and the type of machinery and implements to be furnished. . . ."[4] The regulation goes on to provide that such an arrangement will be treated as considering material participation by the owner or tenant if said individual engages to a material degree in the management decisions relative to the production.

It is worthy to note that the Treasury Department in the issuance of this regulation deems to be of particular importance the owner's or tenant's ". . . (s)ervices performed in making inspections of the production activities and advising and consulting with such persons as to the production of the commodities. . . ."[5] The regulation does not provide that such activity on the part of the owner or tenant constitutes material participation; rather, it suggests that a strong inference can be drawn that there is, or has been, material participation.

It further provides, however: ". . .(T)he mere undertaking to select the crops or livestock to be produced or the type of machinery and implements to be furnished or to make decisions as to the rotation of crops generally is not, in and of itself, sufficient. Such factors may be significant, however, in making the overall determination of whether the arrangement contemplates that the owner or tenant is to participate materially in the management of the production of the commodities. Thus, if in addition to the understanding that the owner or tenant is to advise or consult periodically with the other person as to the production of the commodities and to inspect periodically the production activities on the land, it is also understood that the owner is to select the type of crops and livestock to be produced and the type of machinery and implements to be furnished and to make decisions as to the rotation of the crops, the arrangements will be treated as contemplating material participation of the owner or tenant in the management of production of such commodities."[6]

At this juncture examination of congressional intent is important. The legislative history previously summarized on page 5 of this analysis provided that:

". . .(I)n any case in which the owner or tenant establishes the fact that he periodically advises or consults with such other individuals as to production of the commodities and also establishes the fact that he periodically inspects the production activities on the land he will have presented strong evidence of the degree of participation contemplated by the amendment. . . ."

Compare the language used by the Congress with the language used in Treasury Regulation 1.1402(a)-4. Congress provided that such activity by the owner or tenant constitutes "strong evidence" of material participation. The regulation, subparagraph (3) thereof, allows that such activity provides a "strong inference" that there has been material participation by the owner or tenant (emphasis added). While the difference between the words "evidence" and "inference" may be slight as used in the context herein discussed, there exists, in fact, a difference: ". . . '(I)nference,' as commonly understood, may mean the actual fact inferred, strictly it means the process or reasoning in reaching the fact and not the fact itself; . . ., a process of reasoning by which a fact or proposition sought to be established is deduced as a logical consequence from other facts, or a state of facts, already proved or admitted; . . ."[7]

"Evidence, broadly defined, is the means from which an inference may logically be drawn as the existence of a fact; that which makes evident or plain. Evidence is the demonstration of a fact; it signifies that which demonstrates, makes clear, or ascertains the truth of the very fact or point in issue, . . ."[8] It is important to note that evidence is not the fact; rather, it is that matter or activity which makes clear or ascertains the truth of the point in issue. Therefore, it can be said in its stricter sense that evidence differs from inference.

It is common knowledge that Congress makes the tax laws and the Treasury Department, the Internal Revenue Service, and the courts interpret them. An interpretation, however, must be within the letter and the spirit of the law. In the legislative history, Congress did not state that the owner or tenant must establish the fact that he periodically advises or consults with another as to the production of the commodities and that he periodically inspects the production

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[4] Ibid.
[5] Ibid.
[6] Ibid.
[7] 43 C.J.S. 373.
[8] 31 C.J.S. 815.

activities on the land *and* that he also establishes the fact that he furnishes a substantial portion of the machinery, implements, and livestock used in the production of the commodities or that he furnishes or advances, or assumes financial responsibility for, a substantial part of the expense involved in the production of the commodities, *then, and only then* will the owner or tenant meet the degree of participation contemplated by the amendment (emphasis added). The Congress did not elect to use the italicized conjunction "and." On the contrary, Congress stopped after decreeing that the owner or tenant must periodically advise or consult and periodically inspect the land. It said if these activities are achieved, the owner or tenant will have presented *strong evidence* of having materially participated to the degree contemplated by the amendment (emphasis added). The Treasury Department, on the other hand, suggests that such activities present only strong inference that material participation has occured (see paragraph (3) thereof).

In subparagraph (4), the regulation quotes the language used in the legislative history by providing that the activities above-mentioned will present strong evidence of the degree of participation contemplated by Section 1042(a)(1). Then, the regulation expands the requirement by employing the words "in addition." This language tends to suggest that more is required than the periodic advising or consultiing with another and the periodic inspection of the production activities on the land. Query: Is the Treasury Department interpretation within the letter and the spirit of the law?

Subparagraph (5) of the regulation discusses employees or agents. Initially, it provides that any arrangement entered into by an employee or agent of an owner or tenant and another person shall be considered as being entered into by the owner or tenant for purposes of satisfying the requirement that the income must be derived under an arrangement set forth in subparagraph (2). It further provides that in determining whether the arrangement contemplates material participation by the owner or tenant, the services performed by the employee or agent of the owner or tenant are the services which the arrangement contemplates will be performed by the owner or tenant. In other words, if under the arrangement the services performed by the employee or agent are the services which the owner or tenant would perform absent such employee or agent and these services are of the nature to meet the degree of participation contemplated by the amendment, the owner or tenant will be deemed to have materially participated. In essence, if the arrangement provides for the services contemplated by the law and the employee or agent does, in fact, perform such services, the services will be deemed to have been performed by the owner or tenant. Therefore, the conclusion is drawn that an employee or agent can do what is required to meet the degree of participation contemplated by the amendment and the satisfactory fulfillment thereof will be imputed to the owner or tenant.

Subparagraph (6) sets forth examples which are beneficial in determining whether or not, in the yes of the Treasury Department, the degree of participation contemplated by the amendment is met. Of particular importance to this analysis are examples (4), (5), and (6):

"*Example (4).*—G owns a fully-equipped farm which he rents to H under an arrangement which contemplates that G shall materially participate in the management of the production of crops raised on the farm pursuant to the arangement. G lives in town about 5 miles from the farm. About twice a month he visits the farm and looks over the buildings and equipment. G may occasionally in an emergency, discuss with H some phase of a crop production activity. In effect, H has complete charge of the management of farming operations regardless of the understanding between him and G. Although G pays one-half of the cost of the seed and fertilizer and is charged for the cost of materials purchased by H to make all necessary repairs, G's activities do not constitute material participation in the crop production activities. Accordingly, G's income from the crops is not included in computing net earnings from self-employment." [9]

Analysis of Example (4).—Although the determination reached by the Treasury Department is correct insofar as the regulation is concerned, the question arises as to whether such result is the result intended by Congress. It is recalled that subparagraphs (3) and (4) of the regulation may be considered to deviate somewhat from congressional intent. Under the facts of the example it is admitted that G did not periodically advise or consult with H as to the production of the commodities except in an emergency situation. Also, it is admitted that

[9] Supra, note 8.

G did not periodically inspect the production activities on the land. According to the Treasury Department's interpretation, G did not become involved in the management of the production. This interpretation is sound and within the guidelines of Treasury Regulation 1.1402(a)-4. Would a court, however, reach the same conclusion? As previously suggested, the legislative history did not appear to require that the owner or tenant must periodically advise or consult, must periodically inspect the production of the commodities on the land and must supply a substantial portion of the machinery, implements, and livestock or furnish, advance, or assume financial responsibility for a substantial part of the expense. A strict reading of the legislative history appears to suggest there are alternatives available to the owner or tenant to meet the degree of participation required by the amendment. In this instance G supplied a fully-equipped farm. Taken at face value, this would mean that G furnished the machinery, implements, and livestock used in the production of the commodities. Further, G paid one-half the cost and fertilizer and the entire cost of the materials purchased by H to make the necessary repairs. Unquestionably, the financial responsibility assumed by G is a substantial part of the expenses in the operation of the farm. It is ventured that a court having these facts before it would find that G's activities involved in the production of the commodities establishes the degree of participation contemplated by the amendment. To hold that G must participate in the management of the production in light of all the other activities performed by, or responsibility assumed by, G could tend to obviate the intent of Congress. The question which therefore arises is whether the arrangement itself is to govern or whether activities outside the arrangement but within the congressional intent will control. The controlling factor should be whether participation to the degree contemplated by the amendment has been met.

In *Foster* v. *Celebrezze*, C.A. 8th Cir., 313 F.2d 604, 606, 607 (1963), the court examined social security pamphlet OASI-33d with respect to an arrangement. The pamphlet indicated that an arrangement could be either written or oral. If oral, then the mutual understanding between the owner and tenant is considered. The pamphlet stated: ". . . (Y)our understanding is shown by your acts, those of your tenant, how you and your tenant acted in previous years on similar matters, common practices in the area, and statements by you, your tenant, or even third persons who may know the facts as to how you intend to operate."[10] The court noted ". . . (t)hat volunteer services or inspection on the part of the landlord in the absence of any arrangement therefor will not suffice."[11]

In the instant example there was an arrangement between G and H. It called for G to materially participate in the management of the production of the commodities. The Treasury Department has defined what it deems to be such participation. However, consider the court's view in *Henderson* v. *Flemming*, C.A. 5th Cir., 283 F.2d 882, 888 (1960). In that case, the court held,

"An owner of land who is required to (and does) furnish substantial amounts of cash, credit or supplies toward this mutual undertaking which are reasonably needed in the production of the agricultural commodity and from the success of which he must look for actual recoupment likewise makes a 'material participation.' One is hardly a mere landlord in the traditional sense if he must risk considerable funds in addition to the land in the success of the venture. And what he gets—or hopes to get—is more than rent. It is profit from the operation of a business fraught with financial risks—the business of producing agricultural commodities."[12]

Examples (5) and (6), which follow, are considered together. These examples reflect the Treasury Department's interpretation of employees or agents of the owner or tenant.

"*Example* (5).—J owned a farm several miles from the town in which he lived. He rented the farm to K under an arrangement which contemplated J's material participation in the management of production of wheat. J furnished one-half the seed and fertilizer and all the farm equipment and livestock. He employed H to perform all the services in advising, consulting, and inspecting contemplated by the arrangement. J is materially participating in the management of production of wheat by K. The work done by J's employee, H, is attributable to J in determining the extent of J's participation. J's rental income from

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[10] *Foster* v. *Celebresse*, C.A. 8th Cir., 313 F. 2d 604, 606, 607 (1963).
[11] Ibid. at 607.
[12] *Henderson* v. *Flemming*, C.A. 5th Cir., 283 F. 2d 882, 888 (1960).

the arrangement is to be included in computing his net earnings from self-employment.

"*Example* (6).—Assume the same facts as in the previous example except that J appointed the X Bank as his agent to enter into the rental arrangement with K and to perform the services contemplated by the arrangement. J is also materially participating in the management of production of wheat by K because the work done by X Bank is attributable to J in determining the extent of J's participation even though X Bank is an independent contractor. J's rental income from the arrangement is to be included in computing his net earnings from self-employment." [13]

Analysis of Examples (5) *and* (6).—These examples substantiate the fact that the owner or tenant need not personally participate in the production or the management of the production of the commodities on the land. The previously cited case of *Henderson* v. *Flemming* at page 888 held that ". . . (t)he material participation is not confined to *personal* activities. It may be through agents or employees and quite without regard to the method of their compensation." [14]

To this point only Section 1402(a)(1), the legislative history, and Treasury Regulation have been considered. Revenue Rulings and judicial interpretation merit exploration in order to more completely understand the concept of material participation and what is believed to be Congress' intent. Revenue Ruling 57-58, 1957-1 C.B. 270, provides the preliminary guideline. It states ". . . (t)hat a landowner, who establishes that he (1) periodically advises or consults with the other party regarding the production of the commodity, (2) periodicaly inspects the production activities on the land, and (3) furnishes a substantial portion of the machinery, implements and livestock used in the production activities, or furnishes or advances funds or assumes financial responsibility for a substantial portion of the expense involved in the production of the commodity, should include the income derived by him under the arrangement in computing net earnings from self-employment." [15]

This interpretation by the Service tends to abort the language found in the legislative history. Clearly, in the latter if the aforementioned (1) and (2) are met, (3) does not appear to be required to meet the degree of participation contemplated by the amendment to the Social Security Act. The legislative history does tend to suggest that compliance with (1) and (2) or, in the alternative, compliance with (3) will suffice. This position is borne out in *Bridie* v. *Ribicoff*, 194 F Supp. 809, 815 (1961), where the court reaffirmed the principle of *Henderson* v. *Flemming*, 283, F. 2d 882, 888 (1960), that the advancement of a substantial amount of capital can amount to "material participation" in and of itself.

Revenue Ruling 64-32, 1964-1 C.B. 319 deals with the engagement of an employee or agent to manage and supervise the operation of a farm on behalf of the owner:

"A landlord, whose farm is being operated by a tenant on a crop-share basis, engages an individual to manage and supervise the operation of his farm. The landlord pays a significant part of the costs of production and retains the right to approve crop and management plans. The manager consults regularly and frequently with the tenant regarding the production and management of the production of crops. *Held*, services performed by the manager are considered to be services performed by the landlord. *Held further*, farm rental income received by the landlord is to be considered in computing net earnings from self-employment." [16]

The facts of the example explaining this ruling are interesting. They are as follows:

"A, a landlord living in Illinois, has a farm located in Iowa, which is being operated by a tenant on a cropshare basis. A visits the farm personally at least once a year, but he has engaged B to manage and supervise the operation of his farm, and he pays B a fixed annual fee for this service.

"B and the tenant consult regularly and frequently with respect to such matters as crop planning, harvesting and rotation, field arrangement, selection of seed, and the testing treatment, and conservation of the soil, but A reserves the right to examine and approve their crop plans and those relating to drainage problems, maintenance and repair of the farm buildings, fences, etc. A also controls the farm budget, and he pays all previously authorized bills over *x* dollars and

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[13] Supra, note 3.
[14] Supra, note 12 at 888.
[15] Rev. Rul. 57-58, 1957-1 C.B. 270, 271, 272.
[16] Rev. Rul. 64-32, 1964-1 C.B. 319.

all bills under *x* dollars after they have been approved by B. The manager arranges for the sale of A's share of the crops and forwards the proceeds to him. A keeps a complete set of books concerning the farming operation.

"In the instant case the income derived by A from the sale of his share of the crops constitutes 'rentals from real estate' within the meaning of section 1.1402(a)-4 of the Income Tax Regulations.

"Section 1402(a)(1) of the Act provides, in part, that 'rentals from real estate' (including rentals paid in crop shares) shall be excluded in computing net earnings from self-employment unless—

> "* * * (A) such income is derived under an arrangement, between the owner or tenant and another individual, which provides that such other individual shall produce agricultural or horticultural commodities (including livestock, bees, poultry, and fur-bearing animals and wildlife) on such land, and that there shall be material participation by the owner or tenant in the production or the management of the production of such agricultural or horticultural commodities, and (B) there is material participation by the owner or tenant with respect to any such agricultural or horticultural commodity; * * *

"Revenue Ruling 57-58, 1957-1 C.B., 270 sets forth the guides to be used in determining when income derived by a landlord under a share-farming or other rental arrangement with another person for the production of agricultural or horticultural commodities, by that person on the landlord's land, should be considered in computing net earnings from self-employment.

"An evaluation of the factual situation in this case in the light of the guides set forth in Revenue Ruling 57-58, above, discloses that the combined activities of A and B are sufficient to establish 'material participation.' The question then is whether the services performed by B, acting as agent for A, can be considered to be services performed by A.

"Section 1.1402(a)-4(b)(5) of the regulations provides that any arrangement entered into by an employee or agent of a landlord and another person shall be considered an arrangement entered into by the landlord for purposes of satisfying the requirement of paragraph (A) of section 1402(a)(1) of the Act, supra, that the income must be derived under an arrangement between the landlord and another person.

"For purposes of determining whether the arrangement satisfies the requirement that the parties contemplate that the landlord will materially participate in the production or management of production of a commodity, services which will be performed by an employee or agent of the landlord are considered to be services which the arrangement contemplates will be performed by the landlord. Services performed by such an employee or agent are considered services performed by the landlord in determining the extent to which the landlord has participated in the production or management of production of a commodity.

"Pursuant to the foregoing, it is held that A meets the 'material participation' tests of section 1402(a)(1) of the Act. It is held, further, that the farm rental income A receives is to be considered in computing net earnings from self-employment.

"The conclusion in this case is consistent with the decisions in the cases of *Harper* v. *Flemming*, 288 Fed. (2d) 61 (1961), and *Henderson-Poole* v. *Flemming*, 283 Fed. (2d) 882 (1960)." [17]

Analysis of Example.—The facts clearly illustrate that an employee or agent can manage and supervise the operation of a farm on behalf of the owner, and that the services performed by such employee or agent are imputed to the owner. Suppose that A, the landlord, did not personally visit the farm at least once a year. Further, suppose that while A reserved the right to examine and approve the crop plans, he never exercised that right and that the manager, rather than A, kept a complete set of books concerning the farming operations but kept A informed. Would the result be the same?

It is believed that under proper arrangement among the manager, the owner, and the tenant, the result would remain the same. Where the manager periodically advises or consults and periodically inspects the production of the commodities on the land, these activities are considered as having been performed by the owner. Thus, for purposes of meeting the degree of participation contemplated by the amendment, the requirement is satisfied.

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[17] Ibid.

The judicial decisions which have been rendered in determining whether, under an arrangement, an owner "materially participated" in the operation of the farm are many. In *Foster* v. *Flemming*, D.C., N.D. Iowa, 190 F. Supp. 908 (1960, the court held that Mrs. Foster, a 78 year-old widow, did not actually participate in the operation of her farm. Her application for old-age benefits under the Social Security Act was denied. Upon pendency of appeal, the Secretary of Health, Education, and Welfare ". . . (c)hanged his position on the issue of 'vicarious participation' and, accordingly, no longer contends that appellant could not materially participate through the agent." [18] In its decision, the United States Court of Appeals for the Eighth Circuit stated:

"The important words in the controllong statute are 'material participation.' The meaning of the word 'participation' is not in dispute. The controversy arises with reference to the word 'material.' The word 'material' is a common word having a well-understood meaning. Webster's New International Dictionary, 2d Ed., defines 'material' as follows: 'Of solid or weighty character; substantial; of consequence; not to be dispensed with; important,

"[T]he 1956 amendment does not demand that the owner settle all the problems or even all the important problems that arise in connection with the operation of the farm, for the word 'participation' denotes joint activity in the entire enterprise and its modifier 'material' only requires that the activity be of substantial value or importance. Conley v. Ribicoff, supra, 2944 F.2d 190, 195.

"But the variables of our complex rural economy, well known to Congress, presented other situations in which the owner of the land did much more than furnish the land (and for which he would receive his rental). He might, under the arrangement, determine the crops to be planted, the areas to be cultivated, the time of planting, the fertilization program, and the manner and time of harvesting. If these activities were of a material, i.e. substantial importance from a practical point of view, then the Amendment was to make such activities self-employment by the owner and the proceeds income from self-employment. Henderson v. Flemming, supra, 283 F.2d 882, 888. The legislative history of the statute that we are considering is fully set out in the trial court's opinion. We find nothing in the statute or the legislative history to establish a Congressional intentiton to give the words 'material participation' a strict, unnatural or narrow construction. We believe that the word 'material' should be given its common and well-understood meaning.

Courts have generally taken the position that the Social Security Act, including the 1956 amendment, should be liberally construed. Harper v. Flemming, supra; Henderson v. Flemming, supra." [19]

A similar issue arose in *Henderson* v. *Flemming*, C.A. 5th Cir., 283 F.2d 882 (1960). In this case the claimant was a 91-year-old widow who sought the same benefits that Mrs. Foster sought. The issue before the court whether the claimant had to supervise the farming operations personally or whether the same could be achieved through an agent or an employee. In addition to the land, she furnished seed and assumed financial responsibility for one-half the cost of insecticide and all expenses for the operation of the machinery. In a two-year period the claimant's out-of-pocket expenses were $2,500 and $4,000. In this instance the court held that the working capital provided by the claimant constituted material participation."

In commenting on the interpretation of the concept of material participation, the court stated that ". . . (w)e think that Congress, . . . used these words in a sense consistent with the broadening of coverage . . . , (t)he variables of our complex rural economy, well known to Congress, presented other situations in which the owner of the land did much more than to furnish the land (and for which he would receive his rental) . . . ." [20]

The court also said "... (t)hat under some arrangements. the two, the owner of the land and the so-called tenant, are engaged in a joint venture. The result would be that the owner of the land, as well as the tenant, would in this way be engaged in the business of farming.

"Once that position is reached, there is nothing to distinguish it from other self-employment business. The person supplying the capital—whether land, factory building, storeroom, cash, furniture and fixtures, inventory, or the like—may operate that business wholly through agents and employees with no more effort or supervision on his part than receiving and depositing the fruits of their

[18] Supra, note 10 at 605.
[19] Supra, note 10 at 607.
[20] Supra, note 12 at 888.

labors. Consequently, the material participation is not confined to personal activities. It may be through agents or employees and quite without regard to the method of their compensation."[21]

In the case of *Harper v. Fleming*, 185 F. Supp. 14 (1960), the United States District Court for the Eastern District of North Carolina held that where the owner's income was received from the operation of her farm by the bank under contract with the owner and the bank entered into arrangements with sharecroppers for the production of farm products, there was material participation by the owner acting through the bank as agent. Further, the court found that the owner furnished the tools and equipment and paid the costs of production except the costs of labor, and the bank made inspections, did all the marketing, and kept all the accounts for the owner. It held thus that the income received by the owner from the operation of the farm constituted self-employment income from the trade or business of sharecrop farming, as distinguished from rentals from real estate. Therefore, the owner was entitled to old-age insurance benefits under the Social Security Act.[22]

This decision was appealed by the government. In rendering its opinion, the United States Court of Appeals, Fourth Circuit, said:

"At the bar of this court it is not questioned that the bank's activities, performed as claimant's agent, are properly to be regarded as 'material participation' in the management of plaintiffs' farm. It is argued, however, that such vicarious participation does not satisfy the provisions of the statute, which, the Secretary insists, requires personal participation by the claimant.

"The argument is based on the following line of reasoning. The underlying principle of the social security program is said to provide benefits to the elderly in partial replacement of earnings lost because of advanced age. Accordingly, we are urged to read the term 'material participation' in light of an assumed Congressional purpose to extend old age benefits only to those individual farm owners who are able to establish that prior to reaching the retirement age they directly and in person performed work either of a managerial or a physical character.

"Since the plaintiff's contribution to the income producing enterprise is the use of her land along with the bank's services, the Secretary would treat her income as merely investment or rental income which is not to be considered for social security taxes or benefits under the Act. The contention is that since her income from the farm does not depend on her personal exertions the plaintiff's advanced age probably will not impair her earning capacity—an optimistic forecast, dependent on unknown and unforeseeable factors, which future events may or may not validate.

"This argument takes too restrictive a view of the scheme underlying the social security legislation. Particularly, it does not take into account the legislative history which produced the specific provisions of the statute immediately involved, the social purpose or the text of these provisions.

"Although it is true that prior to 1954 self-employed farmers were excluded from coverage under the Social Security Act, the amendment of that year specifically extended coverage to self-employed farm operators. The 1956 Amendment, with which we are presently concerned, expanded coverage a step further, by including farm owners who materially participate 'in the production or the management of the production' of agricultural commodities. Congress thereby deliberately sought to bring the treatment of farm owners into line with that accorded other self-employed persons. In the case of such other self-employed persons it is recognized that the income on which they are permitted to rely to establish eligibility for old age benefits may be derived from a trade or business carried on through agents or employees."[23]

It is also interesting to note the declaration of Senator Capehart, sponsor of the 1956 Amendment:

"The extension of social security to the farmers means only that by virtue of certain payments they themselves make they are entitled to the same social security benefits which other people receive.

"My amendment provides or makes clear that these privileges are extended not only to people who are actually working on the farms, but to those who own them and those who are the managers of them. I think it is eminently fair and the Senate has agreed with me."[24]

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[21] Ibid.
[22] *Harper v. Flemming*, D.C.N.C. 185 F. Supp. 14, 16 (1960).
[23] *Harper v. Flemming*, C.A. 4th Cir., 288 F.2d 61, 63 (1961).
[24] 102 Cong. Rec. 13819 (1956).

In ruling that Mrs. Harper was entitled to the benefits, the court held that "In summary, the legislation considered in its entirety, reveals a progressive broadening of the old age and survivors' insurance plan to cover not only those originally embraced, namely employees who work for others, but also self-employed professional and businessmen, and later farm operators, and still later specifically farm owners. The purposes, as reported by the Congressional Committees, is clearly to make the coverage of the program 'as nearly universal as practicable,' and 'to give the newly covered groups equitable treatment as compared with those brought in earlier.' (see, Senate Calendar No. 2156, 84th Cong., 2nd Sess. Rept. 2133, p. 1). The legislation had its origin in the observed frequency of the tragic sequence of old age, disability, loss of earning power, destitution and dependency on public or private charity, but coverage has not been limited to cases actually presenting all these features in full scope. The concept of the statute is more inclusive, and the design is, by a comprehensive contributory insurance plan, to avert the personal hazards and the social problems which often, but happily not always, attend old age.

"There is no warrant for reading into the statute fine-spun limitations of which the legislative authority has given no intimation. Doubtless Congress could have narrowed the criteria for coverage in the manner suggested, but the coverage sections are not so expressed. If the 1956 Amendment is to be constructed to embody what seems to us a gratuitous assumption that is the function of Congress. Looking at what Congress has done, we do not think that it would have been willing to adopt the Secretary's suggestion if it had been advanced; at all events it has not done so. Even if the question were more doubtful than it appears to us, we should be in duty bound to give the Act a liberal construction. We would not be free to tailor the Act, even if we found the proposed restriction logically attractive. The conclusion we reach is in accord with the only pertinent decision called to our attention. Henderson v. Flemming, 5 Cir., 1960, 283 F.2d 882, and see Foster v. Flemming, D.C. Iowa 1960, 190 F. Supp. 908. The judgment of the District Court is Affirmed." [35]

CONCLUSION

There is disagreement about the definition of material participation. Congress established in the legislative history what it meant by the concept. The Internal Revenue Service and the Treasury Department have given a restrictive interpretation to Congress's intent. The judiciary, considering the same legislative history, has viewed the concept more liberally. The brunt of these interpretations, unfortunately, has come to rest on the individual taxpayer. It is he or she who must bear the expensive venture of litigation to determine whether the degree of participation contemplated by the amendment has been met.

Inasmuch as qualification for special-use valuation is tied closely to the concept of material participation, the establishment of a workable definition satisfactory to the Service, the Treasury Department, and the judiciary is desirable. One of the goals of the Act is the redrafting of complex provisions. It is interesting that two words, "material participation," can create such misunderstanding. Revenue Ruling 57-58, 1957-1 C.B. 270, 271 provides that "... (w)hile physical work and management decisions are the principal factors to be considered, the furnishing by the landowner of machinery, implements and livestock used in the production activities, or the furnishing or advancing of funds or the assuming of financial responsibility for expenses involved in the production of a commodity are additional factors to be considered in arriving at a borderline case." [36] The ruling also states: "(I)t is evident from the foregoing that, as a general rule, each case must be decided upon its own facts and circumstances. . . ." [37]

Flexibility is not only necessary, but also desirable, in interpreting the concept of material participation. However, to suggest that, as a general rule, each case must be decided upon its own facts and circumstances is to suggest that litigation is inescapable. As previously indicated, congressional intent, as interpreted from the legislative history, appears to provide alternatives for meeting the degree of participation contemplated.

The problems facing individual taxpayers who are members of the agricultural community have become more acute since the passage of the Act. Section 2032A provides that special-use valuation can be elected if certain requirements are met. Does the material participation requirement mean that the farmer or a

[35] Supra, note 23 at 64.
[36] Supra, note 15 at 271.
[37] Ibid.

member of his family must actually live and/or work on the farm? Can the estate of an individual who owned a farm meet the requirement of material participation if he engaged the services of a professional manager, or is it to be denied the benefit of the potential tax savings if such was done? It is admitted that in enacting Section 2032A, Congress's intent was to help preserve the "family farm." It is also admitted that another goal of the Tax Reform Act is to improve the equity of the tax system. Consider these hypothetical situations:

Farmer A is 57 years. He has been actively farming for more than 30 years. He is married and has two sons, neither of whom is interested in farming. Because of ill health, Farmer A is forced to retire. Assume he and Mrs. A move to a warm climate. Since Farmer A's sole source of income has been the farm, he engages a professional manager to operate the farm for him. Within two years Farmer A is dead, is his estate entitled to elect special-use valuation if the other requirements are met? Revenue Ruling 64-32, 1964-1 C.B. 319, provides that the material participation requirement can be satisfied by an agent or manager. Therefore the 5-out-of-8 years predeath material participation requirement for Section 2032A has been met, regardless of whether it is determined that it was fulfilled by Farmer A or by the professional manager on A's behalf.

Section 2032A also requires that active operation of the farm must continue for a specified number of years after the decedent's death. Can Mrs. A engage the professional manager and thereby meet the material participation requirement? Again, if compliance with the other mandates of the provision occurs, it is logical to state that the concept of material participation as envisioned by the Congress has been met. According to Section 1402(a)(1), Treasury Regulation 1.1402(a)-4, subparagraph 5 thereof, Revenue Ruling 64-32, 1964-1 C.B. 319 and various judicial decisions discussed herein, the concept of material participation as contemplated by the amendment is fulfilled.

Consider the same situation, but assume that Farmer A lives a number of years after retiring. Must he take reduced social security benefits if he wants his estate to qualify for special-use valuation upon his death? In order for the estate to qualify, material participation must be met. If a professional manager is engaged, the services performed by the manager are deemed, under proper arrangement, to be performed by the owner. A social security guideline provides that, in most situations, a retired farmer can receive full benefits unless he performs 45 hours or more of substantial services per month relative to working on and/or managing the farm. Likewise, if he engages a professional manager who performs more than 45 hours of substantial services per month, these services are considered to have been performed by the owner insofar as meeting the material participation requirement. Hence reduced benefits appear to be Farmer A's only choice if he wants to qualify his estate for special-use valuation. While the election to take reduced benefits may provide relief to his estate upon his death, his standard of living as well as expendable income most likely will be lowered. Query: Does not forcing the farmer to make such an election conflict with the goal of "extending fiscal stimulus"? Further, assume that Farmer A has been contributing to the social security program since its coverage was extended to farmers in 1956. Are the laws and the tax system equitable when they suggest that it is unfortunate that Farmer A became ill, was forced to retire, and now must weigh the alternatives of whether or not to elect to participate in the social security system to which he has contributed for more than twenty years, or sacrifice potential estate tax savings benefits?

The old-age, survivors, and disability insurance system (OASDI) is not in the truest sense of the words a "welfare program." It is a system supported by contributions of those taxpayers who pay into it. However, there is the ever-present conflict between individual equity and social adequacy. In the long run the individual who earns less and contributes less to the system tends to reap a greater return than does the individual who earns more and contributes a greater portion of his income to the program. In the Reader's Digest, August 1974, Senator Barry Goldwater professed the concept that OASDI benefits "are a repayment of our own earnings, which we have deposited in trust as a regular contribution deducted from our salaries and from our employers on our behalf." The Senator was advocating the view that such benefits should be paid at age 65 regardless of retirement from substantial employment.

Perhaps the time has come to reevaluate this position. With the spiraling costs of day-to-day living, the hour may have dawned for the Congress to permit taxpayers who qualify to have the best of both worlds. That is to say, the concept of equitable treatment under the law should allow the qualifying individual taxpayer to receive full benefits under the social security program while pre-

serving for his estate the right to elect special-use valuation. Preservation of the family farm may come to rest ultimately on this hypothesis.

Finally, consider this situation. Assume N, a nephew of Z, inherits Z's farm upon the latter's death. Assume, also, that Z has met all the requirements for special-use valuation. If N, for example, has never seen the farm, has personally never farmed, and has no intention of ever farming, can he, as a qualified heir, engage the services of a professional manager to operate and to manage the farm on his behalf? Without question, N can. But, can his late uncle's estate now take advantage of special-use valuation? If it is assumed that N desires to keep the farm operational and to receive some income therefrom, the position is suggested that the professional manager could "step into N's shoes" and do all that N would do if he were on the farm. The activities and services performed by the professional manager are, under proper arrangements, deemed to be performed by N. Therefore, such services are satisfactory in meeting the material participation requirement. N, by continuing to operate the farm, is not merely holding the land for pure speculative purposes. On the contrary, N, like any other businessman, is operating the farm for the purpose of making a profit. The farm is not leased nor is it rented to someone outside the family; it is operated by N through the services performed by the professional manager.

The circumstances suggested in these hypothetical situations may never occur. A surviving spouse may decide to sell the farm. A son or daughter who inherits the property may elect to rent the property and merely take the income. The decision of whether or not to elect special-use valuation if all its requirements are met rests with the executor and the qualifying heirs. The position advocated by this analysis of the concept of material participation is that if the statutory requirements of the provision are met, whether by the individual farmer himself or by a professional manager acting on behalf of and in the best interests of the individual farmer and/or his estate, the right to elect special-use valuation should exist.

H. E. BUTT GROCERY CO.,
Corpus Christi, Tex., August 19, 1977.

Hon. HARRY F. BYRD,
Chairman of Subcommittee on Taxation and Debt Management—Committee of Finance, U.S. Senate, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: In response to your press release dated July 1, 1977, the following comments with respect to two problems in the Estate and Gift Tax area arising from the Tax Reform Act of 1976 are submitted for consideration by your Sub-Committee.

Prior to enactment of the Tax Reform Act of 1976, Section 303 of the Internal Revenue Code permitted the redemption of stock included in a decedent's gross estate without dividend consequences to the extent the redemption was necessary to pay death taxes (and funeral and administration expenses). Section 303 applied even to redemptions of stock which had been "Section 306 stock" in the hands of the decedent, because such stock lost its "taint" when it received a "stepped up" basis at death.

Under Section 2005 of the Tax Reform Act of 1976, however, Section 306 stock will not receive a new basis at death and thus it will apparently continue to be Section 306 stock under Section 306(c)(1)(C). This presents for the first time the possibility that a redemption of Section 306 stock received from a decedent, which otherwise qualifies under Section 303, will nevertheless result in dividend treatment under Section 306. Such a treatment is inconsistent with the purpose of Section 303.

Section 303 was carried over from the 1939 Code for the purpose of "allowing stock to be redeemed to pay death taxes *without dividend consequences*". S. Rep. No. 1622, 83rd Cong., 2d Sess. 45 (1954) (emphasis added). Congress explicitly recognized this purpose when it was considering amendments to Section 303 in the Tax Reform Act of 1976. Five times the applicability of Section 303 was equated with "capital gains treatment". H. Rep. No. 94-1380, 94th Cong., 2d Sess. 35 (1976); H. Conf. Rep. No. 94-1515, 94th Cong., 2d Sess. 621 (1976). Elsewhere in the Act (as in Section 2003 and Section 2004), Congress reaffirmed its concern for the lack of liquidity in estates—a condition from which Section 303 has always provided important relief.

When, in Section 2004(e) of the Tax Reform Act, Congress altered the scope of Section 303, it did so in clear statutory terms, for reasons expressly set forth in the above-cited reports. In contrast, there is no evidence that the carryover basis provisions were intended indirectly to restrict the applicability of Section 303 in cases involving Section 306 stock.

Accordingly, we recommend Section 306 be inapplicable to stock redeemed under Section 303. This will prevent an unintended limitation on Section 303, thus confirming the capital gain objectives of Section 303 which Congress has consistently acknowledged.

Respectfully,

CHARLES BUTT.

H. E. BUTT GROCERY CO.,
Corpus Christi, Tex., August 19, 1977.

Hon. HARRY F. BYRD,
Chairman of Subcommittee on Taxation and Debt Management—Committee of Finance, U.S. Senate, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: In response to your press release dated July 1, 1977, the following comments with respect to two problems in the Estate and Gift Tax area arising from the Tax Reform Act of 1976 are submitted for consideration by your Sub-Committee.

The Tax Reform Act of 1976 amended the federal estate tax (section 2601) to provide that any generation-skipping transfer will be included in the transferor's estate for estate tax purposes if it is made after April 30, 1976.

This new rule was made applicable to post-April 30, 1976, transfers even though it was not until July 20, 1976, that the Senate Finance Committee issued a proposed amendment to the tax reform bill (H.R. 10612) to include the new generation-skipping provisions in the bill. On July 11, 1976, the Finance Committee had announced that it had agreed to include a generation-skipping amendment in the tax reform bill, but effective only for transfers on or after January 1, 1978. In its release on July 20, the Finance Committee provided for its generation-skipping amendment to be effective at an earlier but still future date, May 1, 1977. On August 5, 1976, however, the Senate amended the tax reform bill to provide a retroactive effective date of May 1, 1976. This was done notwithstanding the fact that as passed by the House in December 1975, and as originally reported by the Senate Finance Committee, the tax reform bill included no generation-skipping provisions, whatsoever. The Senate's retroactive date of May 1, 1976, however, remained in the bill and became law.

Prior to the Senate's action on August 5, 1976, with respect to a generation-skipping, it was reasonable for taxpayers to anticipate that any generation-skipping provisions which might be adopted would be effective only at some point in the future as the Finance Committee itself had announced on June 11, and had actually proposed on July 20. It would thus allow them time for an orderly revision of their estate plans. In view of this, it is reasonable and inequitable to apply the generation-skipping provisions prior to August 5, 1976, when the Senate first made it clear that it was not thinking of a future effective date.

Accordingly, we recommend that the Tax Reform Act be amended to provide that the new generation-skipping rule of Section 2601 will be applicable to transfers after August 5, 1976.

Respectfully,

CHARLES BUTT.

STATEMENT OF PHILIP S. DEATS

I, Philip S. Deats, am a resident of Iowa Falls, Hardin County, Iowa. I am a member of the Nebraska Bar Association and the Iowa Bar Association and presently am a partner in the Whitesell Law Firm which practices general law in Iowa Falls, Iowa. Prior to entering law school, I practiced in the area of public accounting for three years in the state of Nebraska where I received my Certification as a Certified Public Accountant in July of 1971. I have been, and anticipate that I will continue to be involved in matters involving Federal Income Tax.

Although needed special provisions were included for particularized classes, such as valuing farm real estate, the regulations to make the intended law effective are not practical or workable and create greater limitations and hardships which will adversely affect the economy of this country for many future years. I am specifically referring to the potential lien that the United States Government may impose on real estate where an alternative tax basis is established at the time of a decedent's death. The complications involved in such lien may cloud the marketability of the real estate for at least a ten year period and require potential beneficiaries, for whom the changes were intended, to undertake a legal encumbrance for a future 10 year period. There are no reasonable economic guides to assist in decisions that will require a fixed position for ten years in the future.

The carry-over-basis rule enacted in the 1976 Tax Reform Act is a particularly obnoxious and unworkable aspect of tax legislation which should be repealed. This aspect of tax legislation imposes an arbitrary valuation base as of December 31, 1976. The use of a purely mathematical scale or form of computation to arrive at a fair market value basis on December 31, 1976, at a later date is neither practical nor fair.

The carry-over-basis involves record keeping for property obtained many years ago by family members long since deceased. The potential now exists for an agency of the United States Government to unfairly establish an arbitrary and punitive tax as a result of failure by a present beneficiary for inadequate recordkeeping by his ancestors. In all of American jurisprudence, the basic concept of fault or responsibility has heretofore been placed on the individual involved and never has anyone been responsible for the acts of his ancestors.

Any tax law which is as ill-conceived and broadly legislated as the 1976 Tax Reform Act allows entirely too much legislative freedom to the prescribing of rules and regulations by the Internal Revenue Service. This act allows an enforcement agency the legislative power that our forefathers intended remain in the hands of the Congress. It allows an unpopular agency unlimited freedom in establishing rules and regulations which it can then enforce in an unmerciful and Gestapo manner.

MERLE D. FISHEL,
Marion, Iowa, August 17, 1977.

MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Office Building, Room 2227, Washington, D.C.

DEAR SIR: It has been observed lately that there are some things going on in regard to taxation of estates in regard to the Tax Reform Act of 1976, wherein they are asking that we utilize a "carry-over-basis rule".

This carry-over basis will be a highly complex thing to carry out and become more so as time goes by. Many people are not going to do anything about it at the present time and sales will take place 5 years, 10 years, 15 years from now and the people who could provide the information will be dead. Therefore, it is very unimaginative and impractical.

I look for a lack of uniformity in reporting because of the ability of the parties involved. This will be highly undesirable and unfair and make it difficult to explain to clients and the public at large.

People do not like to gratuitously spend money with their attorney and their accountant until forced to do so and the time that this information should be gathered is now. As a practical matter this is not going to happen.

In light of these circumstances, I would strongly recommend that the carry-over-basis rule be eliminated and some other method of taxation with reasonable certainty substituted should this money be vital under these circumstances.

Very truly yours,

MERLE D. FISHEL.

WADSWORTH, ELDERKIN, PIRNIE & VON LACKUM,
Cedar Rapids, Iowa, August 12, 1977.

MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Room 2227, Washington, D.C.

DEAR MR. STERN: I am writing to urge the retroactive repeal of the so-called "carry-over basis rule", which was enacted, as an after thought, as part of the Tax Reform Act of 1976.

Obviously, this rule promises an enormous amount of work for lawyers, trust officers and accountants; and, assuming these professions would be compensated amply for their time, effort and responsibility, the rule should be a prolific source of fees. However, prior to enactment of this rule, the field of estate and gift taxation, with its related field of fiduciary income taxation, was already so complex that it was barely susceptible to coherent administration. The vast array of complexities and obscure liabilities which seemingly will flow from this new rule is so outrageous that a great many practitioners will shrink from becoming involved. The potential for both civil and tax litigation seems to be endless.

Perhaps, some sort of an intellectual case can be made for this rule, if you accept the premise that an infinite amount of tinkering with the tax structure

can bring into exquisite adjustment every problem perceived from time to time by social planners. But it is a poor doctor whose treatment deteriorates the health of his patient. This rule has, on balance, left our society much worse off. It should be repealed.

Very truly yours,

THOMAS H. PIRNIE.

DICKINSON, THROCKMORTON, PARKER, MANNHEIMER & RAIFE,
Des Moines, Iowa, August 9, 1977.

Re section 1023, Internal Revenue Code (carryover basis).

MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Room 2227, Washington, D.C.

DEAR SIR: This is to strongly advocate the retroactive repeal of § 1023 of the Internal Revenue Code, enacted as § 2005 of the Tax Reform Act of 1976.

Whether or not one agrees with the tax policy underlying this new Code section, the difficulties it will present to estate administrators and their attorneys are numerous, overly burdensome and must be recognized in any fair assessment of this legislation.

One difficulty it presents is simply insurmountable. That is, the almost complete lack of any reliable records concerning the cost and date of acquisition of property (other than marketable securities) acquired prior to January 1, 1977. Taxpayers have not been required by law, and it has not been customary, for such records to be kept. Moreover, § 1023 places the onus on the executor rather than on the decedent to obtain such information and, consequently, there will be little or no incentive for persons to retain records of this kind even for property acquired after December 31, 1976.

Any law which depends for its enforcement upon information concerning transactions which occurred as long as 60 or 70 years ago (even longer in the case of property acquired by gift) is obviously, in my opinion, unworkable. It has been my experience in over 25 years of practicing tax laws that most taxpayers are conscientious, if not eager, to comply with the tax laws and to keep the necessary records so required. However, I believe the same conscientious taxpayers when faced with an obviously impossible record-keeping task (or information-seeking task, in the case of executors) will simply throw up their hands in complete frustration and lose respect for the taxing system in general. The same will be true of their tax advisors who, I might add parenthetically, play no small part in the success—so far—of our internal revenue tax collecting procedures.

Another major problem which the carryover basis rules have engendered is the disproportionate tax consequences which result from selecting assets to be distributed to various beneficiaries pursuant to a power given by the decedent in his will. Even if the wills of most decedents attempt to absolve executors from any responsibility for such selection, it is inevitable that an entire new body of law must be developed either by local statute or case law, or both, defining the fiduciary duties of executors in this regard. This will place an unwelcome burden on our already overburdened courts and state legislatures. Furthermore, there would appear to be no precedent for the formulation of legal principles in this area and, consequently, chaos and uncertainty will follow.

The foregoing problems will inevitably lead to substantial increases in the cost of probating estates, especially estates of moderate size, by way of increased fees to lawyers, accountants, trust departments, etc.

The new rules, in my opinion, will also lead to wholesale evasion of the tax applicable to the sale of assets acquired from a decedent. Perhaps billions of items of personal property, for example, will be sold and not reported (or not correctly reported) on income tax returns either because of ignorance of these requirements or because the required information concerning carryover basis is simply not available. In this same connection, it is apparent to even a casual observer that the burden of preserving information concerning the basis of carryover property required to be reported to the Internal Revenue Service under new § 6039A will not be met. It is already common knowledge that IRS has not been able to coordinate the information shown on 1099's and W-2's with income tax returns filed within the preceding three-year period. I submit it is not logical to assume that the Internal Revenue Service will do any better with

carryover basis information which, in theory, it would need to retain in perpetuity.

Although many other aspects of § 1023 are subject to criticism, this letter will attempt only one final and personal observation. This has to do with the $10,000 "exclusion" for personal and household effects. For insurance purposes, my wife and I have had our dishes, silverware, jewelry and small collection of antique glass and china appraised every five years or so. A recent appraisal of such items, which does not include any furniture, clothing or other household effects, totaled (to my amazement) approximately $23,000. Many of these items were acquired by us as wedding gifts and some by way of gifts from our parents and other relatives. There is a total of 409 items listed on this appraisal ranging in value from $3 to a high of $550, with various acquisition dates (in the case of our purchase) as long ago as 1949, and in the case of gifts, as long ago as some unknown, indeterminable date. If, as is probably the case, the total acquisition cost of these 409 items is less than $10,000, then my executor would, I suppose, be entitled (perhaps required) to allocate that amount among these items plus all other household effects and personal property and report such fact to the Internal Revenue Service and to the beneficiaries of my estate. Certainly, there is no possible way for us to attempt to make a record at this time of the date and cost of acquisition of these items. Nor can I at this time attempt to make a record of the substantial improvements made to our house since we acquired it in 1957 when it was already 50 years old and badly in need of substantial improvements. I roughly estimate these to total at least $25,000 over this period of time, all of which potential basis to my heirs will be wasted for lack of proof.

I strongly suggest that if each Congressman and each member of your staff attempts to relate these rules to your own situation, it will soon be readily apparent that they are completely unworkable and that they impose requirements which are ont just overly burdensome, but literally impossible to fulfill.

Very truly yours,

JOHN H. RAIFE.

NEIMAN, NEIMAN, STONE & SPELLMAN,
Des Moines, Iowa, August 17, 1977.

Re Tax Reform Act of 1976.

MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Room 2227, Washington, D.C.

DEAR MR. STERN: Someone gave Congress poor advice at the time this bill was passed. The publicity was that the bill would reduce death taxes. It seemed to indicate it would simplify procedures but some "whiz" in the back room did some marvels of drafting which effectively did away with the real Congressional intent and increased taxes and probably was not intended by the original drafters of the Act. They stuck in a "carryover basis rule" which is impossible to administer. It will trap people merely from lack of knowledge because they can't understand the effect of the Act and in many instances the Good Lord himself could not furnish the information necessary to comply with the rule. The Act needs to be drastically amended and in simple, understandable language, not all this highly technical garbage.

A very knowledgeable lawyer friend of mine gave me a copy of the letter that he wrote to the attorneys for the Iowa Farm Bureau to assist them in understanding the law. It goes into details much better than can I. I realize that you and the Senators and Congressmen who are getting a copy of this letter are busy and have a lot of material to read. However, if someone could take the time to read the letter from my friend, Mr. Wilson, I think the problems would be brought home.

Sincerely,

JOHN H. NEIMAN.

Enclosure.

RONALD MASON,
Buckingham, Seitzinger & Mason, West Des Moines, Iowa

DEAR RON: At your request I will try to explain some of the very basic problems of applying the 1976 Tax Act to actual practice. I will not enclose the package which you already have but will try to explain the package in more depth.

First, the so-called fresh start application of the Act provides in essence that those who own stock traded regularly on any market could adapt and use as a fresh start the value of the stock as of December 31, 1976. This is comparatively simple if you are an investor. It has some drawbacks but we could live with this.

However, most of our people are not investors in bond stock and market stocks in Iowa and therefore the fresh start rule will be an administrative nightmare. It is my understanding that the regulations require for the equivalent of fresh start on all other personal property and real estate a carryover application for each item of property to be transferred. The formula is quite complex and resolves itself in thumbnail sketch to approximately the following:

1. That you determine the *days* of ownership of the property from the time you acquired it up to January 1, 1977, which we will call x. Then you determine the number of days of ownership of such property from the time you acquired it up till the date of your death. That will be y. Then you determine the highest and best use of the property value as of the date of death. That will be v. Then you have a formula which reads:

$$\frac{x}{y}\cdot v=F$$

Then you must have one more equation. The value of the property to be taxed in the estate, which we will call a, the adjusted gross value of the estate, which we will call b, and the federal death tax which we will call c. Then you get a formula which goes:

$$\frac{a}{b}\cdot c=G$$

We then have to deal with the Iowa inheritance tax adjustment which is the value of the specific item, which we will call i, the value of the adjusted gross Iowa tax estate, which we will call j, and the Iowa inheritance tax, which we will call k, and we have yet another formula which is:

$$\frac{i}{j}\cdot k=H$$

Now the next step is to total the three items, F, G and H. This gives you basis.

We must also take into consideration the initial cost of the property less the depreciation taken, particularly in real estate and depreciable personal property, which is another factor to be considered as the fresh start is applicable as I understand it to profit but it is not applicable to loss.

In the event of real estate where there has been material additions, you must consider each material improvement during the life of the real estate, that is, if during the life of the real estate, that is, if during the course of the time you added a drying bin, a string of tile and a new building, each of these must be figured from the day of their use and basis established and cumulated for each specific piece of real estate and each piece of real estate making up the whole must be calculated by itself and if there is later record of residence on farm real estate, this must be added as well.

No farmer has records to support an accurate determination of carryover basis based on a per day approach. If he did have, he would have no room for crop as the entire farm would be covered up with paper. It is not inconceivable that most any successful farm would have at least 20 material additions to the farm which would mean 20 calculations of basis just to determine the value of the farm for basis purposes. In addition, most of the farms in our area have not been bought in one piece but many have been added by 40, 80 or 160 acres and very seldom when these farms are put together in this fashion have records been kept through the years which would allocate 40 rods of tile in one 40 acres, 35 rods of tile in another 40, and 80 rods of tile in the third 40, all being in the same string of tile.

Now suppose we take the machine shop on the farm which has generally 45 to 50 items of personal property and basis must be figured for each item of consequence in such machine shop, which means an additional number of basis returns to be constructed.

If the farmer was the owner of a cow herd, modest in size, raised on a farm or ranch, composed of let us say, 250 cows which are not purebred and are not recorded, then you have 250 additional basis items and who in the hell can keep track of the birthday of each cow in an unregistered herd and identify

that particular animal in a herd of black cows? This is totally silly. It would be extremely fortunate if the farmer could identify the year of the birth of the female, let alone the month and particularly it would be impossible to identify the day. During the first couple or three years of this application, we have the added burden of a sow herd of 200 or more head of sows and nobody that I know who does not have a registered herd ever keeps track of the birthday of a bunch of little pigs.

If the above seems to pose a problem, most depreciation schedules used on the farm have a minimum of 35 active pieces of machinery being depreciated or more, some run to 100. Each of these require a separate basis calculation and you have the machinery which has been depreciated completely out or to maximum salvage and is still retained and would be passed in the perpetuation of the daily farm.

The carryover basis features alone are so dramatic in application as required by the law that I do not know short of a computerized operation, which in itself would take a great deal of imagination if the same are to be calculated item by item. Failure to calculate item by item on any estate exceeding $60,000 has a substantial effect on the executor or administrator in that each item omitted subjects the executor or administrator to a $100 fine by the Internal Revenue Service when not returned to the Internal Revenue Service and up to $5,000 per estate, and each basis item not be returned to a distributee subjects the fiduciary to a fine of $50 per item up to $2,500 an estate. The means that mama must keep track of all of the items of papa's estate and make such returns or mama, being the personal representative in most instances, is liable to $7,500 worth of fines called penalties so that they will be deductible in no place.

Now suppose after all of these bases have been determined, the auditor for the estate elects to challenge the value used in the estate and alters the value of one item in the estate so as to change the tax liability for the State of Iowa, the federal government or the adjusted gross value of the estate even though you are not considering the particular item for which basis has been calculated, then the basis of that item changes and each item determined changes and the whole procedure starts over again. Does this give you some idea of the problems of carryover basis on personal property in every small business, in every farm, in every blacksmith shop, in every small town garage, in almost every law office, and in all businesses of whatever nature which are not incorporated?

The problem submitted herewith as a hypothetical example does not contain the confusion attendant to the above carryover basis in all of its grandeur but is limited for simplicity of understanding and deals with a cash basis farmer who is a tenant, owns no real estate and has crop harvested after January 1, 1977. The only carryover basis applying there is the basis attributable to the proportionate share of federal estate tax and Iowa inheritance tax as it relates to the estate as a whole. It is interesting to note that in the hypothetical example if the deceased farmer had left 10,000 bushels of beans in kind to either the State of Iowa or the federal government, he would have saved approximately $124,000 worth of total liability, or if he had abandoned the property as unproductive in the same amount of 10,000 bushels, he would have reduced the value of his estate but would have likewise reduced the value of the taxation in greater amount. If the farmer had been so farsighted as to have sold all of his crop before he died and paid the taxes on it, he would have reduced his estate and taxes by not only $233,712 but the federal estate and the Iowa Inheritance tax on that amount of money. This situation borders on the ridiculous, and in the colloquialism of the farm, is no longer a can of worms but a barrel of snakes.

The relief from the farmer to his wife in the amount specified under the Act was minimal. The liability imposed on a farmer to any other person than his wife is more than maximal. Someone has forgotten that marital deduction only applies to one-half of the estates where there is a federal tax, that is one spouse must survive and in the ordinary case that spouse has no marital deduction when it is passed on to his son or daughter.

The example totalling 124% of taxes is about as misleading as a politician's promise in that figured to a fine point on yet another formula this would be reduced by 37% of 8% because Iowa allows the federal estate tax as a deduction against Iowa inheritance tax in full. That still gives us a substantial amount above 100% of the last $200,000 in the estate.

If the foregoing was not confusing enough, the limitations on the new special use valuation of real property after January 1, 1977 are somewhat confusing in their own right. Let us examine these according to the five requirements:

1. There must be material participation 5 of the last 8 years.

a. Material participation is a social security definition and does not purport to be a farm definition as applied in all other areas of the revenue code.

2. Material participation ordinarily discriminates tremendously against women.

3. The code provides for vicarious material participation within the family line.

4. Material participation was basically designed to anticipate in an operating situation by a rental situation where the landlord either participated or did not participate. Participation of this kind is based on days of contribution and not money.

Certain of our operating clients over 65 years of age qualify for receiving social security by working four months per year—two months in planting and two months in harvest—and do not work at all for eight months of the year. This produces additional problems.

5. Social security definitions apply to calendar years and farm participation is generally based on fiscal crop years, that is, March 1 to March 1.

To have an agency of the government whose prime purpose was the dispensing of largesse through social security become the defining agent for the collection of taxes for the revenue department seems to pose many, many problems.

It appears that everybody has forgotten in the Internal Revenue Service that a farmer is defined as a person who received 66⅔ of his gross income from the sale of farm products or produce.

I guess the conclusion of the matter is that there will be much cheating in material participation.

It seems proper that the new special use valuation could not reduce the decedent's gross estate more than $500,000. This seems to be an appropriate limitation.

There is, however, a large problem associate with number 3 in that the assets must amount to at least 50% of the decedent's adjusted gross estate as valued on the decedent's highest and best use (both real and personal). Did it ever occur to anyone who authored this monstrosity that a farmer sold 1,000 head of cattle and received the money therefor, let us say one-half million dollars, two days before his death has eliminated himself from a qualified decedent, whereas if he would have kept the cattle till two days after his death and had one-half million dollars more in business assets he would have perfectly qualified?

The same goes for corn, beans or any other product including hogs. This produces a doubler in the swing of definition of business assets because money as I understand it is not considered as a business asset in a sole proprietorship even though the intent is to invest it in new product to product additional funds. This seems to be exceedingly unfair and almost totally unplanable.

I would say that that part which provides that the real estate less mortgage debt must amount to 25% of value at highest and best use is easily determinable and that the property must have been used for 5 of the last 8 years would seem reasonable to keep out the grocery clerks and the bankers. However, the details of cash rent of similar property in a similar neighborhood poses many, many problems. This factor alone is not available to the United States government at this time. It is totally not available to the University at Ames at this time. It is only available to the large practitioner in a small town who can avail himself of this clientele list, and whether the government knows it or not, cash rent is not ordinarily discussed by the neighbors and is regarded as privileged information because one neighbor if he has an advantageous cash rent does not wish to start a bidding contest by adverstising his situation The only fellow who advertises is the fellow paying so high a cash rent that he is proud of the fact in his community.

The five steps determination of capitalized value over the last five years is an academic nicety and an administrative nightmare. No two persons can possibly agree on such a capitalization and in my own opinion the printing bill for this part of the Act should better have been saved.

Material participation is further complicated by the fact that it is not allowed by agency, that is to say that a farm manager operating a farm for the benefit of his principal cannot produce as such agent a material participation for the principal. However, the committee reports indicate that special use valuation is to be permitted by closely held family farm corporations. This produces a dichotomy inasmuch as a corporation may not act except through agency either in the form of employment or management, and material participation by a corporation must of necessity fall within a definition under social security rules which does not now exist.

Administratively it becomes almost impossible to create an equal division of property between or among the off-farm heirs and the on-farm heirs inasmuch as the liabilities for the payment of said estate taxes follow the farm. If the on-farm heir or heirs elects the special use valuation along with everybody else, the lien follows the land and therefore except in cases of the on-farm heir dying he stands a chance through ill health or other matters to provide for a recapture of that estate tax not paid due to the use of special valuation and thus he is penalized by a private payment of federal estate taxes which are an obligation of an estate. Thus the off-farm heirs will have the taxes paid for by the whole of the estate before its distribution and the on-farm heir will be tax-disadvantaged. As far as I know estate taxes are deductible in entirety from inheritance tax but no provision has been made which would carry the recapture into a deduction for inheritance taxes paid which inheritance taxes will be paid on the basis of highest and best use and this will serve as an additional penalty to the on-farm heir.

This situation except in cases of death, will exist for a period of 15 years. In the early days of this country the bond servant generally only had to serve 5 years for his transportation from the old country to here and was in fact an indentured slave for such time. It appears that we have now again adopted the theory of indetured serfdom except in our concern for human rights we have extended it for a period of 15 years and encouraged death as the only way to terminate the lien.

For more than 5 years last past it has been the object of all persons concerned in probate to speed up the probate procedures and to finalize estates and cause the distribution within a modest length of time, assuring to each person his fair, equitable and just rights for claims and elections. The elections available under this 76 Act are so complex and so mind-boggling and require so many calculations that there is no way possible to speed up the distribution of the estate. In fact there are many, too many elections, each in itself bearing many hidden traps. To this end the time in which an estate may be settled has in most jurisdictions been shortened. The time for the payment of federal estate tax has in most instances been shortened. The time for paying estate and inheritance tax in the state of Iowa has been shortened all to the damage of the decedent's estate but under the guise that such shortening would benefit the distributee. Now under the 76 Act, the shortness of time for payment of tax is still with us at both the federal and state level (except when special provisions of hardship are available) but the estate process has been prolonged and therefore either those people who had made the representations that early payment would assist in early settlement have forgotten their original intent or, on the other hand they never intended to keep their promise anyway.

The State of Iowa through its legislative body, falls into the same trap as the federal legislators in that they did not read the provisions of the 76 Tax Act but followed the habits of years and adopted the federal position upon the advice of some well-intentioned but unknowing person who probably did not read the Act either. As a result, the basis provisions of the 76 Tax Act were in my opinion adopted when the Iowa Legislature through Senate File 32, which at Section 1 of said Act amended Section 422.4(17) of the 1977 Code, by changing January 1, 1976 to January 1, 1977, thus eliminating basis except as designed by the federal act, and in the hypothetical situation increasing the tax $36,966 and in all estates on a cash basis by a pro rata amount reflected by the income tax liability.

In summary, it matters little whether the government calls a tax a death tax or an income tax if the combination is a result of the taxes which will become due arising out of the decease of a farm operator. These euphemisms indulged in by the authors of the 76 Act fall within the area of a nonpermitted use by a taxpayer and one of the principal weapons of the IRS is that substance over form prevails. Whether you call it by one name or another, it seems entirely without substance to collect taxes exceeding more than 100 percent on any given amount of dollars in any estate. The euphoria of the reduction of farm land value is under the 1976 Tax Act totally out of proportion to the penalties which more than half of the farm family decedents will be forced to bear. The problems attendant the Act are basically:

1. Carryover basis as propounded under the Act is administratively most difficult and will lead to many, many problems including the assessment of penalties in gross amount to the unwary. This must have immediate attention.

2. The discrimination against female heirs inherent in the 76 Tax Act of material participation must be eliminated.

3. Material participation is an improper method of defining the special use valuation and there must be some other definition which would be more inclusive than the use of "material participation" as a defining factor.

4. The multiplicity of options is as before stated, so mind-boggling and time consuming as to destroy the effectiveness of all but a limited few estates and will essentially cost in many instances more than the value received to the family farm distributees. These options therefore should be limited in some degree.

5. The lack of credit for payment of taxes between taxing bodies is an expression of tax collectors' greed that defies the imagination and must be remedied.

6. At the Iowa level, I think there should be a recognition of the marital deduction philosophy and a recognition of the special use value for inheritance tax purposes or the basis for inherited property upon which taxes are assessed should be divorced from the Federal Tax Act of 1976.

The foregoing while it seems voluminous is but a thumbnail sketch of the problems arising out of the 76 Tax Act and its failure to coordinate with administration, equity and the claims of other tax bodies, and falls far short of exemplifying all of the problems attending the administration of estates and payment of taxes under the 76 Act.

Nothing is so bad that you can't find something of worth about it. Therefore, it is well to note that the 76 Act had as as a basis for its passage some small item of benefit, that is the recognition of the need to give relief in estate and inheritance taxes to the taxpayers of the United States arising out of the total distortion of value brought about by inflation. However, the benefits were so circumscribed, so limited in application and affected only a favored few that the question remains, were they worthwhile? It appears that the only remedy of consequence that will affect materially a representative group of people was the expansion of the marital deduction for estates under $500,000. Marital deduction as before stated affects only 50 percent of estates for man and wife and the damage visited upon the survivor far exceeds the benefits obtained in most instances.

A problem was remedied which was not serious, that is the passing of property from spouse to spouse. The problem that remained unanswered and was compounded and is serious is the passing of property from parent to child.

The generation skipping provisions are probably desirable to keep from tying up large amounts of money and while the orphan's benefits sound exceedingly beneficial to the orphan, affect so few and are so miniscule as to warrant little attention in the overall and do not affect materially estates and those wherein there was an effect, the end result was exceedingly small.

The expansion of the deduction to an equivalence of $120,000 and thereafter to approximately $180,000 was a step in the right direction but in itself is a small misrepresentation. The only time the equivalency is as represented is when the estate is not larger than the equivalence. When the estate is substantially greater, then the equivalency to dollar value assigned to equivalency is applied at the top instead of the equivalency being applied at the bottom and results in a share of equivalency proportionate to the rate of tax applied.

Remedies:

1. Doing away with carryover basis and establishing a confirmed basis that is at least discernible.

2. Allow a credit against estate taxes for income taxes which are required to be paid on accumulations of the decedent somewhat in the manner of the credits allowed on income in respect to a decedent.

3. Redefine participation to the degree that it does not discriminate against cash basis taxpayers and members of the female sex as a practical matter.

4. Provide that the lien rights of the United States shall be terminated for reasons other than death upon hearing had and hardships of illness or economic failure, or limit the indentured period of bondage to less than 15 years.

5. Provide for a coordination of taxes so that the total taxes charged by all taxing bodies cannot exceed the principal value of the estate.

To do this requires an understanding of the administrative problems, the coordinated problems of taxes and above all, a concern for the taxpaying family in farms and small business.

My own chief concern is that the difficulties imposed by the 1976 Tax Act are so incredible and so burdensome in nature and so avaricious in their application that the voluntary payment of taxes and self assessment which has been that one thing which enabled inheritance, estate, succession and income taxes to be paid will collapse totally and people will do as they have in foreign countries—CHEAT.

Very truly yours,

ARLEY J. WILSON.

104TH ANNUAL MEETING, THE IOWA STATE BAR ASSOCIATION, JUNE 1977, PROBATE WORKSHOP ADDENDUM

Believe it or not—(not by Ripley, but by Congress)

Jim Jones, age 55, died December 1, 1977—a widower, a tenant farmer leaving all his property to his son, Bob Jones, age 30. Jim was on a cash basis, he farmed 1,200 acres,, his son worked as his hired hand.

His inventory was as follows:

1. Machinery and cash on hand net of expenses of last illness and burial and cost of administration	$120,000
2. 100,000 bushels of corn at $2.25 per bushel	225,000
3. 20,000 bushels of beans at $10 per bushel	200,000
Taxable estate	545,000
Federal estate tax:	
500,000 at	155,800
45,000 at 37 percent	16,650
Gross tax (reformed)	172,450
Less State credit:	
440,000 at	10,000
45,000 at 4 percent	1,800
Total	11,800
Less uniform credit	30,000
Net estate tax (reformed)	130,650
Iowa inheritance tax gross	545,000
Less Federal estate tax	130,650
Less exemption	30,000
Taxable	384,350
Tax:	
150,000 at	7,825
234,350 at 8 percent	18,748
Total inheritance tax	+26,573
Total death taxes	157,223
Income tax (simplified):	
Corn and beans sold at inventory value	425,000
Basis Federal $\frac{425,000 \times 157,223}{545,000}$	122,605
Adjustment gross grain Federal	302,395
Federal including tax:	
100,000 at	55,490
201,795 at 70 percent	141,256
Total Federal income tax	196,746

Iowa income tax:	
Basis same as Federal	122,605
Net gain Iowa:	
75,000 at	7,420
227,895 at 13 percent	29,561
Total Iowa income tax	36,966
Total income tax	233,712
Total taxes in estate (Government share)	390,935
Son's total share	154,065

Total percentage of tax on last 45,000 inherited, 124 percent.

If the gross estate had been $200,000 less, the son's total share would have been $137,951 or approximately $16,114 less. In other words, of the last $200,000 inherited, the Government share is approximately $184,000. When is it wiser not to inherit?

Comparison of Pre-January 1, 1977 Tax Act As It Would Apply to the Example Set Out in Believe It Or Not (Not by Ripley But By Congress) Example

Under the pre-January 1, 1977 tax law, the gross Federal Estate Tax would be $140,900.

The State Inheritance Tax Credit would be $11,800.

The net Federal Estate Tax would be $129,100 or $1,550 less than the post-January 1, 1977 tax consequence.

The Iowa Inheritance Tax would be $26,697 or $124 more under the pre-1977 tax because the Federal deduction would not have been so great.

There would be no federal income tax on the sale of inventory. There would be no Iowa income tax on the sale of inventory.

The total taxes then occuring pre-1977 for death tax and income tax would be $155,797 or $235,138 less of total taxes pre-1977, farm family estate.

The Relief Act designed and reported to relieve the family farm operation of taxes in the foregoing hypothetical instance really provided that the farming family estate would be relieved of $235,138 additional dollars which was not the advertised effect of the Act and hopefully was not the Congressional intent.

SEATTLE-FIRST NATIONAL BANK,
August 12, 1977.

MICHAEL STERN,
Staff Director, Committee on Finance, Room 2227 Dirksen Office Building, Washington, D.C.

DEAR SIR: We note that the Senate Finance Committee is investigating the serious problems created by the 1976 Tax Reform Act in the area of estate administration. Please add this letter to other written testimony you have received from those who find these problems a matter of great concern.

We are now beginning to struggle with our first carryover basis computations, and we find that the time-consuming, overly complicated, cumbersome, and ultimately very expensive aspects of this law have not been overstated. At a time when real simplification of our tax laws is being called for more earnestly than ever before, it is impossible to see how this unwieldy law can be justified. It should not be repaired or patched up; it should be repealed.

For Congress to presume that the personal representatives of all or even a majority of American decedents will be able to obtain accurate records of a lifetime of investment and financial activity is foolish and naive. Whether good records are present or absent, the task of making multiple adjustments to each lot of each asset is appalling, and it is all the more wearisome because one knows

that the adjustments are tentative and may have to be redone in their entirety time and time again.

This brings me to the crux of our objection to the carryover basis rules. It is income tax legislation which in most cases cannot be complied with accurately within one, two, or even three taxable years. It requires complicated computations which even when laboriously done once or twice cannot be considered final. It establishes a necessity for repeatedly amending income tax returns, amending notices to beneficiaries and IRS, filing protective claims, and increasing the volume of paperwork which the IRS must process and audit at the taxpayers' expense. I feel that any tax legislation that forces taxpayer and tax collector to cope with a steady stream of tentative filings requiring later amendment is inherently unsound.

Congress should take note, I think, that the yoke of this legislation will fall not just on professional people who are accustomed to dealing with complicated laws and intricate mathematics but—one way or the other—on the entire American public. Why should a reasonably bright surviving spouse have little choice but to hire an expensive technician for a period of several years after a death in order just to get income tax returns done, including amendments and amendments of amendments? Why should a reasonably bright attorney have to do so because, although knowing the law, he is afraid of getting lost in the math? How about a reasonably bright congressman?

It may be supposed that those of us who work for corporate fiduciaries will somehow be able to assimilate all of this and comply with expected accuracy, but I'm not even so sure about that. As manager of a trust division tax department, I cannot see that the law's complexities can be managed by lower-level clerical staff, and I doubt that the employees capable of the work required are going to be interested in doing it for very long because of its frustrating, plodding, perpetually tentative nature.

If you have received no deafening outcry from the general public, I am sure it is because most people are not aware of the complexities underlying the generalities they read in the newspapers and have no idea how much it is going to cost them to find out. They will probably not believe that this is really the law. I know it is, and I can scarcely believe it myself.

I urge that the carryover basis legislation be repealed.

Yours truly,

EDWARD W. KENNEDY,
Assistant Vice President and
Manager, Trust Tax.

WILLIAM K. CARR,
Charles City, Iowa, August 18, 1977.

MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Room 2227, Washington, D.C.

DEAR MR. STERN: I have received word that the Committee on Finance will be receiving testimony to date of September 9 with respect to problems growing out of the Tax Reform Act of 1976.

The problems connected with the administration of the "carry over basis rule" necessary to implement the Tax Reform Act completely overwhelmed me.

I have already written a letter to my Congressman, Chuck Grassley, which expresses most of my criticism and complaints. I am therefore enclosing five copies of that letter.

I would like especially to direct the attention of the Committee to a very important aspect of the Act. In order to make the carry over basis rule work, the facts necessary to the eventual computation of long term capital gains must be preserved in the memory of computers. In order to make certain the information is supplied to the government, Congress has chosen to assess penalties upon the taxpayers and their representatives for almost every non-compliance and with little possibility for mercy. Such compulsion would, in my opinion, destroy the voluntary assessment concept of the original income tax law. I would not be surprised to see the resulting resentment lead taxpayers to follow the practice so common in a number of foreign countries. I am referring to those countries where evasion is the rule and compliance the exception. We have always taken pride in our democratic form of government and I would like to see every effort made in Congress for the perpetuation of every possible freedom.

You will also note that I proposed to Congressman Grassley that similar penalties be imposed upon the representatives of government who fail to use

the date supplied by the taxpayers if penalties are going to be imposed upon the taxpayers for failure to furnish the data required. This may be a new idea and may be somewhat shocking to those in government. I feel, however, that their obligations to support the law may be even higher than those of the taxpayer as a citizen. "Watergate" perhaps has pointed up the responsibility and obligations of those in government which the citizens generally expect to be performed with diligence and fidelity.

Respectfully yours,

W. K. CARR.

Enclosure.

WILLIAM K. CARR,
Charles City, Iowa, August 16, 1977.

Re Tax Reform Act of 1976.

Hon. CHUCK GRASSLEY,
1227 Longworth HOB,
Washington, D.C.

DEAR CONGRESSMAN: Although I am now in my 80th year and have completed more than 54 years in the active practice of law, I have never before written a letter to any member of Congress criticizing legislation already enacted. This letter is a first.

The "Tax Reform Act of 1976" creates almost as many problems as it solves. There are many good features in the Act and I take no great exception to the philosophy behind the enactment. There are, however, some features I do have some strong feelings about. In this letter I will concentrate upon but one, the one probably the most important to my clients.

The "carry over basis" rules create so many complications and generate so much confusion and so many uncertainties that I am overwhelmed by the possibilities. The impact of the "rule" even after the transition period will present many administrative problems for the government as well as for the tax payers and their representatives.

The determination of the "basis" to be carried over can involve several generations. Had my grandfather when he died in 1917 left his home farm to my mother (which he did not) and had she in turn left it to me in 1952 when she died, I would now be facing the problem of establishing the basis at which my son would take the farm if I left it to him at my death, assuming, of course, that the "carry over basis rules" were in force in 1917 and the application of the "fresh start" rules were then no longer applicable.

I do have some hearsay information. I have, however, no substantial evidence to establish the cost of acquisition or the cost of subsequent improvements and no records to establish the amount of the depreciation taken or which could have been taken.

One hundred years is a long time to preserve evidence even when forewarned of the necessity for doing so as the Act now does. As a matter of fact, even with good records, I envision great confusion when a member of the third or fourth generation undertakes to compute the correct "carry over basis" from a deceased ancestor-owner. There are so many "slips between the cup and the lip." The integrity of the records and the proofs could even be challenged. Who would be alive and present to set the record straight?

I know there are those who say "I underestimate the capacity of the computer". There has been for some years computer memory records of information based on returns required to be filed by the taxpayers. If the computer is infallible, why hasn't the government made better use of the data stored?

So far, it is my judgment that the benefit of the data stored by the tax collection agencies hardly justifies the considerable cost and expense imposed upon business and industry in supplying the data required.

The problems implicit in connection with the filing of information returns in connection with the taxation of ordinary income are few compared with the problems generated by the "carry over basis rules". The Act magnifies the word "long" when it comes to the computation of long term capital gains. The "term" involved can cover many years and involve several generations of owners. With ordinary income taxation, all parties involved are dealing with current figures which, for the most part, are readily ascertainable.

I am aware that many technical amendments have been prepared to eliminate some of my objections to the administration of the Act. I commend the Congress for its efforts. I hope that it will continue its dedication to the task.

In its inception, the income tax was conceived as one of voluntary assessment by the taxpayer. For the most part, the taxpayers have responded to this concept.

The Act requires the imposition of substantial penalties. They are more in the nature of punishment. The necessity for data required to implement the "carry over basis rules" is so great that compliance must be strictly enforced. The computer cannot produce the data required to compute such long term capital gains unless the facts are fed into the computer at the proper time. Compliance is so necessary that strong measures must replace the voluntary assessment concept. The taxpayer and his representative therefore become somewhat of a slave to the computer. It is contemplated that the penalties will be assessed without exception and with little mercy for the taxpayers and their representatives.

As a matter of fact, it is reported that the penalties assessed are expected to cover the cost of the administration of the "carry over basis rules" and yield a net revenue of more than $20,000,000.00. Apparently the enforcement may become a matter of revenue.

The taxpayers and their representatives have been so frustrated by the complications of the law that resentment will surely develop if penalties are assessed as apparently contemplated. The voluntary aspect of the assessment will disappear. Resentment may follow frustration if "strong arm" measures are employed to collect penalties for non-compliance. Elimination of the voluntary aspect of the assessment followed by substitution of dictatorial enforcement may lead to frustration and evasion. If evasion becomes the rule, enforcement will become a game of "catch as catch can".

If penalties are to be assessed against taxpayers and their representatives for failures and delinquencies, then it would be only fair that similar penalties be assessed against the representatives of the government who fail to use the data required of the taxpayers and their representatives. So far as the "carry over basis rules" are concerned, the use of the data furnished is just as necessary and important as is the furnishing of the data required by the Act.

I suspect the outcries of those affected by this new concept with respect to enforcement would soon be heard in the Halls of Congress. It may be somewhat novel. It has always been said, however, that what is "sauce for the gander is sauce for the goose."

The representatives of government are paid for their services. They have as much responsibility for the performance of their services well and in accordance with the law as have the taxpayers and their representatives. Why shouldn't they suffer the same or similar penalties for derelictions in performance!!

The "new basis" rules have worked reasonably well for many years. As already stated, I favor the restoration of the "new basis" concept for taxation of capital gains on the disposition of property acquired from a decedent. The cost of implementing and enforcing the "carry over basis" rule is hardly worth the gain in revenue realized after credit for the estate taxes paid thereon. If it is and Congress deems it necessary to preserve the "carry over basis" concept, then I implore the Congress to find a simpler way of realizing the revenue needed.

Respectfully,

W. K. CARR.

PRYOR, RILEY, JONES & ASPELMEIER,
Burlington, Iowa, August 18, 1977.

Re meeting of the Subcommittee on Taxation and Debt Management of the U.S. Senate Finance Committee, July 25, 1977, written testimony regarding the anticipated effects of certain provisions of the Tax Reform Act of 1976 relating to the "carry-over-basis rule."

MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Room 2227, Washington, D.C.

DEAR MR. STERN: One of the many changes effectuated by the Tax Reform Act of 1976 was an amendment to Section 1014 of the Internal Revenue Code of 1954. As you know, this section previously provided that property acquired from a decedent would have as its basis, or "cost," in the hands of the taxpayer, the fair market value on the date of death of the decedent. Section 1014 as now amended constitutes one of the most monstrous complexities ever included in the Internal Revenue Code. In adopting a modified carry-over-basis rule providing that most

property will receive a prorata step up in basis based upon the portion of the total holding period which was prior to January 1, 1977, and the difference between the basis of such property and its fair market value on the date of death, Congress has made a grievous error.

One of the justifications for this change has been the thought that many taxpayers were escaping the taxation of capital gains by holding the property until death. The heirs would, of course, receive a basis equal to the fair market value at the date of death, and when such property was sold there would be little gain or loss. In theory, then, it sounds as if a loophole exists. I would like to point out that from a standpoint of the theory of taxation, the capital gains tax was never avoided. What happened was that the estate tax was a substitute for the capital gains tax. Experience has shown the old rule to be a sound one, based on convenient, practical administration by the Internal Revenue Service, a minimization of inconvenience to taxpayers, fairness and equity.

The new provision is sorely lacking in these attributes. To make the computations necessary to arrive at the basis in the hands of the heirs, it is necessary to have the original cost and date of acquisition of the property, as well as a considerable amount of other information. As a practical matter, original cost and date of acquisition will be available quite rarely unless the property was a trade or business asset subject to depreciation and was not fully depreciated at the date of death, or if the purchase was recent enough that bank records and check statements are available.

With regard to the situation of trade and business assets, I would state to the Committee that it has been the practice, and continues to be the practice, of many small businessmen and farmers to eliminate an item from their depreciation schedule when it has been fully written off. Thus, many farmers and small businessmen have a great deal of equipment, but, because of the fact that it has no book value and does not give rise to any depreciation deductions, the information as to original cost and date of acquisition has been discarded. In addition, few people have retained their tax returns more than five years, since it has not been thought necessary under most circumstances.

Some information can also be gleaned from bank records. However, in many instances this will not be sufficient since most people discard canceled checks after a few years. Even if available, canceled checks will not be enough because in may instances the decendent's basis may have many adjustments so that the true basis differs from the cash which actually changed hands. For example, a decedent who has continually traded automobiles will have included as a portion of his basis in the new vehicle a substantial amount of the basis in the old one, the basis of which will be in part determined by the basis of its predecessor, and so on. Thus, we may need to determine what grandpa paid for his Model T Ford so that we may know what the basis of his 1975 Chevrolet is.

A simple change of record keeping in the future will not suffice to relieve the absolute dearth of this sort of information presently existing. It is quite likely that no records at all will be available for nine out of ten items included in a decedent's estate. In most estates, this figure will be even higher, particularly, when the decedent did not engage in a trade or business. It is quite easy to see that with each succeeding generation the problems of generating such information become increasingly difficult, if not impossible. The Tax Reform Act of 1976 will not only require computations which in many cases will be physically impossible, but also contains severe criminal penalties for failure to produce this information.

The net result of the Act in most cases will be that the information required, if, in fact, it is available at all, will be generated at an extreme cost. The majority of this cost will be in increased attorneys' and accountants' fees. This will affect not only the taxpayer but also the Internal Revenue Service. I believe that the ultimate cost of this provision to the government and to the taxpayer will be incalculably vast.

Whatever the aims of taxation are, be they the generation of revenue, equalization of wealth, or the proscription of certain activities, it must be kept in mind that our system of taxation as it presently exists is basically a voluntary compliance system. Even the United States government, as large as it is, cannot marshal the forces necessary to audit every single taxpayer on a continual basis. There must of necessity be a point beyond which compliance with the Internal Revenue Code becomes so difficult that it is ignored, not by reason of the heaviness of the financial burden of the taxes, but through impossibility of compliance with the intricacies of a law which is too complex for the best tax specialists

in the country to fully comprehend, and which calls for the production of information which will often be impossible to obtain. I hope that Congress will repeal this section of the Tax Reform Act of 1976, and retroactively reinstate the previous rule in effect until December 31, 1976.

Very truly yours,

GEORGE H. FRAMPTON.

KAYE, SCHOLER, FIERMAN, HAYS & HANDLER,
New York, N.Y., August 15, 1977.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance, Room 2227, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: I am writing in connection with the investigatory hearings of the Subcommittee on Taxation and Debt Management on estate and gift tax problems created by the Tax Reform Act of 1976. For the reasons set forth in the enclosed copies of our prior submissions to the Treasury Department, there is an urgent need for clarification of the grandfather clause (section 2006(c)(2)(B) of the Act) which excepts certain transfers from the tax on generation-skipping transfers. To qualify for this exception, a transfer must be made pursuant to a will which was in existence on April 30, 1976 and was not amended after that date to create or increase generation-skipping transfers.

Clarification of section 2006(c)(2)(B) is required with regard to the allowable mechanisms for adopting amendments the substance of which are permitted under the grandfather clause. It is apparent that use of a codicil is a permissible mechanism. However, it is less clear that it is permissible to use the mechanism of executing an entire will with the exact same terms as the pre-May, 1976 will except for the desired modification ("Amendment by Execution of an Entire Will"). As set forth in the enclosures with this letter, Amendment by Execution of an Entire Will is a much preferable mechanism because it avoids (1) embarrassing public disclosure and (2) unnecessary expense and delay in probate. Accordingly, we have repeatedly urged the Treasury Department to interpret section 2006(c)(2)(B) to allow use of the mechanism of Amendment by Execution of an Entire Will. However, to date, the Treasury Department has failed to confirm (nor has it contradicted) this interpretation of the Act. Accordingly, testators have been faced with the dilemma of having either to amend their wills in an undesirable manner or to risk relinquishing an exception Congress granted to pre-May, 1976 wills. Therefore, we respectfully request that Congress provide clarification that under section 2006(c)(B) it is permissible for testators to adopt an amendment (which does not create or increase generation-skipping transfers) to a will in existence on April 30, 1976 by means of an Amendment by Execution of an Entire Will.

FREDERICK GELBERG.

Enclosure.

KAYE, SCHOLER, FIERMAN, HAYS & HANDLER,
New York, N.Y., November 18, 1976.

PATRICIA METZER,
*Room 3064, Main Treasury Building,
Washington, D.C. 20220*

DEAR MS. METZER: As promised in our telephone conversation yesterday, I am enclosing herewith a copy of my November 16 letter to the Commissioner regarding the need for clarification of the grandfather clause provided in the Tax Reform Act of 1976 with respect to generation-skipping transfers.

The enclosed letter is self-explanatory. However, I want to emphasize, as I did yesterday, that this issue is urgent. I have discussed this problem with many New York estate lawyers, and we are all deeply concerned about the apparent necessity to forego what we consider to be careful and intelligent practice of law in order to protect against the possibility that the grandfather clause will be interpreted (even though such interpretation is not compelled by its language) as requiring the use of codicils.

This dilemma was posed for me again just yesterday when a client who has a

pre-May 1976 will with generation-skipping trust provisions, requested that I change an unrelated provision bequeathing property to his son-in-law if he is married to the testator's daughter at the time of testator's death, to one making the bequest, independent of the marriage condition. In this case making the change by codicil would frustrate the testator's intent. In lieu of a gracious bequest, there would be a trail left by the old will and codicil showing the testator's vacillation and previous lack of complete confidence in his son-in-law. I frankly am at a loss as to what to do.

I think you will agree that interpretation of the law as I suggest in the enclosed letter does not pose substantial administrative problems. This interpretation would merely put the burden upon the taxpayer to produce the preceding version or versions of the will going back to one in existence before May, 1976. A taxpayer who would produce a fraudulent will or a perjurious affidavit to comply with such a requirement could just as readily produce a fraudulent will dated prior to May, 1976 to comply with the statute, whatever the interpretation of the grandfather clause.

I would appreciate hearing from you at your early convenience.

Thank you again.

Sincerely,

FREDERICK GELBERG.

Enclosure.

KAYE, SCHOLER, FIERMAN, HAYS & HANDLER,
New York, N.Y., November 16, 1976.

COMMISSIONER OF INTERNAL REVENUE,
Washington, D.C.
(Attention: PR:L).

DEAR SIR: I am writing to request clarification of the transitional rule of section 2006(c)(2)(B) of the Tax Reform Act of 1976 (the "Act"), which sets forth an exception to the effective date of the tax imposed by the Act on generation-skipping transfers.

In general, the tax is effective with regard to any generation-skipping transfer made after April 30, 1976. However, under section 2006(c)(2)(B) oft he Act, the tax will not apply to a transfer "in the case of a decedent dying before January 1, 1982, pursuant to a will (or revocable trust) which was in existence on April 30, 1976, and was not amended at any time after that date in any respect which will result in the creation of, or increasing the amount of, any generation-skipping transfer."

We seek clarification that utilization of a codicil is not the only permissible method under section 2006(c)(2)(B) for adopting an "amendment" (which does not create or increase a generation-skipping transfer) to a will in existence on April 30, 1976. It seems clear that adoption of an amendment by means of a codicil which sets forth the desired modification ("Amendment by Codicil") is permissible under section 2006(c)(2)(B). However, in my view it is not completely clear that section 2006(c)(2)(B) permits adoption of an amendment by means of executing an entire will with the exact same terms as a pre-May, 1976 will except for the desired permissible modification ("Amendment by Execution of an Entire Will").

For the reasons set forth below, I respectfully request that you confirm (in a news release or otherwise) that Amendment by Execution of an Entire Will is an appropriate method under section 2006(c)(2)(B) for revising a will which was in existence on April 30, 1976. Although this question relates solely to a matter of mechanics, it is an issue of great importance. Responsible estate lawyers more often than not advise their clients who wish to make minor changes in their wills to do so not by codicil, but by execution of an entire will. There are many reasons for such advice, including:

(1) *Amendment by Execution of an Entire Will Avoids Potentially Embarrassing Public Disclosure.*

If a will is revised by an Amendment by Codicil, the changes in the testator's intentions become a matter of public record because both the codicil and the will

to which it relates must be filed with the probate court. However, if the revision is accomplished by means of an Amendment by Execution of an Entire Will, only the newly executed will need be probated so that changes of intention are not made public. Set forth below is a list of some of the situations in which it would be most undesirable to disclose a testator's change of mind:

(a) The testator does not want a beneficiary to learn that under a prior version of the will he would have received a larger bequest;[1]

(b) The testator does not want a beneficiary to learn that under a prior version of the will he would have received a smaller bequest—especially if the beneficiary is a child of the testator and under the prior version of the will he would have received less than his siblings; or

(c) The testator wishes to change the fiduciaries named in his will and does not want the previously named fiduciary and/or the newly named fiduciary to learn that a change of intention had occurred.

(2) *Amendment by Execution of an Entire Will Avoids Unnecessary Expense and Delay in Probate.*

In a number of situations, administrative problems resulting in unnecessary expense and delay in the probate process will arise if an amendment is adopted by the codicil mechanism but will not occur if the revision is accomplished by means of an Amendment by Execution of an Entire Will. Set forth below is a list of the unfavorable consequences that may arise in the administration of an estate in New York (and, we assume, elsewhere) if the codicil mechanism is employed.

(a) A person who is affected adversely by an amendment, even if the effect is only his removal as a fiduciary, becomes entitled to notice and has standing to object to probate if the amendment is adopted by means of a codicil;

(b) As a corollary to (a), above, it is necessary that a guardian *ad litem* be appointed to represent a minor beneficiary if his interest, even though remote and contingent, has been reduced by codicil,[2] and

(c) In order to probate a will which has been amended by codicil, it is necessary to produce (or obtain the affidavits of) the witnesses to the codicil as well as the witnesses to the will to which the codicil relates.

Thus, even though the substance of a revision will be the same regardless of the mechanism used to adopt the amendment, in the majority of cases, in our experience, it is preferable to use the mechanism of an Amendment by Execution of an Entire Will. Accordingly, it would work a hardship on testators if section 2006(c)(2)(B) of the Act is interpreted as requiring utilization of only the codicil mechanism.

We recognize that if section 2006(c)(2)(B) is interpreted to all Amendments by Execution of an Entire Will, a taxpayer will have the burden of proving that the generation-skipping provisions in the newly executed will are no more extensive than those which were in the will as it read on April 30, 1976. It is our view that such burden could be satisfied without difficulty if the original copies of all superseded versions of the testator's will (beginning with the version in effect on April 30, 1976) are retained.

The issue set forth in this letter is urgent. Until the issue is clarified, estate lawyers are being forced either to adopt drafting techniques inconsistent with good estate practice or to run the risk of foregoing the exception granted by Congress to pre-May, 1976 wills, a choice it seems to me clearly not intended by the new legislation.

If you have any questions about any of the matters discussed above, please call me or Franklin L. Green of my office, collect, at (212) 759-8400.

Very truly yours,

FREDERICK GELBERG.

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[1] Indeed, under the laws of some states, a person who was eliminated as a beneficiary by a codicil must be cited in the probate proceeding even though under the will, as amended, he will receive nothing from the testator.

[2] This would be the case even if the reduction in the interest of a minor who is a beneficiary of the residue of the estate is reduced indirectly as the result of an increase in a preresiduary gift to some other beneficiary.

NORTHEASTERN BANK OF PENNSYLVANIA,
Scranton, Pa., August 16, 1977.

Re estate and gift tax problem areas, Tax Reform Act of 1976.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance, Room 2227, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: By way of this letter we desire to submit written communication regarding the problems we have encountered with particular reference to the Estate Tax area of the Tax Reform Act of 1976.

First and foremost is the fact that we are now required to keep three distinct and separate tax costs for each individual security item which is eventually passed on to a beneficiary of an estate. I refer specifically to the fact that we must provide for a bookkeeping system which provides for a Federal Income Tax cost for capital gains purposes, a Federal Income Tax cost for capital loss purposes, and a Pennsylvania Income Tax value for the Pennsylvania Income Tax. I assume that states which have similar income tax situations also are involved with the same problems.

Just to relate this to the pre-1976 law, as you are aware the value for Federal and Pennsylvania Income Tax purposes took on a new basis which was that as of the date of death. Of course, the 1976 Tax Act changed all this and, therefore, the bookkeeping and record keeping is triple what it was before. This then represents an additional cost of administration to a decedent's estate and to the ultimate beneficiaries. This is so because we feel we must charge additional fees simply because we are forced to provide additional bookkeeping and operational services. Therefore, the cost of dying and the cost of administering one's estate has been increased substantially as a result of the change in the tax values as relates to the 1976 Tax Act.

Additional problems arise when the decedent did not keep accurate records of his or her costs basis of securities. This then necessitates additional work in establishing cost values which can be extremely cumbersome and difficult. All of this takes time and effort and involves, again, additional costs to the decedent and the ultimate beneficiary.

The problem will become even more pronounced as we proceed into the future years because the cut-off value is now December 31, 1976 for gain purposes and the further we go into the future, the more difficult and the more pronounced will become the capital gain situations for particular securities, especially those which have substantial appreciation.

The fact that we must keep these three separate values is confusing to the taxpayers, is much more bookkeeping and work for the Executor of an estate, and in essence provides for a much more costly administration because of the way in which the law was written.

The other item that is a great maze is the problem of any personality which is over $10,000, such as furniture, coin collections, stamp collections, etc. When you run into a situation like this, the work entailed in securing tax costs and December 31 values for 1976, and the work entailed in providing for all this maze of paperwork and bookkeeping is utterly horrendous. That figure of $10,000 seems to be too low and, in addition, I am wondering if it is necessary to single out objects of art, stamp collections, etc. merely for the purpose of attempting, at some time in the future, to attach a capital gain situation when in fact most of these items are handed down from generation to generation anyway.

With all these complications in mind and with the additional costs that have been perpetrated by this law, we feel very strongly and do so urge that the stepped-up basis part of the law be rescinded and that it revert back to the original form. That is, all items take on a new basis as of the date of death which seems to provide for an equitable situation as far as Inheritance Tax is concerned as well as any capital gain or loss situations which may occur in the future.

In short, I would have to inject a personal opinion here and that is the fact that, again, the law seems so designed and so destined as another attempt to thwart the capitalist spirit and by all means have the government bite the hand that has fed it so well for so many years.

Very truly yours,

LARRY D. STETLER,
Senior Vice President.

NORTHEASTERN BANK OF PENNSYLVANIA,
Scranton, Pa., August 29, 1977.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
Dirksen Office Building, Washington, D.C.

DEAR SIRS: I wish to express my great dissatisfaction with the new carryover basis rules as promulgated by the Congress in the 1976 Tax Reform Act, more specifically, the new section 1023 of the Internal Revenue Code.

In 1969, the Treasury Department issued a lengthy study of the estate and gift tax law, together with recommendations for change in the law. The study was entitled, "Tax Reform Studies and Proposals," published February 5, 1969, jointly by the Committee on Ways and Means, and the Committee on Finance of the U.S. Senate. Many of the proposals approved by Congress in the 1976 Tax Reform Act were forecast in the 1969 study. One of the recommendations was a change in the existing law which permitted an estate value, and consequently the value passing to heirs, to be "stepped-up" to the value of the date of death or the alternate valuation, if elected.

The net result being, that since the estate tax was, in most instances, lower than the income tax that would have been paid if the property were sold prior to death, there was an element of untaxed appreciation. This has been termed a "tax-free" step-up in basis, and referred to by congressional and other reform proponents as a major tax loophole.

If indeed this was a tax loophole, it was the only real loophole available to the lower and middle income taxpayers. Unquestionably, it afforded a taxpayer a means of avoiding the payment of income tax upon the unrealized appreciation inherent in an asset by simply holding it until death.

Additionally, the thrust of the reform of the step-up rules rested upon two major points: (1) the then existing law discriminated against individuals who sold appreciated property prior to death and thereby forced them to build their estate with after tax dollars, and worked in favor of those who chose to retain their assets until death. (2) The then existing law was considered to foster an inducement for individuals who might otherwise dispose of appreciated property, to defer disposing of it.

I would direct my comments first to the effect the new section 1023 has had on the majority of the taxpayers, that is the small and middle income group. These are the people who have worked all their lives to accumulate a small, or moderate estate, consisting of a family home and a small amount of securities. The assets they hold were acquired generally for one purpose, to provide some income security and comfort in their declining years. They have not, nor have they intended to accumulate a vast fortune to be passed on to heirs at a low tax effect.

The four basis adjustments are an absolute nightmare to administer. Enclosed as Exhibit A, is a draft calculation worksheet, which indicates the data necessary to determine the basis of assets passing to heirs or beneficiaries, and delineates the four basis adjustments which must be performed on virtually every asset in an estate. In order to complete the four adjustments, there are as many as thirty-three separate steps which must be completed for each asset.

Let us now direct our attention in particular to some of the problem areas in determining basis, which estate executors must determine with respect to carryover basis property.

(*a*) The executor must determine the decedents adjusted tax basis for all property includible in an estate, as well as the date of or approximate date of acquisition. How many of us now living have a record of the basis and acquisition date of all of our property, real and personal? Just try then, to imagine the problem of an executor in determining this information after an individual dies.

(*b*) The executor must also determine the fair market value of all such property as of the date of death, the alternate valuation date, and in the case of listed securities, as of December 31, 1976.

(*c*) The Executor must compute on a asset by asset basis, the amount of appreciation inherent in each asset.

(*d*) The executor must calculate the December 31, 1976 basis adjustment for all assets other than listed securities using the "Special Valuation Method". He must modify the basis of each asset to determine the tax add-on adjustment.

(*e*) The executor must keep estate beneficiaries informed of the correct Federal income tax basis of property received from a decedent, including his separate basis for gain and separate basis for loss.

The executor must of course, file the fiduciary income tax return to reflect the transactions for the estate during the periods of administration, reflecting gains and losses of assets, which may have been sold to pay estate taxes. It is quite commonplace for this to be done prior to the time the estate valuation return is examined by the Internal Revenue Service. If IRS makes adjustments which change the estate values and estate tax, the executor must start all over again with his 33 step calculation of all assets receiving the tax add-on adjustment as well as filing an amended fiduciary tax return.

There is no easy or simple way for me to say the problems created by section 1023 are horrendous. To fully appreciate the problems, one must really sit down and try to go through the calculations required by this section of the law.

In addition, I believe that the subsequent returns filed by heirs to estate property will be replete with errors caused by the confusion over the separate basis for gains or loss.

My comments, of course, would be meaningless, unless I had some suggestion to accomplish the result that was sought by Congress. As mentioned in the first part of my letter, Congress sought to tax the previously untaxed appreciation in value of property, which occurred from the date of acquisition to the date of death. My suggestion is not a new one, but I sincerely believe it is a good one.

The alternative would be a flat rate or graduated rate capital gain tax upon unrealized appreciation to be collected as an additional estate tax, payable out of estate assets.

The alternative would be simple to apply, simple to compute, simple to administer, simple to enforce, and simple to collect.

The same exemptions and exceptions could be written into the alternative as were written into Section 1023.

I, therefore, implore the honorable members of Co:.ress to reconsider section 1023 of the Code, and legislate a more simple alternative.

Respectfully submitted.

DALE F. HOFFMAN, C.P.A.,
Trust Officer, Assistant Secretary.

Computation of Basis of Property
For Income Tax Purposes in the Hands
of Beneficiaries or Decedent's Estate

Date of Death / /

Estate and Inheritance Taxes Paid (Net of Credits and Discounts) $ ________

Fair Market Value of all Property Subject to Tax (see separate calculation) $ ________

(1) Decedent's date of acquisition if known or estimated date of acquisition. __/__/__

(2) Decedent's adjusted basis at date of death. $ ____

(3) Fresh-start value - 12/31/76 value only if (1) is prior to 1/1/77. $ ____

(4) Federal Estate Tax Value (date of death or alternate valuation). $ ____

(5) Net appreciation in property - (excess of (4) over (2)). $ ____

(6) Number of days property held prior to 1/1/77. ____

(7) Total days property held by decedent. ____

(8) Is property carryover basis property? (See section 1023(b)). YES ☐ NO ☐

(9) If answer to (8) is no, basis for gain or loss to recipient is Estate Tax Value (see sections 1014 and 1023). Proceed no further for such property.

(10) If answer to (8) is yes continue for all such property hereafter referred to as "carryover basis property".

(11) ~~Exclude the first $10,000 of F.M.V. of personal and household property with respect to which a timely election has been made (see section 1023(b)(3)).~~

Adjustment #1

(12) If answer to (8) is yes, is property also a marketable bond or security as defined in section 1023(h)(2). YES ☐ NO ☐

(13) If answer to (12) is yes, and decedent's date of acquisition is prior to 1/1/77, then for purposes of determining gain (but not loss) basis is increased (but not decreased) to 12/31/76 value, item (3), but not beyond estate tax value, item (4):
indicate gain basis in col 1, $ ____
indicate loss basis in col 2 (Same as (2)). $ ____
(This is the "Fresh-Start Adjustment".)

(14) If answer to (12) is no, continue for all other assets as follows:
If date of death (but not alternate) value exceeds decedent's actual basis, decedent's actual basis is increased by net appreciation allocable to period ending 12/31/76 as follows:

BEST COPY AVAILABLE

	GAIN BASIS	LOS. BAS.
(a) (Value on date of death) - (Decedent's actual basis) + (Depreciation, amortization or depletion for holding period ending on date of death).	$	
(b) Percentage relationship of (6)/(7).	$	
(c) 14(a) x 14(b)	$	N/A
(d) Depreciation, amortization or depletion for holding period prior to 1/1/77.	$	
(e) Item (2) + 14(c) + 14(d)	$	

Adjustment #2 - applicable (to gain basis) only if estate tax value exceeds 12/31/76, "Fresh-Start Value".

		GAIN BASIS	LOS. BAS.
(15)	(a) Net appreciation in value of asset which equals: date of death or alternate valuation less basis after fresh-start adjustment or adjustment #1 determined at item (13) or 14(e) as applicable.	$	$
	(b) Fair Market Value of all property subject to tax (does not include marital deduction and charitable deduction property since not subject to tax).	$	$
	(c) Total federal and state estate and inheritance taxes paid by the estate (net of all discounts and credits).	$	$
	(d) (a)/(b) x (c)	$	$
	(e) 13 or 14(e) + 15(d)	$	$

Adjustment #3 - applicable if aggregate adjusted basis of all property as determined at 11, 13, 14(e), and 15(c) is less than $60,000.

		GAIN BASIS	LOS. BAS.
(16)	(a) Net appreciation in value of asset which equals date of death or alternate valuation less basis after fresh-start adjustment and adjustment + 2 at item (13) or 15(c) as applicable.	$	$
	(b) Net appreciation in value of all carryover basis property	$	$
	(c) (60,000) - aggregate adjusted basis of all property as determined at 11, 13, 14(e) and 15(e).	$	$
	(d) (a)/(b) x (c)	$	$
	(e) 15(e) + 16(d)	$	$

Adjustment #4 - applicable only if recipient of property pays additional state succession taxes.

		GAIN BASIS	LOS. BAS.
(17)	(a) Net appreciation in value of asset which equals date of death or alternate valuation less basis after fresh-start adjustment or adjustment #3 at item (13) or 16(e) as applicable.	$	$
	(b) Fair Market Value of all property acquired by recipient and subject to such taxes.	$	$
	(c) Total succession taxes paid by recipient.	$	$
	(d) Item (a)/(b) x (c)	$	$
	(e) 16(e) + 17(d)	$	$

MICHAEL L. ZENOR,
Spencer, Iowa, August 4, 1977.

MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Room 2227, Washington, D.C.

DEAR MR. STERN: I would like to take this opportunity to express, in writing, my opposition to several matters contained in the Tax Reform Act of 1976.

Although I am not a tax specialist, I am a small town attorney in Iowa and because of this, tax work necessarily consumes a fair amount of my time. I feel I am not only speaking for myself but also for other attorneys who perform tax work for farmers and other individuals in small towns. Our difficulties are numerous, particularly as we are more and more required to live up to the standards of specialists even though the type of practice found in rural communities does not generally allow for specialization. Therefore, the increasing complexity of federal legislation, and particularly the tax laws, presents an almost insurmountable burden for myself and ultimately my clients who must pay for the additional time required to keep current on laws such as the Tax Reform Act.

Of particular difficulty is the "carry-over basis rule." I am sure you are aware of the gist of this rule and so I will not burden you with the ins and outs which I don't fully understand anyway. However, I will state that I feel the rule requires such esoteric bookkeeping that it is beyond the capacity of all but the largest of operations. Fixing a value on property is almost always a complex operation but the record keeping and accounting gymnastics required by this act are simply incredible. The net result is that I, as an attorney, expose myself to incredible potential liability of malpractice and my clients are going to pay for this in staggering fees which are necessary both to pay the malpractice insurance and to pay me according to my normal hourly rate.

It seems to me, if we are truly interested in providing for the welfare of the consumer or the common man, we should attempt to provide legislation of a type such that compliance won't cost the consumer an arm and fifteen legs in attorney fees. Of course, you must understand that I am not opposed to high attorney fees but I do feel I have better things to with my time than attempting to administer some law that is unnecessarily beyond control.

I might also add a few comments about the change in the contemplation of death rule on gifts. While I have not as yet personally observed any inequities arising from this change, I can readily foresee such inequities. As I understand the law now, any gifts made within three years of the date of the death of an individual will be automatically and conclusively presumed to be in contemplation of death. The problem with this provision is the same general problem which arises with any other conclusive presumption: inflexibility. Such conclusive presumptions have, in many contexts, been roundly and appropriately criticized in the Supreme Court. For example, the Supreme Court has held unconstitutional a conclusive presumption made by Illinois that an unwed mother is more fit than the father to raise their child. The fallacy of such a presumption is readily apparent to any person who has had any involvement with family law, and there is a good analogy between the foregoing unconstitutional presumption and the existing illogical contemplation presumption.

While such presumptions may be true most of the time, they can quite frequently cause gross inequities. If we presume the purpose of the three year contemplation death rule is to avoid intentional evasion of the estate tax laws, then we must also allow for the 35 year old man who makes a gift and immediately thereafter dies in an automobile accident. Such an individual is certainly not involved in an intentional evasion of the estate tax law, and to treat him in the same manner as the octogenarian who makes death bed gifts is to make a mockery of the concept of the law as a delicate instrument.

I trust that these views are shared by a number of my colleagues, as these matters have been the subject of much discussion among lawyers in my locality. I further hope that the congress will see fit to reform the Tax Reform Act of 1976, by correcting what I see as two of the more grievous errors committed in passing the law.

Thank you for your kind attention to my views.

Very truly yours,

MICHAEL L. ZENOR.

THACKER & THACKER,
Owensboro, Ky., August 24, 1977.

Re Statement regarding Tax Reform Act of 1976—Carry over basis rule.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance, Room 2227, Dirksen Office Building, Washington, D.C.

DEAR MR. STERN: Pursuant to press release of July 1, 1977, I thought I would take the opportunity to submit a statement to you regarding application and interpretation of the new Carry Over Basis Rules under the Tax Reform Act of 1976.

Code Section 1023(h)(2)(E)(ii) appears to provide that if an asset eligible for the "fresh start" formula application was owned by a decedent on December 31, 1976, that if such asset was subsequently disposed of and/or exchanged in a transaction tax free to the decedent, that the "replacement asset" actually held at time of death would be deemed one and the same as the asset that had been owned on December 31, 1976, for all computations, including the holding time owned prior to December 31, 1976.

This certainly appears to be an equitable position but it has raised question as to whether the converse of this situation would also be true.

This would deal with a situation where a taxpayer prior to December 31, 1976, would have exchanged or disposed of an asset in a tax free transaction, which therefore would have resulted in the decedent owning technically a different type of asset on December 31, 1976, as opposed to the asset he presumably would have held for many years prior to the tax free exchange. The question becomes whether upon his subsequent death after December 31, 1976, as to whether or not the holding time of the original asset would be considered as part of the time period for the "fresh start" formula.

An easy example of this principle would be a decedent taxpayer who had owned a farm for many years prior to December 31, 1976. Let us presume that the taxpayer on December 15, 1976, transferred the farm asset to his own corporation, in a Section 351, tax free incorporation. The corporation would therefore have the same exact tax basis in the farm that the decedent himself had had. The decedent would now own stock in such corporation, having the same basis that he had previously had in the farm asset. Let us presume that the decedent therefore held the stock on December 31, 1976, or some portion of such stock. Thereafter, and subsequent to December 31, 1976, the decedent dies still owning all or part of the subject stock. Obviously, in my example such would not be considered a marketable security.

The question then becomes whether or not the time period that the farm asset itself had been owned by the decedent would be considered as part of the holding time for the "fresh start" formula. It would be my thinking that such certainly should include this as it was not a taxable transaction where the form of the asset was replaced. The Code Section clearly covers a situation where the exchange occurs after December 31, 1976, and I think a reasonable interpretation should provide that it would also apply to exchanges prior to December 31, 1976, in the context herein set forth.

I do feel, however, that amending legislation might be in order to make sure that this would be the applicable law.

I would appreciate the Committee considering this as I think it is a situation that definitely needs clarification as it presumably has occurred to many many taxpayers.

Thank you very much.

Yours very truly,

THACKER & THACKER,
By GEORGE THACKER.

DULL, KEITH & BEAVER,
Ottumwa, Iowa, August 15, 1977.

Re Tax Reform Act of 1976.

MICHAEL STERN,
Staff Director, Committee on Finance, Room 2227, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: I have just learned of your identity and position so I want you to know my attitude toward the Tax Reform Act of 1976.

I have no real quarrel with some of the ideas such as the Unified Credit, curtailing generation skipping transfers, and matters which really do go to equity and simplicity.

Though I think the provisions for special valuation of farm real estate and closely held business will prove to be a painful trap for those who use it, I must assume it has such political clout that repeal is impossible.

However, the provisions relative to the carry-over basis ought to be repealed retroactively immediately. Executors, attorneys, accountants, and people engaged in the preparation of death tax returns will never make it. I have attempted to practice first-class, and there is no way, in my judgment, that the carry-over basis conceived in the Tax Reform Act of 1976 can be effectively followed and administered. I have talked to lawyers all over the State of Iowa who have in the past been knowledgeagle in the field, and they feel devastated. The cost of it all to the citizens just to attempt to comply is mind boggling.

I have previously written to the same effect to my Senators and Congressmen, but I also send them a copy of this letter.

Respectfully,

WILBUR R. DULL.

SHIRK, REIST & BUCKWALTER,
Lancaster, Pa., August 23, 1977.

Hon. MICHAEL STERN
Staff Director, Committee on Finance, Room 2227, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: Not being able to appear at the hearing on Monday, July 25 (this letter is being dictated July 20), I would like to present the following statement:

The so-called Tax Reform Act of 1976 (which I have dubbed the "Tax Confusion Act of 1976") has caused extra expenses for those persons for whom it was designed to save taxes—those in the brackets between $120,000 and $300,000 (even up to $500,000).

Many of these people are just working persons who have by their savings accrued housing which by inflation has increased in value, substantial life insurance, and a few stocks and bonds.

The planning which is necessary to save taxes when the second spouse dies is still necessary under the "Tax Confusion Act of 1976". All the Act did was save taxes when the first spouse dies but none when the second spouse dies.

Further, the carry over basis rule affects all taxpayers and has caused quite a bit of difficulty because of its complexity.

For the suggested benefits for farmers and small businessmen to have any effect, it seems to me that the values to be used by farmers in determining the percentage of their estate should be the gross market value rather than the reduced market value. Further, by changing 6166, you are preventing the small business-person from trying to have a diversified estate portfolio (by making it harder to take advantage of this provision).

All in all, the "Tax Confusion Act of 1976" has tended to hurt the small estate in the federal tax brackets from the standpoint of cost of tax planning, while the cost of tax planning for those over $500,000 remains the same.

Respectfully yours,

K. L. SHIRK, Jr.

THE FIRST NATIONAL BANK OF BRUNSWICK,
August 22, 1977.

CLERK OF SENATE FINANCE COMMITTEE,
U.S. Senate, Washington, D.C.

DEAR SIR: It is my understanding that your committee is now considering the 1977 Technical Amendments Act relating to 1976 Tax Reform Act.

The carry-over basis provisions of the 1976 Act and the related reporting provisions have imposed a great inequity on the American people and an almost impossible administrative nightmare on fiduciaries.

The carry-over basis provisions and the proposed amendments thereto are particularly harsh when applied to timberland.

I sincerely urge the repeal of the carry-over basis provisions of the 1976 Tax Reform Act.

EDWARD R. GRAY, Jr.,
Vice Chairman of the Board.

THE FIRST NATIONAL BANK OF BRUNSWICK,
August 22, 1977.

CLERK OF SENATE FINANCE COMMITTEE,
U.S. Senate, Washington, D.C.

DEAR SIR: I understand that a hearing will commence shortly on the 1977 Technical Amendments Act relative to the 1977 Tax Reform Act. One of the items to be considered is the so-called "carry over" cost basis.

As a Trust Officer involved in the everyday administration of trusts and estates, I have found the carry over basis as required under the 1977 Tax Reform Act to be entirely unworkable. In most cases, decedents simply did not maintain the type of cost information required under the Tax Reform Act. This is particularly true where land has been passed down through successive generations. Therefore, I would strongly support elimination of the carry-over basis or modifications to make it more practical in application.

Cordially yours,

JAMES P. LANGSTON,
Vice President, Trust.

THE FIRST NATIONAL BANK OF BRUNSWICK,
August 24, 1977.

CLERK OF SENATE FINANCE COMMITTEE,
U.S. Senate,
Washington, D.C.

DEAR SIR: It is my understanding that a hearing will begin shortly on the 1977 Technical Amenments Act concerning the 1976 Tax Reform Act. Of particular interest to me is the consideration given to the so-called "carry over" cost basis, a portion of the estate tax section of the Act.

In the short time which we have been subject to this carry over basis, we have found it to be a nightmare. The principal reasons for our problems have been the simple fact that the decedents did not maintain the type of cost information required under the Tax Reform Act. This is particularly true with real estate which has been passed down through successive generations and the residence and other real estate purchased by the Testator and especially any improvements to this property. Therefore, I would strongly urge the Committee to consider eliminating the carry over basis or modifying it to make it more practical in its application.

Cordially yours,

RALPH B. SMALL, *Trust Officer.*

WHITFIELD, MUSGRAVE, SELVY, KELLY & EDDY,
Des Moines, Iowa, August 23, 1977.

MICHAEL STEARN,
Staff Director, Committee on Finance,
Dirksen Senate Office Building, Washington, D.C.

DEAR SIR: My attention has been called to the fact that the Subcommittee on Taxation and Debt Management of the United States Finance Committee is considering possible revisions of the Tax Reform Act of 1976.

Having tried to work with this Act since its enactment, you are advised that in my opinion such should promptly be corrected:

(*a*) The carry-over basis rule is unreasonable and cannot be administered. People with the desired information are unavailable, deceased and many times no records are available.

(*b*) The record keeping required places a staggering burden and cost on the taxpayers which is unjustified and a burden on the public while producing no revenue to the Government.

(*c*) Taxpayers, to say nothing of lawyers and accountants, who are of necessity working with the Act, do not understand it. It is unnecessarily complicated and does not obtain the goals for which the Washington proponents announced as intended.

For all of the above reasons, corrective action should be promptly taken to correct deficiencies in the Act, and in particular to eliminate the so-called "Carry-over-basis rule".

Sincerely,

EDWARD J. KELLY.

SOLON, IOWA, *September 8, 1977.*

Mr. MICHAEL STERN,
Staff Director, Committee on Finance, Room 2227, Dirksen Office Building, Washington, D.C.

DEAR SIR: I feel that the capital gains aspect of the 1976 Tax Reform Act is confiscatory. I feel that the present estate tax, which starts at the 30% rate, is high enough. When capital gains tax is assessed on the cost basis of a person's estate and carries over to his estate and his heirs, there is not one medium-size family business out of 100 that could come up with the amount of money needed for taxes without selling assets, usually in a depressed market because of the pressure to sell. Also, Section 303 is not available to provide funds to pay the two capital gains taxes. The corporation can only pay them by declaring a dividend. But the estate must pay income tax on the dividend. The new law, the way it is set up starting with 1977, imposes an automatic increase of the capital gains tax for each year, regardless of whether there is any appreciation. One solution would be to eliminate the "carry-over basis," which (a) causes serious multiple administrative and tax problems never foreseen; (b) destroys the incentive to build medium-size businesses, and (c) would produce no meaningful revenue during the next two decades. Looking at the realities of the situation, if Congress is to give effect to its oftstated view that family businesses constitute the fundamental basis of our private enterprise system, then there is no choice except to eliminate the capital gains aspect of this law.

Sincerely,

GARY L. WAKEFIELD.

MOORE OVERALL,
WICHITA, KANS., *September 22, 1977.*

Hon. HARRY F. BYRD, Jr.,
Committee on Finance, Dirksen Office Building, Washington, D.C.
(Attention of Mr. Michael Stern, staff director).

DEAR SIR: It has been called to my attention that you are reviewing the 1976 Tax Reform Act.

We find in reviewing this Act that the new capital gains tax at death and the 15% minimum tax—both of which apply to appreciation accruing after 1976—impose an impossible burden on family corporations.

We have worked in the field of estate planning since 1935. We find on the average that stockholders of closely held corporations do not have funds to pay these taxes.

Since Congress has created this additionaly burden, it is imperative that Congress makes it possible for the small corporation to retire additional stock under Section 303 to meet these taxes.

Yours very truly,

ELMER C. MOORE.

MCCORMICK, BARSTOW, SHEPPARD, COYLE & WAYNE,
Fresno, Calif., September 13, 1977.

Re 1976 Tax Reform Act.

Hon. HARRY F. BYRD, Jr.,
Committee on Finance,
Room 2227, Dirksen Building,
Washington, D.C.
(Attention of Michael Stern).

DEAR SIR: It is my understanding that the Senate Finance Committee is restudying the affect of the "carry-over basis" rules incorporated in the 1976 Tax Reform Act. As an attorney who has for many years engaged in estate and corporate planning in the San Joaquin Valley of California, I wish to add my comments.

When the 1976 Tax Reform Act was suddenly enacted, and we had an opportunity to study its provisions, we were appalled that Congress could enact such legislation without close consideration of the practical affect. While the change to a unified credit is in many cases laudable, the carry-over basis provisions of the law are nothing short of a tax disaster for many families with modest estates. They are especially disastrous for farmers and other small businesses, which are in fact the heart and soul of our nation.

It seems to me to be essential for the Congress to consider that a very large portion of the farms in the San Joaquin Valley are family owned businesses, many of which were acquired over the past 30 or 40 years and built through hard work and careful attention to expense. In the past few years, our area and other portions of the nation have experienced tremendous inflation in real property values, and that inflation is continuing in 1977 at a rapid pace. As a result, as a business, a farm in our area may become well over capitalized in land. In those cases, which are almost universal, the federal estate tax alone is virtually a disaster, and may often require a sale of the land simply to finance the tax liability on the death of the farmer. Superimposed by the 1976 Tax Reform Act is the carryover basis with the attendant capital gains tax on the sale. It can be easily demonstrated that a rather small farm in our area may become the subject of confiscation by tax within two generations, unless the farmer has the means and the health to insure himself sufficiently to pay the tax liability. Even in the latter case, it becomes of vital importance that the landowner carefully plan his insurance estate to avoid inclusion of the proceeds for estate tax purposes.

Congress apparently intended to provide relief from the foregoing catastrophe by means of Section 2032A of the Act. However, your Committee should consider the practical effect of Section 2032A in the real world. First and foremost, farm families must finance their operations, yet Section 6324B establishes a lien for the difference in the tax which can limit seriously farm financing. Second, many farmers have children who do not remain on the farm. The farmer's intention to benefit his children equally may be seriously frustrated by the necessity to make use of Section 2032A in order to preserve the business.

Finally, I am certain that you have had many comments on the fact that the Act frustrates the use of Section 303 of the Code. Here again, effective planning in order to protect a family business, which was the purpose of the Section in the first instance, is completely frustrated. In my exprience of over 20 years of practice. I have found that people are willing to pay their fair share of taxes. However, the rules of the 1976 Tax Reform Act, when the impact is fully felt, can do nothing but produce an overwhelming reaction against the Congress and such confiscatory legislation.

A practical problem with the carryover basis of the Act should also be considered. In the case of farmers who have acquired land over many years, in most cases they have leveled the land, introduced irrigation, planted crops, or vines or trees, removed the same and replanted to other crops, and otherwise developed their properties to their highest potential. They have also acquired equipment and other personalty over the years. Under the carry over basis rules, the Congress has made it essential that the tax basis for the farms and improvements and equipment be determinable at death, or accept a fixed discount on market value. For clients who have consulted me since the 1976 Tax Reform Act concerning their estate plans, I have suggested that they consider and itemize the basis for everything they own. This is an almost impossible and highly impractical exercise for the great majority of farm owners. If it is not accomplished, however, heirs will apparently be at the mercy of the IRS on future audits. Again, the carry-over basis is neither fair, justified nor well considered in its practical application.

Those of us concerned in the foregoing matters and in the day to day provision of practical advice to our clients urge you to eliminate the carry-over basis provisions of the Reform Act before businesses, farms and Congress' credibility in tax matters are all completely destroyed.

Very truly yours,

J. H. PERKINS.

ELECTRIC EQUIPMENT & ENGINEERING CO.,
Denver, Colo., September 15, 1977.

Senator HARRY F. BYRD, JR.,
Dirksen Office Building, Room 2227,
Washington, D.C.
(Attention Mr. Michael Stern).

DEAR SENATOR BYRD: It has come to our attention that you have asked for comments on the 1976 Tax Reform Act. Although these comments were to be in by September 9th, we have just heard of your request.

I can assure you that the new carry over basis signals the death of the small family owned business. The estate taxes were bad enough before the new legis-

lation went into effect, but the 1976 laws insure that the family owned business cannot be passed on. A little arithmetic will show that there is now no way that the small business can come up with enough money to pay the taxes when one of the owners dies.

I can tell you of many companies in the Denver area which have sold out to large multipurpose organizations because of the old tax laws. I can assure you that the 1976 act will accelerate this type of action.

Many times congress has expressed concern over the growth of the conglomerate organizations, but I submit that the main reason for this growth is the official U.S. tax policy. Also, we small business operators have become tired of hearing about the "concern" our government has for the small businessman. We hear about the concern but we see OSHA, EPA, EEOC, IRS, ad nauseam and now a tax "reform" act which will completely legislate us out of business.

I will be surprised if anything is done about our situation. Enclosed is an article from the Rocky Mountain News which outlines the official thinking in Washington about this kind of situation. Treasury Secretary Blumenthal believes that the government knows what is best for the people.

Very truly yours,

D. J. MORBONI, *President.*

Enclosure.

[From the Rocky Mountain News, July 29, 1977]

TREASURY CHIEF IN DENVER, ARGUES TAX SIMPLIFICATION CASE

Treasury Secretary W. Michael Blumenthal came to Denver Thursday to try to sell President Carter's proposals for a "simpler" tax system to a group of persons who have nothing to gain by one—tax lawyers, accountants and professors.

But beyond having a possible vested interest in complexity, many in the group obviously were worried that possible changes such as taxing capital gains as ordinary income could reduce the amount of money available for investment.

Blumenthal had invited a score of regional tax experts to the Regency Inn to discuss possible changes in the internal revenue code. It was just one of a number of seminars and speeches he has been holding around the country.

He spoke in Louisville, Ky., at noon Thursday, flew to Denver for a two-hour session, then headed for St. Louis for another appearance Friday.

The public was welcome at the Denver seminar. The spectators sat along the walls a respectful 12 feet from the participants—except for Trenton Parker, a Republican candidate for the U.S. Senate, who invited himself to the table in mid-session, the better to challenge Carter's tax policies.

Blumenthal said the Carter tax package would go to Congress by the end of the summer and might even have some hearings before the October adjournment. "With luck," he said, it would be approved by late summer 1978.

He made it plain that tax simplification does not mean an overall tax reduction, except perhaps for lower income persons. And he said there would be a "substantial reduction" in the preference given capital gains.

This bothered Hover Lentz, a Denver tax lawyer. That would cut the incentive to invest, he said. Why should a person take a risk if he can buy an 8 per cent bond?

Howard Rea, another Denver tax lawyer, suggested that capital gains should be "indexed," or discounted by the inflation factor. Otherwise, he said, the investor is paying a tax on an increase that is not a real economic gain at all.

Des Birch, Parker's campaign manager, said a flat rate should replace the graduated in come tax, because inflation pushes persons into higher tax brackets even though their purchasing power stays the same.

Blumenthal replied that Congress periodically revises the tax schedule so the average wage earner doesn't have to pay more than 10 per cent of his gross income in federal taxes.

The Secretary was also unsympathetic to a suggestion that federal estate taxes are confiscatory. A person should be able to keep most of what he earns during his lifetime, Blumenthal said, "but people who inherit a large amount of money go down to the beach and enjoy themselves, and that's not good for them."

Blumenthal said that despite all the meetings he's holding around the country, many persons complain the administration is going the wrong way, no matter what it proposes

WIGGIN & NOURIE,
Manchester, N.H., September 26, 1977.

Re: Tax Reform Act of 1976—Carryover basis.

Mr. MICHAEL STERN,
Staff Director, Senate Committee on Finance,
Dirksen Office Building, Washington, D.C.

DEAR MR. STERN: I understand Senator Byrd has invited comments regarding the Carryover Basis provisions of the Tax Reform Act of 1976 as they regard decedent's estates and that you are the suggested addressee.

I recently completed giving a presentation on the Carryover Basis provisions to a Massachusetts Bankers Association audience of approximately 200 fiduciaries and estate administrators in Boston, Massachusetts. I can say without hesitation that they are utterly indignant over this new law. Not only is it complex and time consuming, but the record keeping problems involved are horrendous. The New Hampshire Legislature could have done a better job of raising revenue.

My first suggestion would be repeal in their entirety the estate Carryover Basis provisions enacted by the Tax Reform Act of 1976.

My second suggestion would be to (if you must) tax capital gains at death, with liberal extension of payment provisions. This second suggestion would not be completely satisfactory, since the basis of the decedent's property would have to be obtained (or guessed at, in a large number of cases). It is true that it would avoid the computations of basis adjustments now required by IRC §§ 1023 (h), (c), (d), and (e)—in that order, of course—and hopefully end the basis reporting provisions of IRC §§ 6039 A and 6694 [A]. But at the same time, this suggestion would subject estates to extraordinary liquidity problems in the face of the capital gains tax. This of course, is the average citizen's objection to both the current law and this alternative.

Thus, my preference for my first suggestion.

Very truly yours,

RUSSELL J. SPEIDEL.

HAMPDEN ENGINEERING CORP.,
East Longmeadow, Mass., September 26, 1977.

Hon. Senator HARRY F. BYRD, Jr.,
Committee on Finance, Dirksen Office Building, Washington, D.C.
(Attention Mr. Michael Stern, Staff Director).

DEAR SENATOR BYRD: As one of the owners of a family business, it is most discouraging to read of the Estate and Gift Tax Revisions included in the 1976 Tax Reform Act, and in particular the effect of the new carry-over basis, i.e., the Capital Gains Tax at death, on a family business.

We would like to see the carry-over basis eliminated; otherwise we believe it will destroy all incentive to start or carry on a medium-sized family business.

Thanking you in advance for your consideration, I am

Very truly yours,

D. M. FLYNN, *Treasurer.*

WILLIAMS, SALOMON, KANNER & DAMIAN,
Miami, Fla., August 24, 1977.

MICHAEL STERN, Esq.,
Staff Director, Committee on Finance, Room 2227, Dirksen Office Building, Washington, D.C.

DEAR MR. STERN: The undersigned is chairman of the Real Property, Probate and Trust Law Section of The Florida Bar. With reference to the investigation being conducted by sub-committee on taxation and debt management of the Senate Finance Committee regarding problems of the Tax Reform Act of 1976, you will find enclosed Resolution adopted by the Section urging the repeal of the carryover basis provisions of the Tax Reform Act. It is requested that you please accept the Resolution for filing and make the same a part of the record.

Very truly yours,

LEWIS M. KANNER.

Enclosure.

Whereas, the 95th Congress of the United States by enacting the Tax Reform Act of 1976 substantially altered the estate and gift tax provisions of the Internal Revenue Code of 1954; and

Whereas, the provisions of the Tax Reform Act of 1976 relative to carryover basis imposed reporting and record keeping requirements unprecedented in magnitude and difficulty of definition and application, requiring personal representatives of estates and trusts and all persons acquiring property from a decedent after December 31, 1976, to establish and maintain records dating from the time the decedent acquired the property until the recipient either dies or disposes of the property, and likewise requires personal representatives to report to each person acquiring property from a decedent and to the Secretary of the Treasury (and presumably requires the Secretary of the Treasury to maintain records of) the adjusted carryover basis of every item of property subject to the carryover basis provisions of the Code; and

Whereas, the provisions of the Tax Reform Act of 1976 relating to the determination of carryover basis are virtually incomprehensible and beyond the ability of the average citizen to comprehend, thus denying the individual the opportunity to compute and report his own tax liability and forcing him to either ignore the law of hire specialists in the field of taxation; and

Whereas, said provisions of the Tax Reform Act of 1976 have been found by tax experts to be overwhelming and unworkable and to impose an undue burden and expense upon all citizens, and, therefore, said provisions will foster disrespect for the tax laws and tend to disrupt and break down the present system of voluntary tax reporting and payment; and

Whereas, the expense of attempting to comply with the carryover basis provisions of the tax reform act will fuel the fires of inflation to the detriment of the county as a whole; and

Whereas, the problems and inadequacies of the carryover basis provisions of the Tax Reform Act have been recognized by certain members of the Congress and caused them to introduce legislation to repeal the carryover basis provisions of the Tax Reform Act of 1976; and

Whereas, the Real Property, Probate and Trust Law Section of The Florida Bar, in recognition of its duty to the citizens and taxpayers of the State of Florida to do whatever is in their power to assist in the improvement and upholding of the laws and to relieve citizens from regressive and oppressive measures, and being convinced of the desirability of the repeal of the carryover provisions of the Tax Reform Act of 1976, it is

Resolved, That the Real Property, Probate and Trust Law Section of The Florida Bar favors the repeal of the carryover basis provisions of the Tax Reform Act of 1976 and urges all members of Congress to act affirmatively and promptly to repeal said provisions.

Resolved Further, That this Resolution be published and disseminated as broadly as possible and that copies of this Resolution be furnished to: Mr. Michael Stern, Staff Director, Committee on Finance, Room 2227, Dirksen Senate Office Building, Washington, D.C. 20510.

ORINDA, CALIF., *September 21, 1977*.

Re Amendments to 1976 Tax Reform Act, carryover basis problems.

Hon. HARRY F. BYRD, Jr.,
Attn.: Mr. Michael Stern,
Staff Director, Committee on Finance,
Dirksen Office Building, Washington, D.C.

DEAR SENATOR BYRD: I respectfully request that your Committee on Finance recommend an amendment to The 1976 Tax Reform Act allowing the old rules on stepped-up basis to apply to taxpayers' principal residence as of the date of his death.

In my over 20 years of experience as a tax attorney, I have observed that a substantial majority of those taxpayers who own a principal residence do not maintain adequate records for the purpose of determining cost basis; this problem is further compounded by the fact that most taxpayers have owned three or more principal residences and each time the residence has been sold, a more expensive one has been purchased, thereby resulting in postponement of capital gain and the necessity to carry over the cost basis of the first house purchased by a taxpayer many years ago.

It is a real burden to a widow and to the widow's tax adviser to attempt to go back 40 or 50 years of home ownership to determine the cost basis of the principal residence. If the stepped-up basis provisions of the pre-1976 Tax Reform Act Law were allowed to apply to residences only, there should not be a substantial tax loss to the Government and many arguments with the Internal Revenue Service on audit and much work in going back to determine cost basis would be avoided.

Very truly yours,

HERBERT P. MOORE, Jr.

DALLAS, TEX., *September 12, 1977.*

Senator HARRY F. BYRD, Jr.,
Attention: Michael Stern,
Staff Director, Committee on Finance,
Dirksen Office Building, Washington, D.C.

DEAR MR. STERN: Many feel that the Estate and Gift Tax revisions and particularly the "carry-over basis" provisions contained in the 1976 Tax Reform Act were too hastily considered and little understanding of the effect of the new, drastic tax changes on descendants estates existed outside of the Revenue Committees.

We understand Senator Byrd is inviting comments on this issue and we have the following:

The 1976 Tax Reform Act provides, for the first time, that when an individual dies the cost basis of his property will "carry over" to his estate and his heirs. Congress eased the immediate impact of this law by providing a "fresh start" on December 31, 1976, but for new businesses started after 1976 the effect of the new law is to impose a capital gains tax at death on all future sales of appreciated assets, even when they are sold to raise money to pay estate and inheritance taxes and expenses of administration. This tax would be added on top of the present estate tax, which starts at a 30% rate. The serious impact of these combined death taxes on one's incentive to start and build a family business is graphically demonstrated by the following figures:

1. Assume a $100,000 business started after 1976, which at the time of the founder's death is worth $3,000,000, no marital deduction and no other assets:

Funeral and administration expenses	$125,000
Estates taxes and inheritance tax credit	1,225,000
Capital gains tax (after adding the proportion of estate and inheritance tax to basis)	267,000
Minimum tax on capital gain	40,000
Total taxes and expenses	1,657,000

There is not one medium-size family business out of 100 that could come up with this amount of money without wrecking the business. Nor could such a company afford to purchase enough life insurance to pay such taxes. And the installment payment provisions will merely serve to convince the founder that building such a business is not worth the effort.

But this is not all. Section 303 is not available to provide funds to pay the two capital gains taxes. But they must be paid. The corporation can only pay them by declaring a dividend. But the estate must pay income tax on the dividend. Calculations will demonstrate that a dividend of at least $870,000 will be needed to pay all the income taxes, both ordinary and capital gain. Thus $2,220,000 will have to come from the $3,000,000 corporation to pay administration expenses, death taxes and income taxes.

2(a). Assume the same $100,000 business organized after 1976, which is worth $3,100,000 at death, a maximum 50% marital deduction and no other assets:

Funeral and expenses of administration	$130,000
Estates taxes and inheritance tax credit	501,000
Capital gains tax	172,000
Minimum tax on capital gains	27,000
Total death taxes and expenses	830,000
Plus additional dividend to pay ordinary income tax on $199,000	368,000
Total taxes and expenses	1,198,000

2(b) When the wife dies later on, the expenses, death taxes, and income taxes on her $1,485,000 estate would aggregate $870,000.

Total administration expenses, estate and inheritances taxes, and income taxes on both estates would amount to over $2,000,000 thus leaving less than $1,000,000 to represent the lifelong efforts of the founder of the business.

It must never be forgotten that the carry-over basis also applies to "old" family business, i.e., those organized or acquired before 1977, pursuant to an arbitrary formula that prorates total appreciation between the period before 1977 and the period after 1976. If, for example, the business was organized in 1967 and the owner died in 1987, one-half the appreciation would be taxable. Thus, the amount of capital gains tax will increase automatically as each year goes by, regardless of whether there is actually any appreciation.

There are only two possible solutions:

1. The best step would be to eliminate the "carry-over basis," which (a) causes serious multiple administrative and tax problems never foreseen; (b) destroys the incentive to build medium-sized businesses; and (c) would provide no meaningful revenue during the next two decades.

2. The only alternative, as we see it, is to provide that the basis of assets be stepped up in an amount that would equal the total of the following estate liabilities by (a) funeral expenses, administration expenses; (b) estate taxes, and (c) inheritance taxes. There are the same items as those listed in Section 303, which authorizes the redemption of sufficient stock in a family corporation to raise funds to pay them. To be fair, this step-up of basis should apply to all estates, whether Section 303 can be used or not. Perhaps the best and most easily understood solution would be to let the executor select assets having a value equal to the Section 303 liabilities.

Looking at the realities of the situation there is no other solution, if Congress is to give effect to its oft-stated view that family businesses constitute the fundamental basis of our private enterprise system.

Your consideration of these solutions is earnestly solicited.

Sincerely,

MONTY C. BARBER.

GORSUCH, KIRGIS, CAMPBELL, WALKER & GROVER,
Denver, Colo., September 20, 1977.

Senator HARRY BYRD,
Chairman, Senate Subcommittee on Taxation, Washington, D.C.

DEAR SENATOR BYRD: Last year Congress passed the Tax Reform Act of 1976 making many changes in the income tax law, but making the first major revision in the estate and gift tax laws since these taxes were introduced fifty years ago. While we believe a few of the new provisions have merit, many are of doubtful benefit as compared to the prior law, and all of them have required extensive review and often a revision of long standing estate plans. Whatever their merit or demerit, the new transfer tax provisions have introduced new complexity and uncertainty into the tax picture. However, the provision with the greatest impact on the most taxpayers and with its own complexities is that of the carry-over basis. Under prior law, on a person's death all of his property received a new basis equal to its fair market value at his date of death, or if elected by the personal representative, as of the alternate valuation date (usually six months after death). The decedent's cost basis then became irrelevant. This was a very simple rule to understand and to follow, and it eliminated the need for delving into the decedent's old records to determine what he had paid originally for the asset, the cost of any additions, the amount of depreciation which had been or should have been taken, and so forth.

Now with the carry-over basis rules, the basis of assets passing from the decedent to his heirs and beneficiaries depends upon the decedent's original cost of the asset, the cost of additions and improvements, if any, the amount of depreciation, depletion or amortization that the decedent took or should have taken, the "fresh start" rule for marketable securities, the amount of federal estate tax and state inheritance tax paid with respect to the asset and the minimum basis provisions. Assuming the decedent kept all of his records (which is a large assumption), many complicated computations must be made in most situations. The personal representative of the estate is required to forward these computations to the Internal Revenue Service and to the beneficiaries of the estate and is subject to substantial financial penalties for failure to do so. These computations are

generally beyond the competence of the average individual fiduciary to perform and will have to be done by corporate trust departments, lawyers and accountants, probably with the help of computers, and always at some expense to the estate.

The new basis rules affect everyone who leaves property at death, whether he be rich or poor and even though the estate is not large enough to incur any estate tax. The well off can afford the additional trouble and expense, while the average person of moderate means cannot and should not have to incur this expense. On occasion, the cost of computing the carry-over basis may exceed the value of the asset. The net effect to the Treasury will be to pick up additional capital gains taxes over the years, since the carry-over basis will generally be lower (due principally to inflation) than the basis would have been under the old rule. Whatever the amount of additional revenue expected to be recovered through this provision, it cannot make up for the additional aggravation and expense to the taxpayer who wishes to comply or for the evasion by those who cannot or choose not to comply, all of which leads to considerable disrespect and even contempt by many people for the tax laws.

It seems to us that much of the new law effects change more for the purpose of change than for the "loopholes" to be closed. While many of the provisions of the new law have been current in academic circles for years, we are informed that no hearings were held on the Bill while in Congressional committees, and thus the useful process of exposing the Bill to public scrutiny and comment was lost. Congress has in the past corrected errors resulting from insufficient consideration of legislative proposals, and we hope that it will do so again in this situation. We urge the repeal of the carry-over basis provisions as they affect transfers at death and the restoration of the former provision retroactively.

Although this letter certainly expresses the views of the undersigned, it is intended to be a communications from and a statement of position by this law firm, authorized by its Executive Committee. It is indeed rare that we go to this length, and we hope you will consider it indicative of the seriousness of our concern as to this matter.

Very truly yours,

JAMES H. TURNER.

ROBINSON, WAYNE & GREENBERG,
Newark, N.J., *September 9, 1977.*

Mr. MICHAEL STERN,
Staff Director, Committee on Finance, Room 2227, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERNS This letter is respectfully submitted to point out some severe problems facing the small, family-owned business as a result of the possible interaction of sections 303, 306 and 1023 of the Internal Revenue Code,[1] as a result of changes made by the Tax Reform Act of 1976 ("TRA '76").

The problem can only be understood in its historical context. Before the adoption of the 1954 version of the Code a popular means of extracting earnings from a corporation and avoiding dividend characterization (i.e. taxation at ordinary income rates) was by utilization of the "preferred stock ballout."

The mechanics of the preferred stock ball-out were as follows: A corporation with large earnings and profits would declare a dividend of preferred stock to existing common holders. Under section 305 such a dividend was not taxable. The shareholders would sell their preferred stock to a third party (for example an insurance company), who would thereafter have its preferred stock redeemed by the corporation. Each sale of stock was taxed at capital gains rates. By this means, earnings of the corporation could be effectively extracted at capital gains rates.

Section 306 of the 1954 Code effectively reached this problem by characterizing any preferred stock received as a dividend on common stock as "section 306 stock". With certain exceptions, a redemption of sale of such stock was to be taxed as if it were a dividend distribution under the rules of section stock ball-out (which had received judicial sanction in *Chamberlin* v. *Commissioner*, 207 F. 2d 462 (6th Cir. 1953).

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[1] Unless otherwise indicated, all references are to the Internal Revenue Code of 1954, as amended, and The Regulations promulgated thereto.

Section 306 curbed this abuse by, in effect, creating a "taint" for such stock received as a distribution on common stock (the "taint" being that any future sale or disposition of such stock would be taxed as ordinary income, again, subject to certain exceptions).

To make it clear that the "taint" followed section 306 stock even if such stock were made the subject of a gift, the Code provides that stock having a transferred or substituted basis in the hands of the donee is still section 306 stock. However, if stock had a "stepped-up" basis, such as that created when a shareholder dies, the "taint" was purged.

Section 303, whose provisions were first adopted in 1951, waives ordinary income treatment to permit redemption for the purpose of paying estate taxes, in situations where otherwise, such a redemption would result in ordinary income because of section 306.

When section 303 was drafted to allow a redemption of stock to pay estate taxes, the need for such a provision was justified as follows:

"It has been brought to the attention of your committee that the problem of financing the estate tax is acute in the case of estates consisting largely of shares in a family corporation. The market for such shares is usually very limited, and it is frequently difficult, if not impossible, to dispose of a minority interest. If, therefore, the estate tax cannot be financed through the sale of the other assets in the estate, the executors will be forced to dispose of the family business. In many cases the result will be the absorption of a family enterprise by larger competitors, thus tending to accentuate the degree of concentration of industry in this country." S. Rep. No. 2375, 81st Cong., 2d Sess. 54 (1951).

The preferred-for common recapitalization has been an important planning tool for at least twenty-five years. A recapitalization whereby the older generation in a family owned corporation surrenders some or all of its common stock in exchange for preferred stock has offered many tax and non-tax advantages to those involved. Preferred stock in the hands of the older generation has a more readily ascertainable value for estate tax purposes and a relatively secure and stable level dividend income. The younger-generation management obtains total or partial voting control and decision-making authority.

The preeminence of section 303 can be further noted by the fact that not only was it possible that stock received in a pre-death preferred for common recapitalization eventually could be redeemed for the payment of estate taxes without ordinary income treatment, but also stock received in a post-death preferred for common recapitalization was available for the same purpose with the same favorable treatment.

A corporation may distribute non-voting stock as a tax free distribution after the shareholder's death and under section 303(3), such shares would be suitable for section 303 redemption. Reg. 1.303–2(d) thus provides: "[A] distribution in redemption of stock will qualify under section 303, notwithstanding the fact that the stock redeemed in section 306 stock, to the extent that the conditions of section 303 are met." It is noteworthy that such a post-death recapitalization appears to remain eligible for favorable treatment under section 303 even after passage of the TRA '76, notwithstanding the possible problems created for a pre-death recapitalization as discussed below.

TRA '76, which has the avowed purpose of trying to preserve the small family business (as evidenced by section 2032A, concerning the valuation of property used in a closely-held business, and section 6166 which extends to fifteen years the period within which estate tax may be paid), creates a catastrophe for the small, closely-held business which had relied on a preferred for common recapitalization to ensure the continued existence of the business in the family's hands and to ensure a source of funds for estate tax payments.

It is our belief, and that of many others, that section 303 overrides section 306. This was made clear as to post-death recapitalization by Reg. 1.303–2(d) discussed above. However, the issue as to pre-death recapitalization has never drawn much attention because of the fact that the stock received a stepped-up basis upon the owners' death (one of the statutory exceptions to section 306) thus eliminating all problems. Now section 1023 provides that the adjusted basis of property acquired from a decedent will be its adjusted basis immediately before the death of the decedent, with certain adjustments. As a result, if section 303 is not considered to override section 306 by its own terms, the stock utilized in the redemption may retain its 306 "taint".

As a result, in addition to the estate taxes due, the redemption of the preferred stock to pay these estates taxes (a device which congressional policy as reflected

in the Code has encouraged for the past twenty-five years) would produce taxable income (due to section 1023 and the carry-over basis) upon its redemption which income would be taxable as ordinary income as to the full amount realized! Computations can be supplied to show that the taxes in such a synergistic situation could easily exceed 100% of the value of the stock—a situation which certainly belies a Congressional solicitude for the problems of small, family-owned business!

It is difficult to believe that Congress could have intended a result so contrary to its previously shown and presently continued concern for the problems of the small business. Especially anomalous is the result that a pre-death recapitalization for valid business purposed followed by a redemption, will result in section 306 treatment, yet a post-death recapitalization and redemption will avoid section 306 "taint".

It is particularly discouraging to note that the expected analysis to clear up the confusion which has arisen as a result of the TRA '76 has not materialized. A simple modification of the Regulation under section 303 to clarify that section 303 overrides section 306 for both pre-death and post-death recapitalizations would be sufficient to resolve the problem.

Instead of this simple modification of the Regulations to prevent an unintended result, we are presented with a technical amendment (H.R. 6715), section 3(a)(2) which represents a de facto amendment of section 303—the bill would deny capital gain treatment for the redemption of section 306 stock to pay estate taxes. This should not be allowed without full consideration by Congress and, in fact, it would appear that Congressional intent has been made clear. Regulations should be adopted to reflect that viewpoint, viz, the opposite of H.R. 6715.

Very truly yours,

SIMON LEVIN.

St. Louis, Mo., September 16, 1977.

Hon. HARRY F. BYRD, JR.,
U.S. Senate,
c/o Mr. Michael Stern,
Staff Director, Committee on Finance, Room 2227, Dirksen Office Building, Washington, D.C.

DEAR SENATOR BYRD: It is my understanding that you have invited comments on the Tax Reform Act, and especially on the new carry-over basis provisions of this Tax Reform Act. As an attorney who has practiced in the estate and probate area for three years, I would like to add my voice to those who favor a repeal of the carry-over basis provisions, and a return to the step-up basis provisions of the prior estate tax law.

The stream of horribles caused by this new law in regard to the burdens imposed on estates in the way of capital gains in order to pay administrative expenses and death taxes, and the monumental inconveniences involved, have undoubtedly already been pointed out to you and your staff. However, I would also like to point out that the administrative time and effort involved in determining the carry-over basis will undoubtedly result in higher fees for the fiduciaries serving in an estate and the attorneys representing the estate.

This will be caused by the added time involved in computing the basis of assets held by the decedent at the time of his death, a burden which will undoubtedly prove extremely time-consuming. This increased expense will not only result in the loss of part of the inheritance of the beneficiaries of the deceased person, but, in effect, will result in less revenue going to the Treasury, since these expenses are deductible expenses for tax purposes. Therefore, while on the one hand the carry-over basis will provide increased income tax revenue, it will at the same time decrease the estate tax revenue, on account of the increased administrative expenses. It will also undoubtedly cost the Internal Revenue Service added time and money in order to have adequate manpower to audit and enforce the provisions of this carry-over basis law, thus also reducing its revenuing producing effect.

In conclusion, I heartily urged you to support repeal of the carry-over basis provisions of the Tax Reform Act of 1976.

Very truly yours,

BERTRAM L. LEVY.

COASTAL DATA, INC.,
Stockton, Calif., September 15, 1977.

Hon. HARRY F. BYRD, Jr.,
Atten.: Michael Stern,
Staff Director, Committee on Finance, Room 2227, Dirksen Office Building, Washington, D.C.

DEAR SENATOR BYRD: I recently read an article which stated that the estate taxes on a family-owned company which was worth $3 million at date of death could approach $2,220,000. As an owner of such a business, I would certainly like to pass the business on to my sons. However, if the carry-over basis if not removed from the provisions of the 1976 Tax Reform Act, I doubt seriously whether I could do so. A tax in that amount can only be considered confiscatory.

I am completely opposed to the very concept of taxation on the estate of a person who has worked hard all his life, paid taxes on the income generated by his labor, and then finds out that the government will end up with most of his property.

I strongly recommend elimination of not only the 'carry-over basis' but the complete elimination of all estate taxes. I would appreciate your comments.

Sincerely,

DONALD S. MACRAE, *President.*

COMMENTS AND RECOMMENDATIONS WITH RESPECT TO CARRYOVER BASIS PROVISIONS OF TECHNICAL CORRECTIONS ACT OF 1977, BY JACK W. PETERS, ATTORNEY, COUNCIL BLUFFS, IOWA

My comments are limited to carryover basis which now appears as Section 1023 of the Internal Revenue Code as introduced by Section 2005 of Public Law 94–455 (Tax Reform Act of 1976). Section 3(c) of the Technical Corrections Bill of 1977 contains various proposed corrective amendments.

Obviously, Congress acted as it did in the Tax Reform Act of 1976 to eliminate supposed inequities resulting from the provision of a stepped-up basis at a time of death for assets owned by the decedent. It attempted to soften the blow by creating a complex "fresh start" adjustment as well as other adjustments relating to death taxes and property in small estate. A limited exemption wa created for personal or household effects.

The carryover basis rules presuppose that records exist concerning the original cot basis and depreciation, if any. Because the rules apply to property not subject to depreciation as well as depreciable property and nonbusiness assets as well as business assets, the presupposition is demonstrably false. Most taxpayers not engaged in busines for themselves have extreme difficulty in reconstructing any cost basis figures. The task of reconstructing such information even by persons familiar with public records is a phenomenal task. The likelihood of any great accuracy in determining carryover basis values is quite small. Unless the Internal Revenue Service is to be increased by great numbers of employees, the opportunity of the service to perform meaningful verification will be quite limited.

In short, the carryover basis provision is a monstrosity. Honest, conscientious taxpayers will be unable to comply with it and the Internal Revenue Service will be unable to administer it fairly.

The technical amendments made a part of the Technical Corrections Bill modify the monstrosity in minor respects, but do nothing to address the problem of the fundamental lack of records which generally exist.

It should be obvious that there are other ways to tax capital gains. If the stepped-up basis at death really is as much of an evil as Congress seems to believe, the cost basis rule could be substituted for the stepped-up basis rule for assets acquired subsequent to 1976, with the old rule left to apply to assets acquired before 1977. Then, at least, people would have the opportunity to respond to the new statutory requirements by now making and preserving the records which later will be necessary.

Such a change would have another beneficial side effect. Congress could then eliminate the requirements for filing and disseminating information concerning carryover basis property which now appear in Sections 6039A and 6694 of the Internal Revenue Code.

THE NORTHWESTERN MUTUAL LIFE INSURANCE CO.,
Milwaukee, Wis., September 12, 1977.

Re 1976 Tax Reform Act.

Senator HARRY F. BYRD, Jr.,
(Attn. Michael Stern, Staff Director, Committee on Finance, Dirksen Office Building, Washington, D.C.)

DEAR SENATOR BYRD: This communication is directed to you expressing my extreme disagreement with the Estate and Gift Tax Revision incorporated in the 1976 Tax Reform Act. For those who have analyzed the effects of these changes it is clear that the new carry-over basis and capital gains tax impact on closely held and family businesses is confiscatory and disproportionately unfair to these taxpayers.

A possible preferable approach could be to step up the basis of an estate's assets to their estate tax value in an amount equal to the four estate liabilities of funeral and administration expenses and estate and inheritance taxes. This approach would avoid the double tax on the assets used to pay these state liabilities. I urge your personal consideration of this possibility. I request that you and your colleagues reconsider and evaluate what this new tax law has imposed on specific groups of taxpayers.

Sincerely,

JACK G. BROWN, CLU, *General Agent.*

THE NORTHWESTERN MUTUAL LIFE INSURANCE CO.,
Milwaukee, Wis., September 9, 1977.

Senator HARRY BYRD,
(Attn: M chael Stern, Staff Director, Committee on Finance, Dirksen Office Bui ng, Washington, D.C.)

DEAR SENATOR BYRD: As a professional estate planner, I would like to encourage your committee to re-evaluate the carry-over basis provision of the 1976 Tax Reform Act.

Although this provision creates added sales for me, it reeks havoc on my clients who have worked hard under the free enterprise system to acquire an estate. These same people are the employers of many because they have accumulated capital.

In my opinion, this new method is destructive and not in the best interests of any segment of the population.

Sincerely,

DAVID L. HETRICK, CLU.

CUDAHY, WILCOX, HANDLEY, MAGEE, & POLKING, P.C.,
206 North Wilson Avenue, Jefferson, Iowa, September 8, 1977.

Re: Tax Reform Act of 1976.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
Dirkson Senate Office Bldg., Room 22-27,
Washington, D.C.

DEAR MR. STERN AND COMMITTEE MEMBERS: We believe that the passage and implementation of the Tax Reform Act of 1976 has produced such grave consequences that we would like to convey to you our opinions:

We are a seven member law firm in Greene County, Iowa. Jefferson, the County seat, is approximately 5,000 population, and the entire County contains approximately 12,000 people. A great majority of our work is with rural matters and with rural people. We are feeling the impact of this new legislation upon the people of our area.

Members of our firm have attended various seminars, schools and conventions dealing with this legislation. Speakers there have characterized the legislation as "an afterthought", "a travesty", "injurious", "dreadful", and even "a fraud on the taxpayers". It is not our purpose to try to convince you that any of the above is true, but simply to point out to you that some of the things that we think are bad about the law.

One of the first things that is wrong about the law is "basis". The complexity of the basis rules are terrifying. This is true because of the method of computation, the records that must be kept, the information that must be furnished—we feel manifest injustice and bad effects result from the basis rules.

Sociologically, the basis rules are probably the worst part of the act. In our community farm land, much of which was purchased during the depression, and much of which was inherited or purchased since that time, has increased in value tremendously. The owner of the land was unable to sell the land because of the capital gain impact that would result from a sale. However, when that person died, and the property received a new basis, the person or persons inheriting the property then could sell it. They would of course have paid a Federal Estate Tax upon the value of the property, but they would then avoid the income tax. The point of this whole matter is that on death farms come available for sale and young farmers in particular are able to find land that they can buy.

The so-called family farm context that the act addresses itself to, and the tax break that is granted in that situation, has its own in-built limitations and creates its own problem areas.

For example, we now have a situation where a family farm is involved. A qualified heir wishes to purchase the farmland from the estate. However, lending institutions have looked at the property and see a long term lien against that property which may be assessed if he does not hold the property for the full 15 years. The lending institution is going to want to have a first lien free from all liens and encumbrances. Yet it is impossible to guarantee that there will not be a lien because no one can guarantee that the man who purchases it will continue to farm it for the required period of time.

Perhaps, and only perhaps, will the rules and regulations of the Internal Revenue Service help us. We are very fearful that they will even be worse than the act itself and thus make our life more difficult.

Other difficulties appear in the act. The so-called deemed transferor must have been conjured up by a Philadelphia lawyer. It is thought that a person can be a deemed transferor and not even be aware of it.

Once again back to basis. I personally have some stocks purchased upon the New York Stock Exchange. The companies have a system called 'automaic dividend reinvestment'. I have taken advantage of this and each quarter end up with a fractional share. As I understand it, I have to keep records. Each fractional share is separated and I need to know what my cost was. I have always done this and have no problems personally with knowing how much money has been invested in stocks under any plan, but if I understand the rules and regulations right in the event of my death someone is going to have to set up a tabulation which will show this whole picture. The Executor of the estate is then duty bound to furnish the information to whoever receives the stocks. Somehow there must be a simpler system.

Other difficulties that arise are that people have perhaps three children and three farms. All are equal in value at the date of death. However, one may have been held ten years, one may have been held 20 years, and one may have been held for 30 years. The cost of the farms in each instance is not the same. In fact the costs are widely spread. If I have three farms of equal value, and give them to my three children who then intend to sell them, I find that I have not been fair to my three children because the child who received the farm with the lowest basis will pay the most capital gains tax. I want to treat my kids equally. Up until now, I could give each of them a farm and it didn't make any difference when I bought it. The value fixed at the date of my death was the fair market value of the property.

We probably could add additional complaints about the bill but you probably have heard most of them. Like all bills, it is not all bad. Certain people are going to benefit. This is so because the increased amount of property that a person can own without paying tax. Overall, however, we believe that it turned out to be a harmful piece of legislation, probably passed too much in haste to give the advantage of the additional exemption and not giving enough consideration to the technicalities built into this bill by the so-called "thinkers" in the Revenue Department who were able to produce for Congress all of these ideas. We rather feel that Congress looked mostly to the exemption portion of the bill (although not truly an exemption) and did not pay enough attention to the other facets of this legislation.

The basis provisions ought to be stricken retroactively. As we said before, sociologically, they are very bad. We feel that the only sociological result of this

bill will be to pyramid land in the hands of the few and we believe that the young farmer ought to be able to have the opportunity to purchase land. The provisions of this bill can only tend to increase the value of farm land and it has already skyrocketed out of reality.

We believe that the so-called technical amendments and the legislation proposed to strike the basis provisions ought to be seriously considered by Congress.

Very truly yours,

FRANCIS L. CUDAHY.

CHRISTIAN HARDWARE CO.,
Athens, Ga., September 7, 1977.

Re: Tax Reform Act of 1976.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
Room 2227, Dirkson Office Building,
Washington, D.C.

The present income tax and welfare structures are already such that it discourages a person to work and try to build an estate. Now, the straw that will break everyone is the "carry over basis" on estate taxes. If this clause is left in the act, it can only do one thing and that is to remove all incentive to build an estate. It will cause problems never before seen in tax returns and administrative costs and at the same time produce very little revenue for the next 20 years or more.

Thousands of businessmen have already quit applying their best efforts to serving the community at the lowest cost simply because of the tax structure. The income tax takes 50% or so and then, at death, the estate taxes take an additional 50% or so. Yet, a loss by the taxpayer is born 100% by him. Don't you admit that is rather poor odds?

After income taxes have been paid, there should be no estate taxes at all. But, if there is going to be one, for realities sake, eliminate the "carry over basis", which is double taxation plus some.

Your vote and influence along this line will be appreciated.

Yours truly,

R. FELTON CHRISTIAN.

WESTERN OHIO NATIONAL BANK & TRUST CO.,
Covington, Ohio, September 9, 1977.

Senator HARRY F. BYRD, Jr.,
Committee on Finance,
Dirksen Office Building,
Washington, D.C.
(Attention Michael Stern, Staff Director.)

GENTLEMEN: I am writing to express my concern as a trust officer about the carry-over basis provision that was enacted as a part of the 1976 Tax Reform Act.

First of all, this provision has added an incredible amount of complications to an already complex tax picture. In some cases it will be an almost impossible task to try to establish basis for listed securities because of stock splits, stock dividends, tax-free exchanges and securities received by gift. Real Estate may not be too difficult to work with if no changes or improvements are made following acquisition. However, in reality, this is often not the case. And with each "substantial" improvement regarded as a separate improvement for purposes of the time-apportioned determination of the "fresh-start value", this can result in some very involved computations. There are other potential problems such as the inheritance tax adjustment when there are different rules for inclusion in the gross estate for Federal and State purposes.

Secondly, I am quite concerned about the effect of the new carry-over basis, i.e., the capital gains tax at death on family businesses. Unless some relief is forthcoming, it would appear that many, many businesses that have enjoyed a good appreciation simply cannot survive the strain caused by these additional capital gains taxes. I would strongly recommend the repeal of the current carry-over basis law.

Very truly yours,

CARL W. BOWMAN, *Trust Officer.*

CAPITAL CITY IRON WORKS, INC.,
Richmond, Va., September 15, 1977.

Senator HARRY F. BYRD, Jr.,
Committee on Finance,
Dirksen Office Building,
Washington, D.C.
(Attention Michael Stern, Staff Director.)

DEAR SENATOR BYRD: My father and a partner started this business in 1913. My father and his partner are now dead. The business is now controlled by me and my brother. I am 67 years old and my brother is 62 years old.

I am writing because I am concerned about the effect of the new carryover basis, or the capital gains tax at death, on family businesses. I hope your judgement will cause you to decide to eliminate the carryover basis entirely, because:

1. It will cause serious multiple administrative and tax problems never foreseen.
2. It will destroy the incentive to build medium-sized business.
3. It would produce no meaningful revenue during the next 20 years.
4. It could wreck our business at our death.

I hope you will agree with me and will vote against the above proposed changes.

An expression from you will be appreciated.

Yours very truly,

P. J. CERVABICH, Jr., *President.*

EBCO MANUFACTURING CO.,
Columbus, Ohio, September 14, 1977.

Hon. HARRY F. BYRD, Jr.,
Chairman, Subcommittee on Taxation, Committee on Finance, Dirksen Office Building, U.S. Senate, Washingtno, D.C.
(Attention: Michael Stern, Staff Director).

DEAR SIR: I feel the attention given to the Estate and Gift Tax revisions contained in the 1976 tax reform act is highly inadequate.

As a member of a family business, I feel we are a forgotton group of people. It is unfair that Government caused inflation will cause tremendous increase in Estate Taxes by taxing capital gains.

Sincerely,

Mrs. B. B. BENUA,
Assistant to the President.

EBCO MANUFACTURING CO.,
Columbus, Ohio, September 15, 1977.

Hon. HARRY F. BYRD, Jr.,
Chairman, Subcommittee on Taxation, Committee on Finance, Dirksen Office Building, U.S. Senate, Washington, D.C.
(Attention: Michael Stern, Staff Director).

DEAR SIR: Family businesses are vital to our private enterprise system. Any reform to the 1976 Tax Reform Act should eliminate capital gains on estates. Inflation, not speculation causes tremendous taxes. Why should estates pay for inflation twice.

Sincerely,

KATHY B. CRONIN,
Legislative Coordinator.

RESOURCES INVESTMENT CORP.,
Denver, Colo., September 13, 1977.

Re comments on estate and gift tax revision.

Senator BYRD,
Committee on Finance,
Washington, D.C.
(Attention: Michael Stern, Staff Director).

DEAR SENATOR BYRD: I am a small business owner who has spent the last twenty (20) years of my life building a business for my family. This letter is being sent concerning the disastrous effect of the new carryover basis, i.e. the capital gains tax at death, on family businesses.

There are only two possible solutions:

1. The best solution would be to eliminate the "carryover basis", which (a) causes serious multiple administrative and tax problems never foreseen; (b) destroys the incentive to build medium-sized businesses; and (c) would produce no meaningful revenue during the next two decades.

2. The only alternative solution, as I see it, is to provide that the basis of assets be steeped up in an amount that would equal the total of the following estate liabilities by (a) funeral expenses, administration expenses; (b) estate taxes, and (c) inheritance taxes. These are the same items as those listed in Section 303, which authorizes the redemption of sufficient stock in a family corporation to raise funds to pay them. To be fair, this step-up of basis should apply to all estates, whether Section 303 can be used or not. Perhaps the best and most easily understood solution would be to let the executor select assets having a value equal to the Section 303 liabilities.

Looking at the realities of the situation there is no other solution, if Congress is to give effect to its oft-stated view that family businesses constitute the fundamental basis of our private enterprise system.

Sincerely,

ARTHUR J. PASMAS.

WHITE, SUTHERLAND, PARKS & ALLEN,
Portland, Oreg., September 7, 1977.

Hon. HARRY F. BYRD, Jr.,
U.S. Senator,
Chairman, Subcommittee on Taxation,
Attention: Michael Stern, *Staff Director, Committee on Finance, Room 2227, Dirksen Office Building, Washington, D.C.*

DEAR SENATOR BYRD: I am really pleased to have a chance to comment on the "frozen basis" provisions of the Tax Reform Act of 1976. Most of us here in the outlands felt we had been sandbagged on this issue without real chance to comment. Thank you for keeping an open mind on the subject.

Comment. The "frozen basis" provisions do not distinguish between (a) real, or economic, appreciation in value, and (b) inflationary appreciation in value.

An example of (a), real appreciation, is found in real property, where because it is a non-renewable resource in diminishing supply, real value tends to far outstrip inflation. An example of (b), inflationary appreciataion, is the family business. Here, assuming a fair share of a viable market, the main factors leading to increase in value are (i) the efforts of the proprietors (lost on death) and (ii) inflation.

As to the family business, the book value increase due to the proprietor's skill must increase 6% a year just to "stand still." Any further increases are fought out through a constantly increasing spiral of wage, inventory, and equipment costs. While these are paid for with inflated, or cheaper dollars, the problem of getting more product or service dollars out of customers similarly afflicted is a serious one, which deserves study.

Since Government—the Congress, Executive, and Federal Reserve—have considerable power to affect inflation, the citizens' tendency, on paying taxes on that portion of value appreciation clearly referable to inflation, is to believe themselves to be highly manipulated. I suggest that some method be devised—arbitrarily if necessary—to account for and exempt from tax a rational and equitable factor for merely inflationary value increases.

Comment. These estate *income* tax consequences of selling frozen basis property at appreciated price-value, will simply be horrendous. Yet it will be necessary to sell more of such property to pay the inflated inheritance tax. A rational mathematical case can be made that an entire business can be consumed to pay both taxes, or very nearly so.

I have numerous other comments, but in the interest of brevity and respect for your workload, I have limited myself to these, the most important.

Very truly yours,

MALCOLM J. MONTAGUE.

TESTIMONY OF THE REAL ESTATE, TRUST AND PROBATE LAW COMMITTEE OF THE STATE BAR OF SOUTH DAKOTA

The Real Estate, Trust and Probate Law Committee of the State Bar of South Dakota submits the following account of problems arising from the Tax Reform Act of 1976:

1. CARRYOVER BASIS RULE

A. The onerous burden placed upon executors, surviving spouses, surviving joint tenants, etc. with respect to ascertaining, recording and reporting the carry-over basis. This problem is particularly compounded when, now almost one year after the passage of the statute, we still have no regulations or forms that offer any guidance as to when the report must be made or how to compute carry-over basis. Estate tax returns are falling due, income tax returns will be soon due and there is a total void in the way of guidance as to how to compute or report carry-over basis.

B. The fact that, under Section 1023(b)(3) the ten thousand dollar exclusion cannot be applied to assets independently, or broken down between assets. For example, take the case of a decedent who owned two identical antiques for which he paid a thousand dollars each and they were worth ten thousand dollars each at the date of death. He leaves one of his son and the other to his daughter. One of the children will bet a ten thousand dollar basis under Section 1023(b)(3) and the other will get a one thousand dollar basis (the decedent's basis) because the ten thousand dollar exclusion cannot be apportioned.

C. The requirement that carry-over basis be allocated asset by asset. For example, if a decedent owns stock in one company which has been acquired in numerous small lots, each lot will be construed as a separate asset and the carry-over basis apparently must be computed separately.

D. There was a change in the holding period rules so that there is no longer automatic long-term capital gain treatment for carry-over basis property. The decedent's holding period must be tacked on to the holding period of the estate or the heir. Section 1023(h)(2)(E)(ii) terminates the holding period at death. Tacking of holding periods would appear to be allowed. The automatic long-term capital gain treatment under Section 1223(11) is no longer applicable to carry-over basis property by virtue of the provisions of Section 1014(b).

E. Redemptions of corporate stock under Section 303 will now, in many instances, be subject to capital gains tax because the carry-over basis will be less than the redémption price. This is in fact an additional expense for which a Section 303 redemption should be permitted, but the capital gains tax resulting from the Section 303 redemption does not qualify as an administration expense permitting additonal 303 redemptions.

F. The adjustment to carry-over basis for death taxes under Section 1023(c) is calculated at the average rate of estate tax. Thus any adjustment on audit of the estate taxes will change the average rate of tax. Therefore, it will change the carry-over basis. That would seem to mean that every income tax return filed before the autdit of the estate tax return has been completed will probably be wrong, because if there is any adjustment to the estate taxes, the carry-over basis reported on the income tax returns (in the case of income in respect of a decedent or capital gains) would have to be changed.

Many of the problems that arise with respect to carry-over basis may be insoluble. We are opposed totally to the concept of carry-over basis and urge its repeal.

2. CHANGES IN THE CONTEMPLATION OF DEATH RULE

Outside of the fact that it seems downright unfair to enact a conclusive presumption that any gift made within three years of death is made in contemplation of death, the only problem that we have been exposed to in this area is the question of the operation of the Section 2503(b) exclusion. The general explanation of the Tax Reform Act of 1976 prepared by the Joint Committee on Taxation takes the position that if a three thousand dollar gift is made within the three year period, and the property given is worth six thousand dollars at the time of death, you subtract three thousand dollars from the estate tax value of the gift and the other three thousand dollars is included in the estate. That seems inconsistent with the statute. The property which is the subject of the gift should be excluded from the gross estate if it was worth three thousand dollars or less on the date of gift, regardless of its value on the date of death.

3. DIFFICULTIES AFFECTING FARMERS AND SMALL BUSINESSMEN

Here is a list of problems that we see with using the special use valuation permitted by Section 2032A.

A. The alternative formula for valuing the property (Section 2032A(e)(8)(A) through (E)) seems unworkable because there is no indication of how the

five factors in the formula are interrelated in the determination of special use value. In addition, there is no indication of what is meant by "any other factor which fairly values . . . " provided in Section 2032A(e)(8)(E).

B. In all cases both the value based upon the highest and best use of the property and the special use value must be determined to ascertain qualification for the special use value and to ascertain that the five hundred thousand dollar limit on reduction has not been exceeded.

C. There are numerous administrative complexities, such as the consent of all owners (of present and future interests) must be filed consenting to the recapture tax and to the special lien (how does the guardian of a minor give such consent?) In addition, records must be maintained (by whom?) for fifteen years after the decedent's death to show that during a special eight-year period the qualified heir or family member materially participated in the qualified use and that the qualified use continued for the balance of the fifteen-year period. If an audit of the estate tax return raises the value of non-Section 2032A property, the Section 2032A election could be retroactively disqualified for failure to meet the percentage tests, resulting in interest and penalties on the deficiency in tax.

D. Extreme care must be taken to see that use of the Section 2032A election does not lower the value of the real estate to the point that the election for deferral of tax through the ten or fifteen year installments under Sections 6166 and 6166A is no longer possible. The executor will have to decide if a low value of realty or deferred payment of the tax is preferable.

E. Reducing the value for estate tax purposes by using the Section 2032A election will probably reduce the basis of the property for income tax purposes. Thus, the executor has to choose between saving estate taxes and saving income taxes.

F. It is unclear as to who pays the recapture tax if recapture occurs, qualified property is left to a surviving spouse and the will requires taxes to be paid by the residuary heirs. In that situation, does the marital deduction share bear a part of the recapture tax if recapture occurs?

These kinds of problems put the attorney for the executor in an impossible situation. One certainly should not advise the executor to make the election without the consent of all of the heirs. Yet, since the heirs may well have conflicting interests as to whether the election should be made, each of the heirs should be represented by independent counsel. As a matter of fact, if one is to advise the executor not to make the election, shouldn't all the heirs be involved in that decision, after each having been advised by independent counsel?

We submit that legislation is needed to reinstate the unified credit lost by reason of gifts made between September 8, 1976 and December 31, 1976. The loss of this credit arises by reason of the provisions of Section 2010(c) which reduces the credit in an amount equal to 20% of the aggregate amount allowed as a specific exemption under Section 2521. If the gift made between those dates is brought back into the estate because of the operation of the gift in contemplation of death rules as they existed prior to January 1, 1977, it would seem that an injustice would result. The injustice results because there was widespread publicity prior to December 31, 1976, to the effect that gifts could be made under the old rules prior to December 31, 1976, and there was very little publicity explaining the loss of the credit for gifts made between September 8th and December 31st.

CRESCO LINES, INC.,
Crestwood, Ill., September 6, 1977.

Senator BYRD,
Attn: Michael Stern,
Staff Director, Committee on Finance, Room 2227, Dirksen Office Building, Washington, D.C.

DEAR SENATOR BYRD: I am writing to express my concern about the 1976 tax reform revisions that pertain to estate taxes.

In 1959 my wife and I started a trucking business. Through years of ups and downs we today have a fine company employing over 100 people.

My accounting firm has brought to my attention the new estate tax law, as pertains to a family owned business.

I am now saying to myself. Why am I working so hard?? Senator, all of us who started from a meager beginning look forward to the day when our children can in some way reap the rewards of our hard work. I love my Country and want to contribute my fair share towards paying for our way of life.

Someday, taking away from our children most everything my wife and I labored so hard and long is not an encouraging thought.

Do not take away from us that great virtue, the initiative to get ahead.

I, along with thousands of other family owned Corporations, am hopeful that remedial legislation will correct this almost unbelievable hardship facing our estates.

Respectfully yours,

CHESTER STRANCZEK, *President.*

OMAHA, NEBR., *September 7, 1977.*

Re: Tax Reform Act of 1976—Investigatory hearings by Subcommittee on Taxation and Debt Management.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance, Room 2227, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: I would like to take this opportunity to express to the Committee on Finance my concern with regard to a number of provisions of the Tax Reform Act of 1976 as passed by Congress. My particular areas of concern briefly are as follows:

I. CARRYOVER BASIS—SECTION 2005, TRA; SECTION 1023, U.S. CODE

The carryover basis provisions which were added by the 1976 Tax Reform Act are ridiculously complex—so much so that in many small and medium sized estates the cost of compliance will conceivably exceed the estate tax.

A determination of fresh start basis will require with respect to each asset in the estate (other than listed securities):

(1) the ascertainment of original cost (or date of death value with respect to property inherited by the decedent),

(2) the holding period mandated by Section 1023, and

(3) in the case of depreciable property, a record of depreciation allowed.

The basis so determined will then be adjusted (again on an asset-by-asset basis) for federal and state estate and inheritance taxes attributable to the appreciation therein. These computations become more complex when marital deduction properties are involved. These adjustments also apply to listed securities.

In the case of gifts, tax-free exchanges, Section 351 transfers, and other transactions which were governed by basis and holding period carryover provisions, preceding ownerships must be penetrated in order to determine the original basis.

The burden of identifying, tracing and adjusting for death taxes will be substantial with respect to any multiple asset estate and, in many common situations, will be exceedingly oppressive, if not impossible, to resolve. For instance:

(1) An estate with a valuable collection of coins, stamps, etc., particularly where early acquisitions are not dated or otherwise documented,

(2) the estate of most farmers, particularly those with unregistered cattle herds or hog operations,

(3) an estate with a controlling interest in a family corporation where the corporation was the successor to a proprietorship or partnership business. The determination of basis of such stock in the estate would require an analysis of the Section 351 transaction. The individual holding periods of the capital assets that were transferred would have to be ascertained. The holding period of all other assets would commence with the incorporation. The holding periods thus determined (and there could be many of them) would have to be assigned somehow to the shares in the estate. The problem would be compounded if some of the original shares had been disposed of by gift or sale.

(4) a widow's estate containing valuable gifts (jewelry, perhaps) from her deceased husband. It used to be considered to be crass to leave the price tag on a gift.

A list of such examples is limited only by one's imagination. However, an expansion of the list submitted would serve no additional purpose except that a full realization of the complexities of new Section 1023 can be achieved only by actually getting involved into the mechanics of such determinations.

It should be noted though that even a minor adustment made by an estate tax agent will necessitate a total redetermination of the death tax adjustment for every appreciated asset in the estate.

II. SPECIAL USE VALUATION FOR FARMS AND CLOSELY HELD BUSINESSES—SECTION 2003 (A) TRA; SECTION 2032 A, U.S. CODE

It would seem that "material participation" should not be defined by reference to Section 1402(a) which relates to self-employment tax and which has been a subject of controversy (and abuse). Based upon initial reactions to this area and subsequent questions, it is evident that "material participation" is one of the main problem areas. Definitive standards are badly needed; or, in the alternative, the requirement should be eliminated.

The requirement for material participation can be decidely unfair to the estates of some elderly owners who might have structured their farm affairs differently if the new provisions had been foreseeable.

The disallowance of participation by agency could have a significant effect on the operations of farm management companies and on many country banks that manage farms. The cancellations of management contracts purely for the sake of qualification can easily result in reductions of income to the owners and, in some instances, may require payment of non-productive self-employment taxes or cause cancellation of social security benefits. In addition, the refusal to recognize agency participation will foster devices designed to circumvent or camouflage the agency relationships. Neither can the discriminatory aspects be overlooked. Take, for instance, two estates which own adjacent quarter sections, each worth about $600,000. But, because one was farmed by a family member, who will continue, and the other was supervised by an unrelated manager, who will continue, there being no intent on the part of either set of beneficiaries to dispose of the properties, the first farm will be valued for Federal Estate Tax purposes at approximately one-half of the value of the second farm. It would be very difficult to acceptably rationalize the difference in tax treatment to the beneficiaries of the second estate.

A five-year average of cash rent may be difficult to establish with respect to a grain farm in a given area. This also could lead to considerable controversy.

III. CARRYOVER BASIS SECTION 306 OF THE U.S. CODE

A disposition of 306 stock can trigger ordinary income treatment. Prior to 1977, an estate's receipt of such stock presented no particular problem because the 306 taint was eliminated by virtue of the step-up in basis. Under the Reform Act, however, since basis now carries over, so does the 306 stigma. This means that if 306 stock is redeemed to pay death taxes (Section 303), the entire proceeds could be treated as a dividend. The Congress surely could not have intended such a catastrophic consequence. This is extraordinarily unfair to those taxpayers who, many years ago, accepted 306 stock with the understanding that it could be redeemed without penalty so that death costs could be paid.

IV. SECTION 644, SECTION 701 (E) TRA, SECTION 644, U.S. CODE

This section, in essence, provides that if appreciated property is transferred in trust, and if the trust sells the property within two years, then the tax on the gain may not be less than it would have been had the transferor sold the property.

This represents government regulation at its poorest. It purportedly was designed to curb abuses; however, the abuses could not have been overly prevalent since no significant effect on budget receipts was anticipated. It appears to be another instance of many being penalized for the sins of very few; but, to what effect? The same purpose can be accomplished by making outright gifts, in which event, the donee is not disciplined correspondingly.

An inter-vivos transfer of securities, some of which may have appreciated, to a trust for a child, grandchild, or whomever is common practice. More often than not, the trustee is a bank, and it is virtually automatic for a responsible corporate trustee to analyze the portfolio shortly after the receipt thereof to insure that it can meet the purposes specified in the trust instrument and to establish a sound investment plan. Sales might be dictated for purposes of diversification, better yield, protection, or whatever. It is unfortunate that the trustee will henceforth be inhibited from exercising his fiduciary responsibilities.

There are also practical disadvantages to this section. The grantor's return may not be readily available; different years may be involved; the donor may have loss carry-backs. The solution will be provided by regulations to be issued. When? Where necessary, the Service will compute the tax attributable to the donor;

that is after suitable statements or petitions have been filed. This is much todo about nothing.

It is particularly unfortunate and unfair that the new section was made retroactive to May 21, 1976.

V. CARRYOVER BASIS—MUTUAL FUNDS

(The estate of a decedent who had accumulated mutual funds over a long period of time and had reinvested the dividends.)

Each credit of stock shares created a separate asset which is subject to the adjustment for death taxes. If a decedent had purchased, say 100 shares of Putnam Fund 15 years before he died, there could be as many as 61 separate computations on the accumulated Putnam shares alone in his estate.

Sincerely yours,

WAYNE S. RASMUSSEN,
Attorney at Law.

BANK AND TRUST COMPANY
TAX ASSOCIATION,
Philadelphia, Pa., September 7, 1977.

MICHAEL STERN,
Staff Director, Committee on Finance, Room 2227, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: This writing is devoid of the customary flowery preamble principally to concentrate more fully on the deficiencies and/or apparent generally unanticipated negative results stemming from the 1976 Tax Reform Act.

Respectfully,

ADAM N. ZACCARIA,
Chairman of the Death Tax Committee.

Enclosure.

CARRYOVER BASIS

An extract from our major tax service tells us:

Carryover basis rules for property received from a decedent—Section 2005 of the Act (Tax Reform Act of 1976)—Decedent's basis continues to recipient subject to several possible adjustments.

If the fair market value as of December 31, 1976 is higher than decedent's basis, that basis may be increased by an amount equal to the excess of the fair market value of the property on December 31, 1976 over its adjusted basis on that date.

This step up rule applies only if decedent's adjusted basis reflects the adjusted basis December 31, 1976. Thus, if decedent owns property at his death which he acquired after 1976 in a non taxable exchange for property held on December 31, 1976, the step up rule applies.

Ditto for property received as gift!

Marketable securities.—December 31, 1976—value is to be market value of such securities on that date.

Other property.—December 31, 1976—is obtained:

(*a*) By prorating appreciation in value over the period during which decedent or predecessor whose holding period for the stock is carried over to the decedent; held the property prior to the decedent's death, and

(*b*) By adding the appreciation attributable (on a pro rata basis) to periods BEFORE 1977, plus depreciation, amortization, depletion prior to 1977, to the decedent's adjusted basis as of the date of death.

Proration rule is mandatory, i.e., December 31, 1976 value (other than marketable securities) may not be established by appraisal or other means.

Adjustment by adding Estate and Inheritance Taxes atributable to apreciation in value of property over the adjusted basis therefor (not above fair market value on date of decedent's death).

If aggregate carryover basis of all property subject to carryover rules is LESS than $60,000, a further step up may be taken so that aggregate basis for

that property reaches $60,000 as long as basis for any asset does not exceed its fair market value.

If market at date of death exceeds decedent's adjusted basis and if beneficiary incurs state death tax for which estate is not liable, he may take further basis step up or death tax attirbutable to the appreciation of that property over the decedent's adjusted basis.

Exclusions from carryover basis rules: (1) life insurance, (2) joint and survivor annuities, (3) certain deferred compensation plans, (4) stock options or stock obtained through the exercise of options, (5) stock of personal holding company, (6) gifts within 3 years of death, (7) property subject to general power of appointment disposed of prior to death in a taxable transaction, and (8) revocable transfers.

Executor may elect to exclude up to $10,000 of personal and household effects from carryover basis rule and instead use estate tax value as new basis for such assets.

Rule allowing step up of basis for Gift Tax.—Step up is limited to Gift Tax attributable to any unrealized appreciation.

As under prior act, donee's basis will not be increased beyond the fair market value at the time of gift.

Section 1040—where executor uses appreciated property to satisfy a pecuniary bequest, the gain recognized by the estate will be limited to appreciation above the estate tax value.

Recipient's basis will be the estate's basis for the property used to satisfy the bequest increased by the amount of gain recognized by the estate.

IMPRACTICALLY OF APPLICATION

A. Unavailability of historic basis:

1. No cost basis found in decedent's records at death

2. Inaccuracy of use of certificate dates as purchase date

3. Review of each holding for: (*a*), stock splits, (*b*). rights, and (*c*) stock dividends: I. issue from earned surplus vs. from capital surplus.

4. Particular difficulty with holding of capital or mutual fund

B. Extremely time consuming process:

1. Establishing initial basis figure.

2. Gleaming data for adjustment.

3. Application of formula for each individual acquisition for each security holding.

4. Comparison of result for each as to gains or loss treatment separately with gains handling one way and losses another.

5. Maintenance of separate costs for State Taxes.

C. Because of decedent's fractional acquisition scheme, vis through stock purchase plan at his place of employment or otherwise, frequently at death, his stock holding could be composed of many small multiple holdings each requiring the multi-step process previously referred to above.

D. See Schedule [1] setting forth steps required to accomplish basis for each holding of each bond or security held by decedent:

1. A nonsophisticated fiduciary will either: (*a*) ignore rule, and, (*b*) be forced to seek expert assistance at obviously additional cost to estate or trust

* * * * * * *

Wow!!

One may now inherit negative basis!

A beneficiary who inherits property subject to a liability that exceeds the carryover basis from the decedent may be sitting on potential income tax liability greater than the value he receives.

As basis is no longer raised to fair market value, beneficiary gets decedent's adjusted basis, stepped up by fresh start adjustment for property held before January 1, 1977. But except for certain Marketable Securities, adjustments ordinarily won't raise decedent's basis up to fair market value at his death.

Thus—negative basis:

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[1] See Schedule—Carryover Basis Adjustments.

Real estate purchased before 1977	20,000
Increased in value to	150,000
Mortgage placed on property	100,000
Ignoring mortgage, current worth	110,000
Real estate	20,000
Fresh start addition	50,000
New basis	70,000
Son inherits worth	10,000
i.e. Current worth	110,000
Less mortgage	100,000
Net Equity	10,000
If son sells @110,000	110,000
Basis	70,000
Gain (× 35 = percent bracket)	40,000
Gains Tax	14,000

Tax would be 4,000 more than economic profit of $10,000. (Minimum tax not considered.)

Recommendation

Complete elimination of Sec. 1023 carryover basis for certain property acquired from a decedent dying after December 31, 1976.

APPRECIATED SECURITIES ONLY

[illegible]		[illegible] 12/31/1976 VALUE	[illegible] VALUE	ALTERNATE VALUE	[illegible]	FEDERAL: COL. 5 ÷ [illegible]	TOTAL [illegible] TAX PAID	COL. 6 X COL. 7: ADJUSTMENT FIGURE	STATE: COL. 5 ÷ [illegible]	TOTAL [illegible] TAX PAID	COL. 9 X COL. [illegible]: ADJUSTMENT FIGURE	STEPPED-UP CARRYOVER BASIS AFTER DEATH TAX ADJUSTMENTS: *GAIN COL. 2+8+11	LOSS COL. 1+8+11

A) [illegible] ______

B) [illegible] ______

* NOT TO EXCEED COL. 3 OR 4 [illegible]

RECOMMENDATIONS

Because of the impracticality of carryover basis as presently set forth in paragraph 2005 of the Tax Reform Act of 1976, we strenuously urge the following changes or adjustments:

(*a*) A specific exemption for household furnishings and personal effects be written into law, thus avoiding the necessary research and development of cost basis records for rather obviously small and insignificant items. We do not suggest that this exemption be extended to collection of antiques, paintings, stamps, coins, etc. As an example of the above, would you ask your dear Aunt Sara the cost basis of a wedding gift?

(*b*) The fresh start rule for property rather than marketable bonds and securities calls for the use of *days* in determining the appreciation subsequent to December 31, 1976. This seems rather burdensome when using months is more feasible.

(*c*) As pointed out by Byrle M. Abbin in his article on Carryover Basis appearing in the March 1977 issue of Trust and Estates, there is definitely a need for a better definition of what is exactly meant by the term "marketable bonds and securities."

(*d*) The executor should be allowed to use average cost for each security holding in determining any carryover basis adjustment as opposed to the present requirement for making such adjustments to each individual lot.

(*e*) With respect to the negative basis situation outlined above, a limit as to the beneficiary's exposure to Income Tax should be established so that his Income Tax liability could never exceed the economic benefit received by way of a bequest or inheritance.

(*f*) In light of Gift and Estate Tax unification, a discrepancy still exists with respect to basis of property acquired by reason of death or gift, should not the donee of gifted property receive the same basis adjustment as a beneficiary?

(*g*) Small estates particularly those not required to file a Federal Estate Tax return should be allowed a step up in basis to date of death values of all property. This in effect would eliminate the necessity of the basis adjustment for $60,000 or less carryover basis property and free such small estates from the carryover basis burden.

POSSIBLE ALTERNATE APPROACH IN LIEU OF CARRYOVER BASIS

Recommendation: Taxation of Appreciation at Death.

To mitigate the burden provide a diminuative scale of credit or exclusion so that 100% of such gain is exempt in estates 1978, or year enacted, reducing to 0 in 1983 so that the exclusion or credit reduces 20% for estates in each successive year.

A deduction similar to the income with respect to a decedent may be allowed to overcome the obvious double taxation of the gain for income tax as well as estate tax. Although this alternative would not obviate the necessity of establishing or obtaining the historic basis, it would overcome the problem of the various adjustments for death taxes $60,000.00 minimum basis, etc. Likewise, there would be no need to consider a different basis for each holding re gain or loss.

* * * * * * *

Giving Executor right to make non-pro rate distributions of property now a must.

Problem Created by New Carryover Basis Rules:

If the will or state law is silent as the Executor's authority to make a non-pro rata distribution in kind, the such distribution made with the consent or agreement of the beneficiaries are to be treated as an exchange of property be-between the beneficiaries to the extent of the non-pro rata portion, with resulting taxable gain or loss.

Because of the new carryover basis rules, there may be substantial conflicts of interest between beneficiaries over distribution of assets in kind with more or less favorable basis. Such conflicts may have to be settled by agreement of the beneficiaries as to who should get which property.

Empowering the Executor to make any agreed non-pro rata distributions may avoid the possibility of taxable gain.

* * * * * * *

Owners of a life interest in a testamentary trust were pre 1976 able to sell their interest at practically no gain, while buyer could then amortize his cost. The Code was then amended to stop this by barring any basis for the life interest, thereby making the entire sale price taxable to a potential seller.

BEST COPY AVAILABLE

Under the 1976 Tax Reform Act carryover basis rule, a person who inherits a life estate in a trust can again have a basis for his life estate, so that the sale procedure has been opened up again.

TRANSFER TAKING EFFECT WITHIN 3 YEARS OF DEATH

Gifted property within three years of death is included regardless of motive. Also, this property will be included at its value as of the date of death (not the value when the gift is made), and this is so even if the donee has sold or given the property to someone else before he dies.

A gift of property other than cash has been labeled a virtual "time bomb" in several of our tax services. This results as no donor has a guaranteed additional three years of life and property can increase substantially in value between the date of gift and date of death.

Further concern over the "time bomb" seems justified assuming a will contains a tax paragraph directing all taxes from residue of the estate. Assuming further that transferred property appreciates between date of gift and date of death, the donee through sale within three years of death realizes a windfall profit. There would appear a serious inequity as the heirs of the estate must bear burden of Federal Estate Tax on the sale value and donee enjoys the gift appreciation. It would appear conceivable such a construction could serious diminish or cause the estate to be insolvent!

It is strenuously urged that property disposed of by the donee be included in the decedent's estate for Federal Estate Tax purposes not at the date of death or alternative values, but rather at the proceeds of sale of such property net of any Federal or State Income Tax consequences.

ADDITIONAL RECOMMENDATIONS

Provide an exception to Non-Rebutable Presumption Rule where death resulted from accidental causes and/or where a transfer was accomplished before a certain age (Example—Age 50).

MISCELLANEOUS

Re: income in respect of the decedent

Recommend revision of Section 691 allowing deduction based upon the highest estate tax bracket of the estate not average.

Implementation of the post 1976 method i.e. multiplication of the estates taxes the net amount of income in respect of the decedent over the value of the decedent's gross estate seriously diminishes the deduction.

If the true purpose of this deduction is to aid in overcoming double taxation, establishing a tax credit of the amount so established might be more realistic, equitable, and achieve the result intended.

FIRST UNION NATIONAL BANK,
Charlotte, N.C., September 6, 1977.

Re: 1976 estate and gift tax legislation.

Hon. HARRY F. BYRD,
Chairman, Subcommittee on Taxation and Debt Management, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

Attention: Michael Stern, *Staff Director.*

GENTLEMEN: We wish to offer the following comments on the estate and gift tax legislation passed by the United States Congress in 1976, specifically relating to the carryover basis provisions of the Tax Reform Act of 1976.

We believe that the enactment of carryover basis legislation is creating serious and insurmountable problems for both taxpayers and practitioners, to wit:

I. Determination of original cost basis:

A. Many, if not most, persons lack sufficient records as to their cost basis for assets so that original basis cannot be determined with a reliable degree of accuracy. This is particularly true of items such as household furnishings, personal effects such as jewelry, clothing and the like, inherited or donated property and noncommercial realty, for the simple reason that these items are seldom sold or exchanged and the need for cost basis while the taxpayer is still living is negligible.

B. The decedent's survivors are seldom knowledgeable about the decedent's affairs to the extent that they can provide the needed information.

The primary impact of this problem is that carryover basis cannot be determined without reference to the decedent's original basis. If the original basis cannot be determined, a sale of the property will result in a larger capital gain or a smaller, if not nonexistent, capital loss. For example, 100 shares of X stock acquired in 1977 for $1,000 will have a basis for gain and loss of $1,000 plus the "basis bump" adjustment (assume this equals $100), or a total of $1,100. If the stock is sold for $2,000, a gain of $900 results; if sold for $500, a $600 loss results. However, if the original basis cannot be determined, the maximum basis may be only the "basis dump" of $100. If sold for $2,000 the gain is $1,900; if sold for $500, a gain of $400 is realized rather than the loss the heirs would have been entitled to had the true cost basis been known.

C. Even if records are available in excellent condition, the process of determining the basis immediately prior to death is costly and time consuming. An excellent example is an estate of $900,000 recently encountered by the undersigned: the decedent passed away in February, 1977, and left excellent and complete records as to his basis for all assets owned in his safe deposit box. Despite this wealth of information, it has taken the personal representative 6 months to bring it up to date so that initial basis for gain and loss can be determined. In the meantime, it has been necessary to sell some of the assets to pay expenses; the investments department could not ascertain the amount of gain or loss on the sale of those assets since that initial basis was still being determined. The bookkeeping and tracing of costs is voluminous, particularly when capital changes in securities and capital improvements in realty are involved.

II. Appreciation from date acquired (or fresh start if held on December 31, 1976) to date of death is taxed at least twice: once in the form of estate tax and again in the form of income or transfer tax when the heir to the property disposes of it by death, gift or sale. The only exception to the double taxation would be if the property were bequeathed or donated either to charity or to the spouse of the taxpayer, and then only if charitable and marital exemptions were allowable.

III. The $10,000 personalty exemption is insufficient for most estates. The figure should be at least $25,000. When one considers the value of personal possessions today, including the typical two-car family situation, $10,000 is unrealistic. In many instances, family antiques, jewelry, art and coin collections and cars more than consume the $10,000. These items not infrequently are placed on the market, causing for those not falling within the exemption the same problem discussed above for assets with unknown basis. The income tax treatment of these assets is therefore unequal when some personality will fall within the exemption and some will not. To increase the exemption to at least $25,000 would be an equitable solution; however, repeal of the carryover basis provisions would be the wisest and most equitable solution.

IV. "Basis bump" for death taxes:

A. The adjustment to basis for gain and loss attributable to death taxes paid on carryover basis property ("basis bump") cannot be computed with certainty until the death tax returns are accepted by the taxing authorities.

This process takes anywhere from six months to two years following the filing of the returns.

1. This means that sales of carryover basis property within the settlement period must be reported erroneously, i.e., without the basis bump, and the income tax returns must be amended at a later date when the adjustment is ascertained. Amended returns are costly and time consuming and would necessitate prolonged administration of the estate until additional taxes are paid or refunds received. Payment of additional taxes would require payment of interest at the expense of the estate.

2. Some carryover basis assets are not eligible for the basis bump on the theory that they are not liable for payment of death taxes. The most prevalent example of this theory is the marital deduction assets which pass to the surviving spouse free of tax. In an estate where assets are sold during administration prior to the division of the estate into marital and residuary shares, it is difficult if not impossible to ascertain the reason for sale, i.e., was the asset sold for investment and/or administrative expense reasons or to generate funds for payment of taxes? We can see only three alternative solutions to this problem:

(a) Establish the marital trust immediately or make outright distribution to the surviving spouse immediately. All assets sold in the residuary will then be

considered sold for payment of taxes to the extent necessary. This solution, however, negates any income tax planning which is possible for the initial year of the estate. In many cases, it is desirable to cut the initial year of the estate short to fall within the year of death of the individual, distribute income to the widow and give her an opportunity to use her joint income tax rate privilege to the fullest extent while minimizing the income tax to the estate at the same time. This tax minimization planning is destroyed with an immediate distribution of marital assets, since such a distribution would result in taxable income to the widow to the extent of distributable net income of the estate for the period.

(b) Instruct the investment portfolio manager to differentiate between assets sold for investment purposes and assets sold to pay taxes. This solution is not workable because the investment manager will frequently sell assets for dual reasons, i.e., the estate needs the funds for taxes so he will sell assets which should be sold anyway for investment reasons. Query: Does the tax reason for sale override the investment reason?

(c) The only other alternative is the obvious, both from the common sense standpoint and from the standpoint that the law is not enforceable: *repeal* those provisions dealing with carryover basis.

V. The concept of carryover basis will lead to sales in contemplation of death wherever possible to avoid leaving the heirs with the problem. The sale, if it takes place immediately prior to death, could result in a debt of the decedent equal to the income tax payable by reason of the sale, which would reduce the estate and inheritance taxes payable. The implications of this are obvious.

VI. In states where federal laws have not been adopted, the bookkeeping problems are multiplied for the personal representative and beneficiaries of the estate. Not only does one have two cost cases for federal income tax purposes (one for gain and one for loss) one has cost basis for state income tax purposes; all three may differ from each other. Different federal and state laws also create the problem of two bases for depreciation computation.

VIII. The majority of beneficiaries do not understand the prior law and the new law will complicate matters further. One must consider the noncorporate/non-attorney executor who finds himself administering an estate with problems he may not even recognize much less be able to solve. The average beneficiary will not understand the dual bases theory and the information presented to him by the personal representative upon distribution of the assets will be an item shelved and forgotten for lack of understanding.

VIII. Professional people, whether they be corporate executors, attorneys or accountants, will find themselves in need of additional personnel and/or equipment to handle the increased paperwork involved with carryover basis assets and their administration. The increased costs associated with this will ultimately be passed to the client; the result may well be that the taxpayer will not only be paying more taxes, but will also be paying someone more to figure what he owes.

In conclusion, we cannot urge too strongly that the Congress seriously consider repeal of the carryover basis provisions of the Tax Reform Act of 1976. It is our firm belief that, had the consequences of these provisions been realized, they would never have been enacted. The only equitable correction is that of retroactive repeal.

Respectfully submitted,

ELIZABETH L. MEYER,
Assistant Vice President and Trust Officer.

AMERICAN COUNCIL OF LIFE INSURANCE,
Washington, D.C., September 9, 1977.

Hon. HARRY F. BYRD, Jr.,
Chairman, Senate Finance Subcommittee on Taxation and Debt Management, Dirksen Senate Office Building, Washington, D.C.

DEAR SENATOR BYRD: The purpose of this letter is to urge that, in the Subcommittee's review of the estate and gift tax problems arising from the Tax Reform Act of 1976, especially those affecting estates containing interests in small, closely-held businesses, consideration be given to a technical, but significant tax problem created by the Tax Reform Act in the case of stock buy-out arrangements. The problem results from the interrelation of the income tax "transfer for value" rules applicable to life insurance policies and the new

"carryover" basis rules contained in the Tax Reform Act of 1976. In this regard, we would appreciate having this letter included in the printed record of the hearings being held on this subject by your Subcommitttee.

The American Council of Life Insurance has a membership of 446 life insurance companies which have in force approximately 92 percent of the life insurance written in the United States.

NATURE OF PROBLEM

A very common method of retaining control of a corporation in the hands of the surviving shareholders on the death of one of the shareholders, especially in small, closely-held corporations, is a stock buy-out arrangement. Such an arrangement has historically taken one of two forms and, in either form, is usually funded with life insurance on the lives of the shareholders. Under one alternative—a stock redemption agreement—the corporation owns the life insurance policies on the lives of the stockholders and uses the proceeds of the policies to purchase and retire the stock of decreased shareholders. Under the other form—a cross-purchase agreement—the shareholders own the life insurance policies on the lives of each other and use the proceeds to purchase the stock of deceased shareholders.

Prior to the enactment of the Tax Reform Act of 1976, the basis of property acquired from a decedent generally was the fair market value of the property at the date of the decedent's death. (Section 1014(a) of the Internal Revenue Code). The Tax Reform Act of 1976 added section 1023 to the Code which eliminated the "stepped-up" basis rule for property of decedents dying after December 31, 1976. Section 1023 provides that generally the basis of property acquired from a decedent is the decedent's basis in the property immediately before his death ("carryover" basis). The result of this change is to put the stock redemption agreement form at a significant tax disadvantage to a cross-purchase agreement in a substantial number of cases where before there were no tax disadvantages, in these cases.

The following examples illustrate the problem created by the Tax Reform Act of 1976:

Assume co-shareholders A and B each own 50 percent of the stock of Corporation X. The value of the corporation at all times is $1,000,000. Each shareholder owns 1,000 shares of stock with a tax basis of $10,000. Each shareholder is insured for $500,000 under a buy-out arrangement where the stock of a deceased shareholder is to be purchased at its value at the date of death. If the arrangement is in the form of a stock redemption agreement, Corporation X would receive $500,000 of life insurance proceeds upon A's death and would purchase A's stock for $500,000. B would now be the sole owner of the corporation, His basis in his stock in the corporation would still be $10,000. The potential gain on the sale of the stock after B's death (under the new carryover basis rules), would be $990,000 ($1,000,000 value—$10,000 basis in the stock).

Assuming the same facts except that a cross-purchase arrangement is utilized instead of a stock redemption agreement, B (who owns the life insurance policy on A's life), would receive the $500,000 life insurance proceeds upon A's death and would purchase A's share for $500,000. As in the first case, B would be the sole owner of the corporation. However, the basis for all of B's stock in the corporation would be increased to $510,000. ($10,000 original basis plus $500,000 basis for A's stock.) Therefore, the potential gain on the sale of the stock after B's death would be only $490,000 ($1,000,000 value of the corporation—$510,000 basis in the stock).[1]

Prior to the 1976 Tax Reform Act changes, the basis of the stock would, on B's death, be stepped up to its value at that time with the result that the tax consequences of its sale thereafter would be the same under either arrangement.

The simple solution to the problem is to change existing stock redemption plans to cross-purchase plans. However, if the corporation in the example either sells or distributes the policies to the shareholders to accomplish this result, a portion of the life insurance proceeds will lose its tax-exempt status under section 101(a) of the Code. The reason is, as explained below, that such a transfer runs afoul of the transfer for value rule (Section 101(a) (2) of the Code). [It should be noted that a change the other way, that is, from a cross-purchase arrangement

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[1] While we recognize that a similar difference in realized gain will occur if the stock is sold before B dies, as a practical matter, the stock of shareholders is closely-held corporations is rarely sold prior to death.

to a stock redemption plan, can be accomplished without adverse tax consequences since there is an exception to the transfer for value rule for this type of transfer under section 101(a)(2)(B) of the Code.)

Section 101(a)(2) of the Code provides generally that if a life insurance contract is transferred for a valuable consideration, only the actual value of the consideration and subsequent premiums paid by the transferee are excluded from the beneficiary's gross income on the death of the insured. The legislative history of this provision indicates that Congress was concerned that a full exemption for life insurance proceeds in a transfer for value situation could result in trafficking of insurance policies and, thus, encouraging speculation on the death of the insured. (S. Rept. No. 1622, 83rd Congress, 2d Sess., p. 14 (1954)). Congress recognized, however, that transfers for value could take place for certain legitimate business reasons and therefore provided certain exceptions to the transfer for value rule. Accordingly, complete exemption is provided for life insurance proceeds paid under a contract which has been transferred to the insured, to a partner of the insured, to a partnership in which the insured is a partner or to a corporation in which the insured is a shareholder or officer. However, no exception is provided where the transfer is from a corporation to a co-shareholder of the insured.

If such an exception is not provided, the only way shareholders will be able to change from a stock redemption to cross-purchase arrangement without incurring the adverse tax consequences flowing from section 101(a)(2) will be to let the corporation policies lapse and to purchase new policies on the lives of their co-shareholders. We do not believe such an approach should be encouraged since it is an inefficient and expensive way to achieve the desired result. Moreover, because of a change in circumstances between the time the corporation originally bought the insurance and the change to a cross-purchase arrangement is to occur, one or more shareholders may have become uninsurable and, therefore, ineligible for the purchase of new life insurance.

PROPOSAL

We believe that the unequal application of the new carryover basis rules to stock redemption plans and cross-purchase arrangements was an unintended result of the Tax Reform Act of 1976. Thus, we urge that any legislation developed by your Subcommittee include a provision that would amend section 101(a)(2) of the Internal Revenue Code to remove the tax impediment to changing from a stock redemption to a cross-purchase arrangement. This could be accomplished by adding to the exceptions to the transfer for value rule an exception for a life insurance contract which is transferred from a corporation to the co-shareholder of the insured.

We would be happy to attempt to furnish any additional information which you or your Subcommittee might think helpful.

Sincerely,

WILLIAM T. GIBB.

ROCKWELL CITY, IOWA, *September 6, 1977.*

Re: Objections to the Tax Reform Act of 1976.

Mr. MICHAEL STEARN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

SIR: Commerce Clearing House, Inc., has furnished information which indicates that numerous Congressmen are dissatisfied with the Tax Reform Act of 1976, and especially with the "carry-over-basis rule" and the "special-use valuation for farms and closely held businesses".

According to Federal Estate and Gift Tax Reports, (Number 16, August 8, 1977), the 1976 Act has been referred to and described as follows:

"Although the objective of the Tax Reform Act of 1976 was to provide relief for small- and medium-sized estates, the new provisions achieve the opposite result."

"triumph of theory at the expense of practicality,"

"... that, although the special-use valuation provision purports to give farmers tax relief, application of the rules is so restricted that most persons are outside its scope."

". . . the new provisions may generate additional revenue, but, the price of this gain is uncertainty, complexity and additional administrative cost for U.S. taxpayers."

Many of us Iowa lawyers object to the carry-over basis rule because: (1) it probably cannot be administered by the Internal Revenue Service effectively; (2) in many instances the person who could supply the information necessary to comply with the rules will be deceased; (3) the future record keeping required by the Act will be staggering to the lawyer, and (4) very few taxpayers will ever be capable of understanding the effect of the Act which seems to be the exact antithesis of an over-all announced goal of tax simplification.

I will appreciate your bringing these objections to the attention of the appropriate parties and committees.

Respectfully,

L. S. HENDRICKS.

CEDAR RAPIDS, IOWA, *September 7 1977.*

Hon. HARRY F. BYRD, Jr.,
Committee on Finance,
Dirksen Senate Office Building,
Washington, D.C.

SIR: Is there any fair definition of death taxes other than "Communism?" The courts relied on nebulous fictions to find death taxes constitutional at a time when such taxes hardly were noticeable and affected very few, and when few Americans had heard of Communism. Death taxes take property which has been subjected to every kind of tax during the decedent's lifetime. The government furnishes no added service for the property it takes. To have Communism forced upon us by our own government is bad enough when done politely, but the monstrosity referred to as the "Tax Reform Act of 1976" is tyranny beyond that which provoked our Revolutionary ancestors.

There is no constitutional obligation for a person to die charged with enough property for the government to confiscate. The "contemplation of death" theory and the new law tax property which the decedent has given away before his death. If he squandered it in extravagance or reckless investment it is not brought back into his estate to be taxed.

The tax reformers in their beneficent plan to eliminate discrimination against those who make lifetime sales of their property, as compared with those whose property is sold after death, brought forth the "carryover basis", undoubtedly a lowest form of bureaucratic design for unproductive frustration. How many Senators and Congressmen understand it? After all the costs of trying to comply and all the deductions arising from those costs, what net revenue will the government derive? This alone could lead to many changes in who our future Senators and Congressmen will be. More time is spent in keeping score than in playing ball.

All that was needed for reform of the estate and gift tax laws was a simple recognition that the exemptions were outdated by inflation. Time which could be used productively by taxpayers now must be spent trying to comply with more governmental rules and regulations to keep the bureaucrats occupied at public expense.

If we must have Communism in America (while condemning everything Communistic), please take appropriate action to restore the old estate and gift tax laws, with proper exemptions, and abolish carryover basis.

Sincerely,

ROBERT W. NEFF.

RWN/de

STATEMENT OF RICHARD W. STEWART

The average taxpayer is going to be confused and angry when he has to contend with the carryover basis rules enacted by the Tax Reform Act of 1976. As an attorney in a small town, I have had an opportunity to explain the carryover basis "reform" to many couples whose estates are modest. These hard working, middle class people are invariably shocked and outraged at the mess Congress has created.

BEST COPY AVAILABLE

I would like to acquaint the Subcommittee with a few of the problems that the carryover basis rules will create for the average family whose elders are fortunate enough to have a little property to pass on to their children.

The new rules will make modest sized estates so complex to administer that it will probably be impossible for a layman to do any of the work himself. The amounts spent on attorneys and accountants will skyrocket. Much time and effort will have to be spent in calculating the basis of each asset for future income tax purposes. Instead of simply taking the date of death value of each asset, the administrator will have to sort through records to find out what the decedent paid for the property. If the administrator is lucky enough to discover the original purchase price, he will then have to make a complicated series of adjustments for the "fresh start," and federal estate taxes, state inheritance and estate taxes, and other things that cause the eyes of accountants to light up.

The new rules place an unwarranted premium on record keeping since it is essential to know when a decedent acquired each asset and what the purchase price was in order to determine the basis of the property. Of course, this will pose no problem for the wealthy since they have flocks of accountants to document their purchases. The average person, however, usually doesn't keep meticulous records. Often the administrator has no way of knowing what the original cost of an item was. As a result, the administrator will have to depend on the Internal Revenue Service to assign a value. The average person will either have to spend his lifetime meticulously documenting his finances for the next generation or he will have to let his administrator take his chances with the whims of the I.R.S.

Distribution of an estate will also become more complicated. An administrator who wants to distribute an estate in kind in equal shares will be able to do so only with the aid of a computer. Assets that have equal fair market values as of the time of distribution would not be of equal value from an economic standpoint if they had a different basis for income tax purposes. The person receiving the property with the lower basis would receive an asset that was worth less than the person who received the property with the higher basis. Thus, it will no longer be a simple task for the heirs of a decedent to divide the estate into equal shares.

The Tax Reform Act of 1976 was supposed to be a blessing for people with estates of modest size. The carryover basis provisions will make the average citizen think of the Act as a curse. The average citizen will not be able to understand all of the pages in the Internal Revenue Code devoted to Section 1023. All he will know is that life and death are much more expensive and complicated because of these provisions. Congress should act now to keep the administration of modest sized estates a simple process by repealing the carryover basis provisions of the Tax Reform Act of 1976.

HAMPTON, ROYCE, ENGLEMAN & NELSON,
Salina, Kans., September 6, 1977.

Mr. MICHAEL STERN,
Staff Director, Senate Committee on Finance,
Room 2227, Dirksen Senate Office Building,
Washington, D.C.

DEAR SIR: We have been advised that the Subcommittee on Taxation and Debt Management will conduct a fact-finding investigatory hearing to explore estate and gift tax problems arising under the Tax Reform Act of 1976. We would like for you to carefully consider the following matters:

1. The carryover basis provisions are exceedingly complex and difficult for a tax practitioner to economically administer. Taxpayers simply have not been required to nor have they maintained detailed records concerning the date, cost and nature of the acquisition of each asset to the extent necessary to make any reliable computations under the carryover basis provision. The cost of reconstructing these records could become an enormous task in many situations. The responsibility of the Executor to furnish detailed information concerning carryover basis property to the Internal Revenue Service and the beneficiaries is unrealistic and should be modified. The cost of compliance with these provisions may substantially offset any tax benefits realized by modest estates.

2. The carryover basis provisions substantially changes the manner in which Section 306 is applicable to stock redemptions. Apparently this was an oversight

and an unintended result of the Tax Reform Act of 1976. We would suggest that Section 306 be specifically amended so that it is no longer applicable to any shares of stock acquired by or from a decedent.

3. The provisions dealing with the valuation of farm property on the basis of its earnings are beneficial and will permit the continuation of many family farming operations. The special lien for payment of additional estate taxes should be modified to permit the granting of prior purchase money mortgages and security interests so that the farming operation can continue to obtain normal financing. Farm operations require a considerable amount of debt financing and it is important to maintain a degree of flexibility in protecting the lines of credit which are available to family farming operations.

4. The new tax with respect to generation skipping transfers creates an artificial consideration in determining whether trusts should continue from one generation to the next. We feel that these provisions are extremely complex and difficult to apply in specific situations. The exemption with respect to distributions to grandchildren of the settler are not broad enough to exclude most modest estates from the application of these provisions. Certainly a fixed dollar exemption is not compatable with the rates of inflation which we have sustained and are likely to continue to sustain for the foreseeable future. In addition, we would call your attention to the following specific questions:

(*a*) Section 2613(b)(5) provides that a taxable termination does not include a transfer to a grandchild of the grantor subject to the limitations set forth in Section 2613(b)(6). A "transfer to a grandchild of the grantor" should be more specifically defined. Would this include a transfer in trust for the benefit of a grandchild of the grantor? Is it necessary for the property to be includible in the gross estate of the grantor's grandchild in order for this exemption to apply?

(*b*) Section 2613(d)(2) defines the term "power" to include any power to establish or alter beneficial enjoyment of the corpus or income of the trust. Under this provision a Trustee who has any discretionary powers with respect to investments or distributions would no doubt be considered a beneficiary of the trust. This raises havoc with the definition of a younger generation beneficiary and a deemed transferor. We would suggest that the definition of a power should specifically exclude any power held by a person as a fiduciary so long as such person is not otherwise a beneficiary of the trust.

(*c*) Section 2613(e) provides a limited exemption from the generation skipping transfer rules for limited powers to appoint property among lineal descendants of the grantor. We feel that this should be broadened to include the exercise of a limited power of appointment, outright or in trust, in favor of lineal descendants of a grantor and the spouse or spouses of any lineal descendants of a grantor.

We feel that the foregoing provisions constitute the major items which should be carefully reviewed and reconsidered since it appears that substantial difficulties will be encountered by tax practitioners, estate planners and administrators with respect to these matters with very little benefit being obtained in the form of additional revenue as a result of these extremely complex and ambiguous provisions.

Very truly yours,

TOM W. HAMPTON.

WHITE, PRICHARD, FLORES & HAVENS,
Storm Lake, Iowa, September 7, 1977.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Room 2227, Washington, D.C.

DEAR SIR: As a practicing attorney in a small town law practice, I would strongly urge you to support any legislation to repeal the "carry-over-basis rule" of the 1976 Tax Reform Act.

This rule requires extensive record keeping of all purchases of property owned by a decedent at the time of his or her death. These records involve complicated computations as to each item owned by a decedent and must be passed on to the Internal Revenue Service and the decedent's heirs.

This rule and its record keeping requirements will be a nightmare from the standpoint of record keeping and adding to the overhead of law offices, account-

ing offices and bank trust departments. This overhead will have to be passed on to the heirs, beneficiaries and other recipients of a decedent's property.

At a time when our government is striving supposedly to simplify our tax system the "carry-over-basis rule" would do the exact opposite.

Yours very truly,

JAMES M. PRICHARD.

STATEMENT OF THE FOREST INDUSTRIES COMMITTEE ON TIMBER VALUATION AND TAXATION

We respectfully submit for the consideration of the Committee on Finance the views of the Forest Industries Committee on Timber Valuation and Taxation concerning the recent amendment of the estate tax laws by the addition of section 2032A (Valuation of Certain Farm, Etc., Real Property) and section 1023 (Carryover Basis For Certain Property Acquired From A Decedent Dying After December 31, 1976) of the Internal Revenue Code (the "Code").

As discussed below, we believe that section 2032A is an important and equitable provision. However, section 2032A contains two conditions that render it inadequate to fulfill the purposes for which it was adopted. We further believe that section 1023 is an ill-conceived and inadvisable provision which creates enormous administrative burdens and inequitable consequences for everyone, including farmers and timber farmers.

SECTION 2032A ("USE" VALUATION)

In general, property owned by a decedent is included in the decedent's gross estate at its fair market value, determined on the basis of the property's "highest and best" use. Section 2032A of the Code, added by the Tax Reform Act of 1976, provides an exception to the general rule for real property (including woodlands) which is devoted to farming purposes (including planting, cultivating, caring for and cutting of trees, and the preparation [other than milling] of trees for market) or used in a closely-held business. If certain conditions are met, such real property may be valued on the basis of the highest and best use of the property.

Section 2032A recognizes the unusually heavy estate tax burden placed on the estates of farmers and owners of small businesses. However, section 2032A contains two conditions which in many cases will inappropriately deny or restrict the relief provided by the section. These two conditions are (1) the requirement that "use" valuation be available only where there was "material participation" by the decedent (or a member of his family) in the farm or timberland in a manner similar to that applied in section 1042(a)(1) of the Code, and (2) the requirement that the aggregate decrease in the valuation of the estate attributable to use valuation may not exceed $500,000. As discussed below, we believe that these two conditions should be deleted or revised.

THE MATERIAL PARTICIPATION TEST

The material participation test is contained in section 2032A(b)(1)(C)(ii) of the Code. This section provides that, in order for farm or small business property to qualify for use valuation, there must have been "material participation" by the decedent or a member of the decedent's family in the operation of the farm or other business for at least five of the eight years ending on the date of the decedent's death.

Section 2032A(e)(6) defines the term "material participation" by stating that it shall be determined in a manner similar to the manner used for purposes of section 1402(a)(1) of the Code. Section 1402(a) defines the term "net earnings from self-employment" for purposes of computing the tax on self-employment income. Generally, net earnings from self-employment means the net income derived by an individual from his trade or business. Section 1402(a)(1) provides that such net income excludes rentals from real estate (and personal property leased with real estate) except if:

"(A) such income is derived under an arrangement, between the owner or tenant and another individual, which provides that such other individual shall product agricultural or horticultural commodities . . . on such land, and that there shall be material participation by the owner or tenant (as determined without

regard to any activities of an agent of such owner or tenant) in the production or the management of the production of such agricultural or horticultural commodities, and (B) there is material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) with respect to any such agricultural or horticultural commodity."

The Treasury Department has promulgated regulations under this provision which provide guidelines in applying the term "material participation." Treas. Reg. § 1.1402(a)-4. Under these regulations, services performed by an agent of the owner are considered services performed by the owner in determining the extent to which the owner has participated in the production or management of production of a commodity. However, these regulations were issued prior to the addition in section 1402(a)(1) of the two identical parenthetical phrases which provide "(as determined without regard to any activities of an agent of such owner or tenant)." The parentheticals were added by H.R. 93-368, effective January 1, 1974. Because of the parentheticals, it is unclear, but doubtful, whether an owner who retains an agent to consult with and advise the tenant or producer, or to inspect the land, will be deemed to have materially participated in the operation of the farm to a sufficient degree to qualify for "use" valuation.

We believe the activities of an agent should be attributed to the farmer or timber farmer to determine whether the land qualifies for "use" valuation. The cross-reference in section 2032A(e)(6) to section 1402(a)(1) should therefore specifically delete the parentheticals in determining "material participation." In the case of farms and timeberlands, the test of "material participation" should be met by the existence of a professionally planned farm or forest management program, or a management agreement providing for good form or forest management of the property. Adoption of this change would promote the purposes of the legislation; in addition, numerous safeguards exists in section 2032A to prevent any abuse arising from this change.

The Report of the Committee on Ways and Means states as follows with respect to the purposes of section 2032A:

"... it is desirable to encourage the continued use of property for farming and other small business purposes. Valuation on the basis of highest and best use, rather than actual use, may result in the imposition of substantially higher estate taxes. In some cases, the greater estate tax burden makes continuation of farming, or the closely held business activites, not feasible because the income potential from these activities is insufficient to service extended tax payments or loans obtained to pay the tax. Thus, the heirs may be forced to sell the land for development purposes. Also, where the valuation of land reflects speculation to such a degree that the price of the land does not bear a reasonable relationship to its earning capacity, your committee believes it unreasonable to require that this "speculative value" be included in an estate with respect to land devoted to farming or closely held businesses."

Our proposed change in the "material participation" requirement furthers these purposes. In many instances owners of farms and timeberlands retain the services of agents in the management of the production of agricultural and horticultural commodities. The farms and timberlands in these cases are subject to the same development pressures as equivalent parcels for which no managing agent is retained.

The estate tax burden on owners of farms and timberlands for which a managing agent is retained is identical to the burden on other owners who do not retain agents. This burden likewise decreases the likelihood that farming and timber farming will be continued on the parcel after the death of the owner. In fact, the sale of managed land for development purposes may possibly increase the "speculative value" and the development pressure on other nearby farms and timberlands which are not managed.

The use of an agent is simply one method chosen by an owner of a farm or timberland to manage the property and assure maximum productivity. It is not a factor which should be used to deny "use" valuation. Rather, the determinative factor would more properly be that the decedent (or member of his family) retained control over the agent and through the agent (or personally or both) had material control over the farming and timber farming activities.

Further, the proposed change would not create an opportunity for abuse. Section 2032A contains numerous restrictions which would apply to an owner who meets the material participation requirement through the activities of his agent. In this regard we not the following restrictions:

1. The 50 percent and 25 percent limitations contained in section 2032A (b) (1) (A) and (B) which limit "use" valuation to situations where a significant portion of the adjusted value of the gross estate consists of farm property.
2. The 5 year ownership limitation contained in section 2032A (b) (1) (C) (i).
3. The recapture limitation contained in section 2032A (c).

The foregoing limitations effectively prevent the purchase of a farm or timberland for the sole purpose of obtaining a favorable "use" valuation by an estate. It would thus appear unlikely that an investor, in order to obtain favorable valuation, would place a large proportion of his assets in farm or timber property, which he would be required to hold for a number of years, and which would be required to hold for a number of years, and which would be severely restricted on his death as respects who may receive the property and the consequences of disposition.

The proposed change would therefore only aid owners who legitimately operate a farm or timberland as a large proportion of their assets, and intend to pass such land to their families, but who retain the services of a managing agent.

THE $500,000 LIMITATION

The $500,000 limitation is contained in section 2032A (a) (3) of the Code. This section provides that the aggregate decrease in the valuation of farms or other qualifying real property which results from "use" valuation may not exceed $500,000 with respect to any decedent.

For reasons similar to those set forth concerning the "material participation" test, we believe that this limitation should be deleted or revised.

First, the purpose of section 2032A, as stated in the Report of the Committee on Ways and Means, is furthered by removing the limitation. Indeed the limitation may in fact be in conflict with the purpose of the provision. As stated in the Report, it is unreasonable to require that the "speculative value" of farmland be included in an estate when such speculative value does not bear a reasonable relationship to the earning capacity of the land when used as farmland. By adopting a $500,000 limitation, section 2032A puts a limit not on the amount or value of real property which qualifies for "use" valuation, but rather on the speculative element of value. This limitation would appear to bear little relevance to the determination of whether and to what extent "use" valuation should be available. In fact, the higher the speculative value, the greater the need to remove such speculative value from the estate tax valuation.

Second, even if a limitation were appropriate, the amount of the limitation is unrealistically low. Under today's conditions, many farmers and timber farmers hold land reflecting enormous unreasonable speculative value which is not reflected in earning capacity. Most of these people derive only a modest income from farms and timber farms. Furthermore, as land development pressures increase and as inflation continues to decrease the value of the dollar, the $500,000 limitation, as with all fixed numbers, will increasingly reduce the instances in which an estate could afford to elect the "use" valuation.

Third, and finally, the removal or revision of the $500,000 limitation would provide no opportunities for abuse. Only the amount of speculative value would be removed from the value of qualifying real property; the value of the real property for farming or other small business purposes would still be included in full in the estate. Further, the other statutory restrictions on use valuation, cited previously, would clearly eliminate any opportunity for an investor to take advantage of "use" valuation.

SECTION 1023 (CARRYOVER BASIS)

Prior to the Tax Reform Act of 1976, a beneficiary's basis in property acquired from a decedent was the fair market value of the property at the date of the decedent's death (or the alternate valuation date if that date was elected for estate tax purposes). In essence, because of the stepped-up basis, any appreciation in the property between the date of acquisition by the decedent and the date of his death was not subject to income tax.

Under section 1023 of the Code, added by the Tax Reform Act of 1976, beneficiaries no longer receive this "stepped-up" basis for inherited property (with the exception of appreciation in property accruing before January 1, 1977, which is excluded under a "fresh-start" rule). The basis of property acquired from a decedent dying after December 31, 1976 is derived from the decedent's basis im-

mediately before his death ("carryover" basis). Certain complex adjustments, however, must be made to decedent's basis in order to determine the beneficiary's basis.

As discussed below, we believe section 1023 is an ill-conceived and inadvisable provision which creates enormous administrative burdens, yet does not achieve or even promote the objectives which motivated its enactment. In fact, it is more likely that the problems which section 1023 was to correct have been exacerbated rather than improved.

OBJECTIVES OF SECTION 1023

Major objectives of section 1023 are to promote tax equity and eliminate the temporary "lock-in" caused by a step-up in basis at death. With respect to tax equity, section 1023 is designed to correct an imbalance in prior law by imposing equal tax on the sale of an appreciated asset during a taxpayer's lifetime and the sale of the same asset after taxpayer's death. However, the imbalance of prior law has been reversed rather than corrected by section 1023, so that now post-death sales result in greater tax than lifetime sales. This occurs because money used to pay income tax on sales made after death is subject also to the federal estate tax, while income tax paid on sales made prior to death is not.

To take a simplified example, assume a taxpayer in 1978 sells for $110 an asset which he purchased in 1977 for $10. Regardless of whether the sale is made during the taxpayer's lifetime or by his beneficiary after his death, the income tax consequences will now be approximately the same. Assuming, say, a 40 percent tax on the $100 gain, the income tax due will be $40. The estate tax consequences differ, however. With a lifetime sale, only $70 will go into the taxpayer's estate, since $40 has gone to the federal government in the form of income tax. Assuming, say, a 20 percent estate tax rate, the estate tax due would be $14. With a postdeath sale, however, the full $110 goes into the taxpayer's estate, so the estate tax due is $22 (20 percent of $110). The total federal tax due is thus $54 for the lifetime sale but $62 for the post-death sale.[1] Hence tax equity, even in the specific area to which the section 1023 change is addressed, is not achieved.

As the example above illustrates, the carryover basis provision causes a greater tax burden to fall on those taxpayers who keep property until death, than on those who sell prior to death. Yet if any imbalance is to exist, it is appropriate that the lighter tax burden should be on the post-death sale. Death is an involuntary event, in contrast to the usual lifetime sale of an asset. Assets often must be sold to satisfy the estate tax liabilities. With the new carryover basis provision, such a sale now generates an income tax as well. Furthermore, sales are likely to be bunched into a period shortly after the taxpayer's death thereby increasing the overall tax burden. Frequently, survivors are at the same time coping with the financial problems inherent in the loss of the family's primary wage earner, as well as the inevitable stress caused by the loss of any family member. The additional tax burdens placed on them are certain to generate hostility towards the tax system. Hence, not only is equity not achieved between pre-death and post-death sales, but it is also likely that a step backward rather than forward has been made.

Broadening the focus from "equal" treatment of pre-death and post-death sales to more general fairness questions, it becomes apparent that new inequities are created by section 1023. First, double taxation (both income and estate tax) of the same gain results, as the preceding example illustrates. Second, the administrative costs created by section 1023 will be more crippling to estates with few liquid assets, such as the estates of farmers and small businessmen, since such estates lack the cash to cover the administrative costs without liquidating assets. Third, tax planning to minimize the burden of the new tax is affordable only by those with substantial assets.

Ironically, it is the persons that revisions in estate tax laws were designed to assist—surviving spouses, farmers and small businessmen and persons with small estates—who suffer most from the "incidental" adverse effects of the carryover basis provision. In fact, there are indications that the progress achieved by the 1976 estate tax law changes—increase in the marital deduction, the in-

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[1] In assuming that the basis for both the lifetime sale and the post-death sale is $10, the example does not include any of the adjustments to basis required by section 1023. Usually, the post-death basis would be higher than the lifetime basis once the adjustments called for by section 1023 are made, but not sufficiently high to counter-balance the greater estate tax burden on these sales.

cerased exemption as a credit, "use" valuation of farm properties, and deferred payment of estate taxes on farms and small businesses—has been completely nullified by the carryover basis provision.

In addition to promoting tax equity, a second major goal of section 1023 is to eliminate the temporary "lock-in" effect caused by a step-up in basis at death.

The sale of appreciated property generally results in a capital gain tax measured by the amount of the appreciation. Under prior law, however, if the property were held until death a step-up in basis would result and the gain would "escape" taxation. This was thought to create an artificial incentive to hold appreciated property until death, the so-called "temporary lock-in effect."

The tax burden faced by a prospective seller, however, not the step-up in basis, is what creates a disincentive to sell. The step-up in basis provision made the "lock-in" only temporary, by providing a release valve of sorts. Once the owner of the property had died, basis was adjusted to equal fair market value. A decision to sell or not to sell could then be made without the distortion created by a substantial tax burden upon sale.

Substitution of a carryover basis in place of a stepped-up basis eliminates this release valve and converts the temporary lock-in effect to a permanent one. Death no longer eliminates the prospective tax burden upon sale, so it is passed from generation to generation. As the appreciation in the property and hence the tax burden grows, so too does the disincentive to sell. Farmland and timberland, which frequently pass within the family from generation to generation, are particularly susceptible to this increasing pressure against sale.

To illustrate, suppose Junior inherits the family farm, but is not interested in, or not particularly expert at farming. Under prior law, he probably would sell the property to someone more inclined towards farming. Under more skillfull management, the land would be made more productive. Under section 1023, however, Junior would incur a large tax bill upon sale (particularly if the land were passed down through many generations, so that the basis was very low). The mechanism for passing the land into the hands of a more efficient producer is therefore impeded.

At the same time section 1023 converts this lock-in effect from temporary to permanent, it creates an entirely new distortion in allocation of property. Any asset whose basis is lower than its value has a built-in income tax burden. Under section 1023, this burden is now transferred to the decendent's beneficiaries. A testator can minimize the tax burden on his beneficiaries by passing assets with large built-in tax burdens to beneficiaries in low tax brackets, and vice-versa. Since the tax savings can be substantial, this factor is likely to affect a testator's decision about which beneficiary will inherit particular assets. Yet, in the case of productive assets, such as farms and timberlands, maximum efficiency would only be achieved if the decision could be made solely upon the basis of which beneficiary could best use the farm or other productive asset. A stepped-up basis at death facilitates this efficient allocation process; a carryover basis distorts it. Once a misallocation occurs, moreover, the carryover basis makes it less likely to be corrected, given the lock-in effect (or incentive against sale) discussed above.

These distortions—permanent lock-in and misallocation of property—cannot be overemphasized. Their adverse impact is particularly noticeable in the case of the productive units in our economy—farm lands, timberlands, and small businesses. Maximum efficiency in production can be achieved only if productive property is in the hands of the most efficient producer. Section 1023 encumbers the transfer process.

ADMINISTRATIVE BURDENS

Even if the substantive goals of section 1023 had been achieved, it is important to ask, at what cost? The new provision creates an administrative jungle.

The process of determining carryover basis is incredibly complex. The first step is to establish decedent's basis in each asset in his estate. Yet rarely does a decedent leave adequate records of date of purchase, cost, and capital improvements for each asset which he owns. Even if there are records, establishing the basis of a farm or closely held business, with property frequently purchased in small lots over the years, improvements constantly being made and de-

preciated, and large numbers of other business assets, can involve enormously complex calculations.

Admittedly, a taxpayer who sells property during his lifetime is required to determine his basis in the property he sells. Several important factors, though, distinguish the lifetime sale situation from transfers at death. After the taxpayer's death, he is obviously no longer available to reconstruct the facts surrounding his ownership of the property. Incomplete records that the taxpayer could have supplemented by memory, or missing records he could have found, are no longer of any use. Moreover, upon death, basis must be fixed in all assets at once, requiring an enormously time consuming and costly process. In contrast, the occasional lifetime sale creates little difficulty.

The necessity of determining decedent's basis not only causes expense and annoyance for the survivors at the taxpayer's death, but also requires detailed record-keeping by the taxpayer during his life of every transaction affecting every asset he acquires. Moreover, death no longer provides a time for "cleaning house", or throwing out records kept by the decedent. Until a sale takes place old records must be preserved, for section 1023 requires not only knowledge of basis, but proof. In many situations, this means records must be kept for many years, and even many generations, as property is passed down through the family.

The second step in the process, "adjusting" basis, is even more difficult. Four possible adjustments can be made: (1) a fresh start adjustment; (2) an estate tax adjustment; (3) a minimum basis adjustment; and (4) a succession tax adjustment. Calculation of adjustments must be made separately for each asset in the estate. Each adjustment depends upon calculations made in the preceding adjustment, so that an error in one can throw off calculations all down the line. Moreover, adjustments in the basis of one asset are dependent upon the "adjusted" basis of all other carryover basis assets, so an error in the calculation of adjustments for one asset can throw off calculations made for all other assets as well. Adjustments are also dependent upon the average federal estate tax rate, yet that rate can only be finally determined at the time of the final audit. Again, any change sets off a chain reaction of necessary recalculations. Given all these interrelated factors in calculating basis, the likelihood of numerous recalculations is enormous.

Furthermore, there may be several bases for a single asset. The fresh start adjustment is made only for the purposes of determining gain, not loss. Additionally, assets allocated to a marital deduction share for the spouse will have a different basis than if allocated to the residue, since only assets subject to tax qualify for some of the adjustments.

These enumerated complications are merely illustrative, not exhaustive, of the administrative difficulties created by section 1023. In short, the carryover basis provision creates an administrative nightmare which will unfairly burden all taxpayers.

In conclusion, it is our view that the objectives of equity, economic efficiency, and administrative simplicity are not served by section 1023. We believe section 1023 should be repealed or substantially revised. We wholeheartedly support the bills already sponsored by numerous Congressmen to repeal section 1023 and restore prior law.

HOPKINS, SUTTER, MULROY, DAVIS & CROMARTIE,
Chicago, Ill., September 6, 1977.

Hon. HARRY F. BYRD, Jr.,
Russell Senate Office Building,
Room 417,
Washington, D.C.

DEAR SENATOR BYRD: I am pleased that your Subcommittee on Taxation is considering in some depth the extremely serious problems which enactment of carryover basis has visited upon the taxpaying public. I am certain that you will receive numerous detailed analyses of the provisions of the Tax Reform Act of 1976, demonstrating vividly why they do not work. I do not intend to duplicate such statements, except incidentally. However, I believe that your Subcommittee, if it is not fully aware of the history of the former provision for new basis for assets held at death, should be made aware of the facts.

I doubt that the Members of Congress who supported carryover basis last year were aware that similar provisions had been suggested and consistently rejected

since 1919, including rejection in 1942, when there was a need for revenue to support the war effort, and again in 1963 when taxation of capital gains at death was proposed by President Kennedy. The reasons for such consistent rejection of any change from stepped-up (or stepped-down) basis are simply stated—despite the seeming equity of taxation of unrealized appreciation at or after death, schemes to impose such taxation are, in fact, unworkable and, in practice, less equitable than the rule which they are intended to supplant.

Last year, when, at the last minute, it appeared that carryover basis might be passed by the House, I wrote to the members of the Senate Finance Committee and enclosed a copy of my testimony on behalf of the Illinois State Bar Association in 1973 setting out the legislative history of estate tax value basis. The rush of events made my letter futile as the Committee never considered the subject. I now resubmit that letter, noting that the tax computations made therein and in my 1973 testimony are now outdated, but not rendered incorrect in concept, while the history remains as valid as ever.

Accordingly, I enclose a copy of my August 17, 1976, letter to Senator Long (identical to those sent to other members of the Finance Committee), and of my 1973 testimony on behalf of the Illinois State Bar Association. I hope serious reconsideration will be given to the hastily enacted and widely condemned provisions for carryover basis.

Very truly yours,

WILLIAM P. SUTTER.

Enclosure.

HOPKINS, SUTTER, MULROY, DAVIS & CROMARTIE,
Chicago, Ill., August 17, 1976.

Hon. RUSSELL B. LONG,
Russell Senate Office Building,
Room 217,
Washington, D.C.

DEAR SENATOR LONG: As a lawyer who has spent 26 years in probate and estate planning work, I am extremely disturbed by the inclusion in H.R. 14844 of a provision for carryover basis. The Committee Report states that this change is intended to elimiate the "unwarranted" difference in tax treatment between lifetime and deathtime tarnsfers. It should be immediately noted that the bill does not, in fact, equate lifetime and deathtime transfers. Indeed, in some instances it would seriously penalize a deathtime transfer.

For example, assume a taxable estate of $5,060,000, comprised entirely of stock having a basis of $506,000. Under present law, such an estate would pay an estate tax of $2,468,200, but would pay no capital gain tax if it were necessary to sell the stock immediately after death, and the stock been sold immediately before death, the capital gain tax would have been $1,579,390, but the reduced taxable estate would have produced an estate tax of only $1,498,741.60. Thus, under the present law, total taxes would be $3,078,131.60, or $609,931.60 greater if the stock were sold before death. However, sale before death is within the decision-making control of the owner of the stock.

With carryover basis, if it were necessary to sell the stock immediately after death, there would be a capital gain tax of $801,921 to pay in addition to the estate tax of $2,468,200. Total taxes ($3,270,121) would be 32.49 percent greater than those payable under present law, an extremely high percentage increase, and would exceed total taxes payable if the stock were sold immediately before death by $191,989.40. Yet the death of the stockholder may, in many instances, require sale of the stock shortly after death.

In addition, carryover basis imposes a regressive tax burden. For example, if a stock appreciates from $100,000 to $1,000,000, the additional tax incurred on its sale would be approximately $205,000 if that stock were the sole asset of an estate, but would be only $110,000 if it were part of a $10,000,000 estate.

It is vital to recognize that property acquired from a decedent has taken a stepped-up basis under every revenue act since 1916. These provisions have been repeatedly reenacted despite suggestions for carryover basis, the first of which was made as early as 1919. When the Ways and Means Committee conducted its hearings on General Tax Reform in 1973, I was privilliged to testify as President-Elect of the Illinois State Bar Association on this subject, and to submit a prepared statement as well. I do not believe that I can add to what I then said, but I sincerely hope that you will review that material and strenuously oppose carryover basis if it survives the House vote and comes before the Senate.

In the event that the Finance Committee decides to hold hearings, I should be pleased to appear, if that were in order. Thank you for your attention to this important and widely misunderstood subject.

Very truly yours,

WILLIAM P. SUTTER.

STATEMENT OF WILLIAM P. SUTTER, PRESIDENT-ELECT, ILLINOIS STATE BAR ASSOCIATION

Mr. SUTTER. Mr. Chairman, members of the committee, my name is William P. Sutter. I am appearing here on behalf of the Illinois State Bar Association, of which I am the President-Elect.

I have been a chairman of the Probate Practice Committee of the Chicago Bar Association. I am the incoming chairman of the Committee on Income Taxation of Estates and Trusts of the ABA Section of Taxation, and I am a partner in Hopkins, Sutter, Owen, Mulroy and Davis in Chicago.

The reason I am appearing here today is to urge upon the committee what has already been advertised to this morning, the fact that there is a dichotomy sometimes between simplicity and what may seem to be equity.

In Illinois, among the members of the State Bar Association, are a great many practitioners who are not technical tax experts, and they feel very strongly that, unless an inequity is so apparent as to be obvious to all members of the committee and all Members of the Congress, all other things being equal, simplicity rather than one man's idea of equity is to be preferred. This is particularly true if the asserted inequity is alleged to result from a tax provision which has existed for many, many years and which has been found on many, many occasions in the past not to be inequitable.

I am talking now specifically about the question of a new basis for property transferred at death. This is a question which is as old as the Internal Revenue Code. Property began taking a new basis at death under regulation in 1918. It was codified in 1921.

In a paper entitled "Notes On the Revenue Act of 1918," the suggestion was made for the first time that having a new basis for property transferred at death was inequitable, because unrealized appreciation did not get taxed. So that the suggestion has been with us now for 54 years.

Dr. T. S. Adams, testifying as a Treasury expert at that time, opposed any carryover of basis from a decedent to his estate or heirs because he pointed out that the unrealized appreciation had been subjected to estate taxation.

Then, in 1926, the Court of Claims decided a case, the McKinney case (62 ct. cl. 180), in which it held that property acquired by an executor of an estate from a decedent did not get a new basis, that it had a carryover basis.

Instantly, the Joint Committee on Internal Revenue Taxation was out with a report denouncing that result. The committee suggested that the Revenue Act should be changed to provide for a stepped up basis for property transferred from a decedent to an estate because the appreciation had not escaped taxation but had been taxed by the estate tax. The suggested change was made in the 1928 Act, overruling the *McKinney* case.

From that time to the present, the rule has been unchanged, notwithstanding the fact that in 1942, during the war, when there was a great need for revenue, the Treasury proposed a change. This committee did not acquiesce, and the proposal went no further.

Again in 1963, it was proposed that there be a change. This committee did not agree, and it went no further.

Now we are in 1973, and a carryover basis for property transferred at death is again being proposed as the solution to a loophole situation. I submit that any tax provision which has been studied by the Congress for 54 years and never changed has been adequately studied, and perhaps it should be allowed to rest for a short time.

The reasons why change in the taxation of unrealized appreciation at death has been rejected, I submit, are set forth on pages 22 to the end of my paper.

First of all, it is not at all true to say that such appreciation escapes tax at death. If a man has $500,000, he would pay an estate tax of $126,000, approximately. If that $500,000, however, appreciates tenfold, so that it becomes $5 million, he pays an estate tax of almost $2¼ million. He has paid an additional tax of $2,305,000 on $4,500,000 of appreciation. That is a tax on the appreciation of over 50 percent. To say that there is no tax on that appreciation is absurd.

A $5 million estate pays, as I say, $2½ million in taxes. If, however, a carryover basis were enacted, and the $5 million estate had a basis of $500,000 and were sold in order to raise money to pay taxes and for diversification, the carryover basis would result in an additional tax of $800,000, making the total taxes $3,300,000, which is a 33 percent tax increase on the estate which has appreciated.

Obviously, the effect of any proposal of that kind, I submit, would be to encourage people to buy the safest securities they can find, and the ones which are least likely to appreciate, but which will produce a nice income. They won't take risk when the risk is going to increase their total taxes 33 percent in some instances.

In addition, the tax resulting from a carryover basis is regressive. On pages 34 to 36 of my paper, I point out that if a stock appreciates from $100,000 to $1 million, the additional tax incurred on sale by virtue of a carryover basis would be $110,000 in a $10 million estate, and in a $1 million estate would be $205,000, twice as much for the smaller estate.

Regressiveness in taxation is always to be deplored. It certainly is not something that should be adopted in the name of tax reform.

More than the dollar figures, however, are involved. As a probate lawyer I submit that the administrative problems of a carryover basis are totally insurmountable. The executor has no way of deciding what assets should be sold to raise money to pay taxes unless he knows the basis of those assets. That may take a long time to determine, and in the meantime, nothing is being sold. That is not orderly administration.

Even when the executor does know what the basis is, he is in a dilemma. If he sells the low basis assets, he incures a very large tax. If he sells the high basis assets, he may be selling the safest assets, the ones that should be kept for the widow and children. Whichever way he goes, he is apt to be wrong if the market goes up or down. I submit that this puts executors in an untenable position.

The beneficiary has problems too. If a man has a million dollars in good bonds and has another million dollars in a farm or in a closely held company with a basis of $200,000, has a son and daughter, and wants to treat them equally, he may very well give the farm or company to his son and the bonds to his daughter. They will be treated equally under present law, each receiving property with a value and a basis of $1 million.

But with carryover basis, the son, receiving the appreciated property, will not have property of equal value to the daughter, because if he ever disposes of it, he will have nothing like as much left as the daughter.

On the other hand, it has been suggested that you might just split the aggregate carryover basis of $1,000,000. In such case, the basis of the million dollar bond drops from $1 million for which it was purchased to $600,000 in the daughter's hands.

This is both inequitable and probably unconstitutional. If she sells that bond, or it becomes due and she collects $1 million, and she has a basis of $600,000, she is taxed on $400,000 of income that neither she nor her father ever realized, or ever would have realized on that particular asset.

That is no different than saying that all assets should take a basis equal to half their cost on death, or something of that kind. It is a capital levy, and certainly is unfair.

On the other hand, if you don't provide for basis-spreading, then the people who are fortunate to have highly paid, exeperienced, and astute tax advisers can get around the problem, because they will leave their low basis assets to charity, and their high basis assets to people in high tax brackets. The main in a high tax bracket, the son, who is wealthy, having received high basis assets that he doesn't want, can then sell them, realize little gain, and purchase the low basis assets from the charity or other low bracket taxpayer. The son thus can obtain the low basis assets with a stepped up basis without much tax burden.

This can be done by astute planning, but the majority of Americans dealing with taxation do not have astute planners, and they will miss it. You will have created another inequity in the name of creating equity, because simplicity will have been sacrificed, and people will not realize what is about to happen to them.

Finally, carryover basis may perhaps be seen as a revenue raising measure, but don't forget that carryover basis could be a revenue losing measure as well.

We now get a new basis on assets transferred at death. That is a stepped-up basis in most cases because of a great deal of inflation. In a deflationary period, the basis of assets would be stepped down at death, because they would have declined in value.

A carryover basis, however, would entitle the recipient of those assets to sell them and take a loss after the testator's death. The testator wouldn't have had that benefit immediately before death, because there is a limitation on loss carryover, and because carryovers die with his death.

So in a period of declining revenues, carryover basis would accelerate the decline by permitting people to take losses which under present law they are not permitted to take. It is a historical fact that this committee enacted many of the tax-free exchange provisions in the corporate reorganization area during the depression in order to preclude the taking of losses, which prior to that time could have been taken, not to alleviate the taxation of gains, although now, in an inflationary period, the tax-free reorganization does avoid tax on gains.

So that I urge you to consider very seriously whether there is the necessity, the need, or the rationale for any change in the taxation of assets passing at death.

I have one other point which I would like to make very briefly. That relates to generation skipping.

I don't know whether generation skipping is a problem or not. I have written a lot of trusts, and I don't make rule against perpetuity trusts. I have written only one in my life.

It may be a problem, however, that in some instances a beneficiary of a trust can have so many powers and so many controls as to have virtually unlimited ownership, yet the trust property will not be taxed in his estate.

I think that isn't really a generation-skipping problem. I think it is a problem in the definition of what is a taxable interest in property. I would like to urge you to consider attacking it in that sense, in a simpler way, one that doesn't have all the complexities of the generation-skipping approach. Work within the framework of the present Code, and tighten up on some of the present provisions.

For instance, you could get rid of the 5 percent or $5,000 right of withdrawal. That is a nice right for a beneficiary to have, but you could get rid of it, and that would be one less estate that a person could have without producing a tax in his estate.

You could define a taxable power of appointment in a broader sense. A general power now is so narrowly defined that a beneficiary can have almost any kind of a power without subjecting the trust to taxation in his estate.

Perhaps it would be a good thing to define all powers as general powers except those to appoint, for example, to the beneficiary's spouse and his children or their spouses.

That would preclude generation skipping, if you want, because he couldn't appoint to grandchildren.

I don't advance these as solutions. I advance them as suggestions for an approach to a very complicated problem, and all the solutions that have been submitted so far, I submit, are more complicated than the problem merits.

There may be a problem, but I would like to urge that you look for some simple approach before going to the complex.

Thank you very much.

Mr. ULLMAN. Thank you.

Mr. Sutter, would you like your full statement to be included in the record?

Mr. SUTTER. Yes, I would like the entire statement in the record, if I may.

Mr. ULLMAN. Without objection, that will be done.

[Mr. Sutter's prepared statement follows:]

STATEMENT OF WILLIAM P. SUTTER, ON BEHALF OF THE ILLINOIS STATE BAR ASSOCIATION

SUMMARY

1. *Taxation of appreciated assets.*—It has been contended that the provisions of present law which enable appreciated property transferred at death to acquire a stepped-up basis constitute a "loophole" which should be closed. Nothing could be further from the truth. Property acquired from a decedent has taken a stepped-up basis under every revenue act since 1916. These provisions have been repeatedly re-enacted by Congress despite prior suggestions comparable to those now being made, the first of which was made as early as 1919. Indeed, under the impetus of war-time revenue needs, the Treasury Department specifically urged a carryover of a decedent's basis before this Committee in 1942. Then, and again in 1963, this Committee wisely refused to adopt the provision. Thus, the proposal cannot be

put forward as a new concept. The concept is old, but without the wisdom of age. It has at all times been summarily rejected by Congress.

In reality, what is put forward as an income-tax proposal is no more than a disguised, drastic estate tax increase, applied unequally to estates of equal size and discriminating severely against the entrepreneur whose risk capital has been the source of a large part of America's growth. The enactment of this proposal would place a premium upon financial cowardice, upon investment, not in risk-filled ventures with hope of enhanced value, but in assets of a stable value, such as bonds, or in the purchase of insurance which produces no income in the hands of the beneficiary.

To illustrate, under present law, a $5,000,000 estate pays almost $2,500,000 estate tax. Under the proposal, however, between the $5,000,000 estate which is completely invested in bonds and insurance, for example, and the $5,000,000 estate which is completely invested in a common stock which has appreciated ten-fold from a cost of $500,000, the difference in federal taxes payable may approximate $800,000. The $5,000,000 estate representing growth—the dynamic estate—under this proposal may incur an increase in total taxes over those payable under present law of almost 33%. Indeed, the estate may pay as much as $191,980 more taxes than the decedent would have paid had he sold his appreciated stock immediately before his death. The estate which contains no assets of enhanced value will pay no more taxes than under present law.

A discriminatory estate tax increase disguised either as constructive realization of gain at death or carryover of basis to impose a capital gains tax on the next generation is both unjust and unworkable. As clearly demonstrated by the examples discussed hereafter the proposal for carryover of basis at death would have a punitive effect for the successful risk taker, but would be without adverse effect upon the man whose talent has been buried and held safe but has not increased. Present estate tax rates surely are sufficiently high to justify wiping the slate clean and permitting each generation to start on an even basis, paying its own way via capital gains tax on appreciation in value occurring during the period of its ownership.

Both the proposal for constructive realization of capital gains at death and the alternative of carryover of basis at death should again be rejected as they have when advanced over the past 50 years.

2. *Generation-skipping.*—No drastic change in the concept of the estate taxation of trusts should be enacted, especially when such change would result in extreme complexity and would depart from the traditional concept of an estate tax as a tax on the privilege of transmitting property. Experience with the throw-back rules [which are universally admitted to be in need of simplification] should demonstrate that a theoretical but impractical solution to a tax problem will be ineffective under a system which relies heavily on taxpayer understanding and acceptance. There has not been shown any need for punitive taxation of generation-skipping transfers. However, if it is felt that the present estate tax statutes permit trust beneficiaries to enjoy too many of the attributes of ownership of property without such property being subjected to estate taxation, simpler solutions than special taxation of generation-skipping transfers should be sought. Specifically, consideration should be given to elimination of the 5% or $5,000 right of withdrawal under Code section 2041, as well as to a significant expansion of the definition of a general power of appointment.

INTRODUCTION

It has been said by so many that quotation is useless that the public is clamoring for tax "reform." It has also been said by many that the public is clamoring for tax "simplification." I submit that the latter statement is undoubtedly true: the former may also be true, but I am somewhat less sure. On his point I am inclined to agree with Professors Walter J. Blum and Willard H. Pedrick, who have said:

It can be assumed that the reform movement does not come from the masses. They are not touched directly by the transfer tax system and are probably unaware of any stake they may have in its operation. The pressure for reform seems to come, not from a broad political base, but from the insiders—that small band with the ability to lead taxpayers through the tricky reefs and shoals of the Revenue Code at minimum cost and with maximum satisfaction. In general, it is tax lawyers and estate planners who propose estate and gift tax reform. Why? (The Reform School Approach to Estate and Gift Tax Revision, Feb. 1973 *Taxes* 81-90 at 90)[1]

[1] See also, Irving Kristol, Of Populism and Taxes, 28 The Public Interest 3 (1972).

Why, indeed? Tax equity is the usual answer, and to the goal of achieving tax equity everyone must subscribe. To say this, however, is to say little, for one man's equity is another's loophole, and there will be as many approaches to tax reform as there are tax lawyers anxious to implement their personal predelictions. Moreover, tax "reform" is almost inevitably accompanied by a loss of tax "simplicity." The Internal Revenue Code is an amazing document; it has been put together by men of true genius in the field of federal taxation; but it is not easily comprehended, nor are all of its concepts remotely grasped by attorneys and other public counselors, much less by the public itself. Whenever this is the case, it is inevitable that mistakes occur; taxpayers lacking sophisticated advisors fall into tax "traps" or fail to realize the benefits of tax "loopholes" and the cry for "reform" in reality is a cry for "simplification."

Turning specifically to the proposals for estate tax revision which are presently being considered by this Committee, I urge it to bear in mind that the vast majority of all taxpayers who have estates sufficiently large as to require the filing of federal estate tax returns and to justify the use of trusts are nevertheless counselled by general practitioners. These advisors understand common law concepts; they understand fundamental tax concepts, but they are not tax experts. They and their clients and the banks, trust companies and accountants with whom they deal are not likely to understand or to comply with the technicalities inherent in a tax on generation-skipping transfers, for example. They are not likely to understand or be prepared to deal properly with the complexities inherent in a carryover of basis at death.

These are facts of life. They do not necessarily mean that the Congress should shut its eyes to areas of the law which require modification. They do mean, however, that every substantive change in the Internal Revenue Code should be weighed with great care and the question should be asked: Does this change increase or decrease the complexity of the law? If the change is on the side of increased complexity, then, I submit, the "reform" to be accomplished should be so great as to admit of little debate as to its wisdom. All else being equal, simplicity should prevail, and the law should remain as it is.

DISCUSSION—TAXATION OF APPRECIATED ASSETS

In general

This Committee is presently considering two principal suggestions for change in the taxation of appreciated assets at death. The first of these is a proposal to subject unrealized appreciation to income taxation at the death of the owner, such appreciation being included in the decedent's final income tax return. Some proponents of this approach urge taxation at ordinary income rates and others are content to impose a capital gains tax on this value which remains just as unrealized after the death of the property owner as before.

A long list of objections to such a proposal can be and has been marshalled. It may impose an unconstitutional capital levy on appreciation which is not "income" subject to income taxation; it imposes an additional cash requirement on estates which will seriously aggravate liquidity problems; it is regressive because the estate tax deduction allowed for the income tax on appreciated assets would render the additional tax less costly for large estates than for medium sized estates, etc. The reasons for not enacting an income tax on unrealized appreciation at death are so apparent, so persuasive and have been so frequently expressed as to require no additional discussion here.

The second principal suggestion has the merit of seeming equity. Under this proposal appreciated assets are given a carryover basis, increased only by the amount of estate tax paid on the unrealized apprecaition. The argument is advanced that, since the original owner of the assets was not taxed, unrealized appreciation should be taxed when realized by a succeeding owner. The proposal is deceptively simple, but it is both unwise and unworkable. Further, it has been made many times before and always rejected as such.

The Provisions Giving Assets a New Basis at Death Have Been Reviewed by Congress on Many Occasions; Suggested Modifications Have Been Consistently Rejected

President Kennedy's 1963 Tax Message proposed that a capital gain tax be imposed on all net gain accrued on capital assets at the time of transfer at death or by gift. The explanation given by the Secretary of the Treasury for this proposed change in the law was that:

Present law permits the exemption from income tax of capital gains accrued when the appreciated assets are transferred at death. The prospect of eventual tax-free transfer of accrued gains with a stepped-up basis equal to the new market value in the hands of heirs distorts investment chaices and frequently results in complete immobolity of investments of older persons. (Hearings, Committee on Ways and Means, President's 1963 Tax Message, p. 54, p. 49 of Message)

Before this Committee, the income tax approach was seen to be totally unacproposals, however, this Committee wisely made no change in the treatment of property acquired from a decedent be that of the decedent, increased by the estate tax on the appreciation. Both proposals were accompanied by an Administration recommendation that the maximum rate on long-term capital gains be decreased from 25% to 21%. Despite the fact that these were Administration proposals, however, this Committee wisely made no change in the treatment of appreciated assets on the death of the owner. Although the proposal was again made to the Senate Finance Committee, it was not adopted by that Committee either. The Revenue Act of 1963 left the law unchanged.

Now we are again confronted by contentions that a "loophole" exists in the provisions of the Internal Revenue Code which establish a new basis for assets transferred at death. Of course, the "loophole" which is suggested occurs only when assets have appreciated during the owner's lifetime. If they have depreciated, present law imposes a burden on the next owner, since the assets then pass with a stepped-down basis, not one which has been stepped-up.

Disregarding this aspect for the moment, however, let us take a look at the "loophole" seen by those who would change the law to tax appreciation at death or to provide for a carryover basis. With the present laudable effort to close "loopholes" in the Internal Revenue Code no one can quarrel.

The difficulty lies in the misinterpretation sometimes put upon the term "loophole". A provision which is fair and which has been adopted advisedly by the Congress, with full knowledge of its workings and effect, is not a "loophole", despite the fact that by changing it, additional revenue might be raised. The provision which establishes a date-of-death value (or alternate-valuation date value) as the basis of property acquired from a decedent is such a provision.

While there have been relatively minor shifts in Congressional policy relating to the proper basis to be accorded property acquired through certain special types of transfer by decedents, there has been no Congressional deviation from the principle that, in the normal case, any property owned by a decedent and transferred at death shall take a new basis. While the 1916 and 1918 Revenue Acts contained no specific provision relating to property acquired from a decedent, but had only a general provision that, in the case of property acquired subsequent to March 1, 1913, the basis should be "the cost thereof", Treasury Regulations 45, Art. 1562, issued under the 1918 Act, provided:

In the case of property acquired by gift, bequest, devise or descent the basis for computing gain or loss on a sale is the fair market price or value of the property at the date of acquisition or as of March 1, 1913, if acquired prior thereto.

These Regulations accorded with the intent of Congress, and when a specific provision relating to property acquired by bequest, devise or inheritance was added to the Revenue Act of 1921, it was noted that "The special rules embodied in existing law with respect to property acquired by bequest, devise, or inheritance are in substance preserved." (H. Rept. 350, 67th Cong., 1st Sess., p. 9)

Even at this early date, however, some persons who failed to analyze the relationship between the estate tax and the income tax were suggesting that this rule should be changed. On November 3, 1919, the Secretary of the Treasury submitted to this Committee a document entitled *Notes on the Revenue Act of 1918*. This document represented a collection of suggestions for study and was submitted without recommendation by the Secretary, who stated that the Treasury would be opposed to some of the suggestions contained in it. The document contained the following:

It has been suggetsed that, although transfers of property by gift, bequest, devise, or descent should not be treated as giving rise to realized gain or loss, whenever thereafter gain or loss is realized by actual sale, the gain or loss at that time should be measured as the difference between the price received and the cost to the original owner who acquired the property for value.

It is urged in support of this suggestion that the effect of the present legislation is to permit realized gains due to appreciation taking place during the previous ownership to escape taxation, (pp. 10–11)

With this suggestion before Congress, Dr. T. S. Adams, Tax Advisor to the Treasury Department, appeared before the Senate Finance Committee in Execu-

tive Hearings on the Revenue Act of 1921. Dr. Adams made two recommendations of interest here. First, he urged that property acquired by gift should take the donor's basis, as suggested in the foregoing Notes. Second, contrary to the Notes, he urged that property acquired by bequest, devise or inheritance should take as its basis its fair market value at the date of acquisition. His reasoning was given as follows:

Senator McCumber. Whatever the child receives by inheritance or bequest it gets without cost or sale exactly the same as a gift. In the next paragraph you make a distinction.

Dr. Adams. That is because the estate or inheritance tax has been imposed. That is the thought behind that. (Executive Hearings, Senate Finance Committee, Revenue Act of 1921, 67th Cong., 1st Sess., p. 27)

And again, Dr. Adams testified:

* * * Where it is acquired in that way it is subject to estate tax, and I think it is entirely fair and proper. That is the reason we give the value at the time of acquisition. Property acquired by bequest, devise or inheritance is subject to the estate tax. (p. 198)

Congress accepted both of these recommendations, and section 202(a)(2) of the 1921 Act provided a carryover basis in the case of property acquired by gift, while section 202(a)(3) provided that "In the case of such property, acquired by bequest, devise or inheritance, the basis shall be the fair market price or value of such property at the time of such acquisition." It will be noted that there was no gift tax in effect at this time, but that the federal estate tax dates from 1916.

There were no substantial changes enacted thereafter until 1928. However, in 1926, the Court of Claims decided the *McKinney* case, 62 Ct. Cl. 180, in which it held, under the 1918 Act, that a decedent's executor had no "cost" and that the decedent's property in the hands of the executor took the decedent's basis. Congress at once indicated its belief that such a carryover of basis was improper. In the Report of the Joint Comimttee on Internal Revenue Taxation (1927), Vol. 1, the following statements appear:

Until recently gain or loss on executor's sale was measured by the value at the decedent's death of what was sold. As a result of the decision by the Court of Claims in *McKinney* v. *United States*, and the denial of certiorari by the United States Supreme Court, the rule was changed so as to provide that gain or loss on such a sale would be measured as though the decedent had sold the property during his life.

The rule of the *McKinney* case is inconvenient, for it is often impossible to determine the decedent's cost or other basis. Moreover, as a practical matter, it results in taxing the value of bequests, devises and inheritances as income. The old rule seems preferable, and it is recommended that it be set forth in the statute.

Section 204(a)(5) prescribes the basis when the beneficiary sells the property as the value at the time of "acquisition". Some doubt has arisen as to what is meant by the date of acquisition. The "date-of-death" is recommended to make the basis certain and definite. (p. 117)

This rule is particularly desirable in view of the difficulty which may be encountered by executors and administrators in ascertaining what the decedent paid for the property, especially when it had been held by him over a long period of time.

* * * * * * *

The same position was taken by representatives of the Cleveland Chamber of Commerce, the Association of the Bar of the City of New York, the Committee of Banking Institutions on Taxation, and other witnesses who stressed the impractical, if not impossible, requirement of determining decedent's basis imposed upon the executor by the *McKinney* decision. (See Hearings, House Ways and Means Committee, Revenue Act of 1928, 70th Cong., 1st Sess.)

As a result of the foregoing report and testimony, the House of Representatives (in the 1928 bill) adopted a provision that date-of-death value was to be the basis of all property acquired by bequest, devise or inheritance, *or by a decedent's estate from a decedent*. The latter phrase was intended to overturn the *McKinney* decision. In the Senate Finance Committee, the section was altered to provide two different rules. Date-of-death value was made the basis of property acquired by specific bequest, of real property acquired by general or specific devise, or by intestacy, and of property acquired by a decedent's estate from a decedent. In

all other cases, basis was made the fair market value of the property at the time of distribution to the taxpayer.

Thereafter, it became apparent that use of distribution date values permitted a certain amount of tax avoidance by executors who were also testamentary trustees and who could, by judicious selection of the date to effectuate distributions to themselves, control the basis of property in their hands as trustees. A subcommittee of this Committee recommended that the provision be changed "so that a uniform basis rule may be required in the case of property passing at death, whether real or personal." (Hearings, House Ways and Means Committee, Revenue Act of 1934, 73d Cong., 2d Sess., p. 136.)

Roswell Magill, speaking for the Treasury Department, while questioning certain language changes recommended by the subcommittee, stated:

* * * I take it that the subcommittee and the Treasury are in agreement as to what the basis should be in those cases. * * *

* * * * * * *

The Treasury is in entire agreement with your purpose. (p. 145)

Mr. Colin F. Stam, of the Staff of the Joint Committee on Internal Revenue Taxation, appearing before the Senate Finance Committee in Executive Hearings, was most explicit of the Treasury Department position:

* * * Under the present law, we use the value at the date of death for computing gain or loss, in most cases, but in the case of property passing a the result of a general or residuary bequest, the present law permits the person receiving the property to take, as the basis, not the value at the date of death, but the value at the date of death.

For instance, when a man dies he may have a piece of property worth $100,000, taking the same illustration. By the time the executor distributes the property, it may be worth $500,000.

* * * * * * *

* * * The man that receives this property really did not pay anything for it; and *we have gotten the tax up to the date of death through the estate tax*, when the value was $100,000. We have not gotten any tax on the increase in value up to the time of distribution, which was $500,000, and we just want to make it clear that we are going to take as the basis, both for gain or loss purposes, the value at the date of death. (Executive Hearings, Senate Finance Committee, Revenue Act of 1934, 73d Cong., 2d Sess., pp. 65–66; emphasis supplied)

From the enactment of the 1934 Act to the present time, property acquired from a decedent has taken a new basis, either its value at the date of decedent's death, or, since 1942, its value on the alternate valuation date, where such alternate has been elected for estate tax purposes. Rather than restricting this well-established principle, in 1954 Congress extended it to cover, for the first time, all property included in a decedent's gross estate for federal estate tax purposes. This final change clearly indicates a continuing Congressional awareness that the federal estate tax imposed upon appreciated assets eliminates any justification for the imposition of a capital gains tax upon the same appreciation. The reason given by the Senate Finance Committee for the extension of the date-of-death basis provisions in the 1954 Code was simply that "Under existing law, there is no uniform correlation between section 113(a)(5) and section 811 of the 1939 Code, relating to property includible in the decedent's gross estate." (Sen. Rept. 1622, 83d Cong., 2d Sess., p. 423)

It should also be noted that while the concept that all property subjected to the federal estate tax should take a date-of-death basis was not adopted until the enactment of the 1954 Code, the Majority Report of the Special Tax Study Committee dated November 4, 1947, recommended that "The basis of property acquired by gift but included in the gross estate of the donor should be made the same as it would have been had it actually passed at death, if the property is sold after the donor's death." (Hearings, House Ways and Means Committee, 80th Cong., 1st Sess., Revenue Revisions 1947–48, p. 3633)

The foregoing legislative consistency cannot be disregarded, especially in view of the fact that proposals similar to those rejected by this Committee in 1963 have been made periodically ever since the *Notes on the Revenue Act of 1918*, above referred to. When Congress was confronted with the emergency of the

nation's participation in World War II, Randolph Paul, Tax Advisor to the Secretary of the Treasury, stated to this Committee:

Under present provisions the basis for determining gain on an asset acquired from a decedent is the market value of such asset at the date of death. Appreciation in value in the hands of a decedent thus becomes frozen in the basis accorded to the heir or legatee.

A large part of the capital gains inherent in the increased value of property thus escapes income tax, as the assets are handed down from one generation to the other. To remove this special privilege, it is suggested that the basis of property to the recipient for the computation of capital gains and losses be the same as it was in the hands of the decedent. (Hearings, House Ways and Means Committee, 77th Cong., 2d Sess., Revenue Act of 1942, pp. 89–90)

Despite the fact that this constituted a Treasury Department proposal, and despite the need for substantially increased revenues to support the war effort, this Committee wisely included no such provision in the bill reported by it to the House of Representatives and no such provision was in the bill passed by that body and sent to the Senate. The recommendation was not renewed before the Senate Finance Committee.

Thus, the principle that appreciated assets should be given a basis equal to the estate tax valuation in the hands of the person who has acquired them from a decedent is the result of considered Congressional judgment over the past 52 years. Furthermore, such judgment has been exercised in the face of repeated arguments that such appreciation had "escaped income taxation." Such an established legislative policy should not now be reversed in the absence of compelling reasons to do so. Such reasons do not exist. Rather, the reasons which have traditionally supported the present law are equally valid today.

A Carryover Basis Is No More Than a Disguised Drastic Estate Tax Increase, Applied Unequally to Estates of Equal Size

The impact of federal estate taxation, with rates ranging up to 77%, is disregarded by the proponents of the carryover basis. Yet for anyone seriously concerned about "incentives" to encourage the flow of wealth into productive enterprises, the federal estate tax stands as a serious obstacle. One of the prime motivating forces in American life is the desire on the part of taxpayers to enhance their wealth for the benefit of ensuing generations of their family. To the extent that the federal estate tax renders this more difficult, this motivating drive to invest, to furnish risk capital in the hope of reaping a substantial gain, is lessened. Nevertheless, for policy reasons long accepted by Congress, the estate tax is a part of the American scene and it is not here suggested that it be repealed.

However, it must be recognized that the present proposal to establish a carryover basis in the case of property acquired from a decedent is, in reality, a disguised *increase* in estate tax rates. Furthermore, it is an increase which affects only those estates the creator of which has most successfully invested his capital to produce an enhancement in his, and the nation's over-all wealth. The enactment of the proposed amendment would place a premium upon liquidity, upon investments in safe, but non-growth assets, such as bonds and insurance. This is not to say that such investments are unwise, or that they do not furnish capital for the growth of the nation's business; it is to point out that such investments are a far cry from true risk capital.

Validity of the foregoing criticisms may be demonstrated by a comparison of four situations, each involving an estate of precisely the same size.

Case 1

Assume:

Taxable estate compromised entirely of life insurance and bonds with a market value of par	$5,060,000
Federal estate tax	2,468,200
Balance remaining after payment of taxes	2,591,800

This is the result under present law; it would be the result if a carryover basis provision were enacted into law.

Case 2

Taxable estate comprised entirely of stock with a basis is $506,000	$5,060,000.00
Federal estate tax	2,468,200.00
Estate tax on appreciation (4554/5060×2,468,200)	2,221,380.00
Add basis of stock	506,000.00
New basis of stock	2,727,380.00
Ratio of basis to value of stock (percent)	(53.9)
Ratio of gain to value of stock	(46.1)
If stock with a market value of $2,500,000 is sold to raise funds to pay the estate tax:	
Capital gain (.461×$2,500,000)	$1,152,500.00
Capital gain tax (assuming other income of estate just equals exemption	389,240.00
Add estate tax	2,468,200.00
Cash need	2,857,440.00
There is thus an additional cash requirement of $357,440. If an additional $430,000 of stock is sold:	
Capital gain (.461×$430,000)	198,230.00
Capital gain tax at 35 percent	69,380.50
Total selling price	430,000.00
Less capital gain tax	69,880.50
Additional cash raised	360,619.50
Federal estate tax	2,468,200.00
Add capital gain tax on initial sale	389,240.00
Add capital gain tax on second sale	69,380.50
Total taxes	2,926,820.50
Taxable estate	5,060,000.00
Less Federal estate tax and capital gain tax	2,926,820.50
Balance remaining after payment of taxes	2,133,179.50

Thus, due to the need to sell appreciated assets to pay federal estate tax, total taxes are increased $458,620.50, or 18.58%. The value of the assets remaining after payment of taxes is reduced 17.69%, and such assets have a basis of only 53.9% of their value, so that a substantial additional capital gain tax will become due if they are sold in the future.

Case 3

Taxable estate comprised of $1,000,000 insurance, $1,000,000 bonds valued at par and stock with a basis of $306,000	$5,060,000
Federal estate tax	2,468,200
Estate tax on appreciation (2754/5060×2,468,200)	1,343,343
Add basis of stock	306,000
New basis of stock	1,649,343
Ratio of basis to value of stock (percent)	(53.9)
Ratio of gain to value to stock (percent)	(46.1)

If stock with a market value of $500,000 is sold, with insurance and bonds, to pay estate tax:

Capital gain (.461×$500,000)	$230,500
Capital gain tax (assuming other income of estate just equals exemption)	66,165
Add estate tax	2,468,200
Cash Need	2,534,365

There is thus an additional cash requirement of $34,365. If an additional $40,000 of stock is sold:

Capital gain (.461×$40,000)	18,440
Capital gain tax at 35 percent	6,454
Total selling price	40,000
Less capital gain tax	6,454
Additional cash raised	33,546
Federal estate tax	2,468,200
Add capital gain tax on initial sale	66,165
Add capital gain tax on second sale	6,454
Total taxes	2,540,819
Taxable estate	5,060,000
Less Federal estate tax and capital gain tax	2,540,819
Balance remaining after payment of taxes	2,519,181

In this case, by use of the non-appreciated assets to pay the bulk of the federal estate tax, total taxes are increased only $72,619, or 2.94%, but the previously well-balanced estate is now entirely in stock. The stock, of course, has a basis of only 53.9% of its value, as in Case 2.

Case 4

Taxable estate comprised entirely of stock with a basis of $506,000	$506,000
Federal estate tax	2,468,200
Estate tax on appreciation (4554/5060×2,468,200)	2,221,380
Add basis of stock	560,000
New basis of stock	2,727,380
Ratio of basis to value of stock (percent)	(53.9)
Ratio of gain to value of stock (percent)	(46.1)
If, for business reasons it is necessary or desirable to sell all of the stock:	
Capital gain (.461×$5,060,000)	2,332,660
Capital gain tax (assuming other income of estate just equals exemption)	801,921
Federal estate tax	2,468,200
Add capital gain tax	801,921
Total taxes	3,270,121
Taxable estate	5,060,000
Less federal estate tax and capital gain tax	3,270,121
Balance remaining after payment of taxes	1,789,879

Here total taxes are increased $801,921, or 32.49%, an utterly unjustifiable increase, and total taxes are very much greater than would have been the case had the stock been sold immediately prior to death.

Capital gain ($5,060,000 less $506,000)	$4,554,000.00
Tax on gain (assuming other income of owner just equals exemption)	1,579,390.00
Taxable estate ($5,060,000 less $1,579,390)	3,480,610.00
Estate tax	1,498,741.00
Add capital gain tax	1,579,390.00
Total taxes	3,078,131.60
Total taxes if stock sold after death	3,270,121.00
Total taxes of stock sold before death	3,078,121.60
Difference	191,989.40

Orderly administration of estates will be seriously jeopardized by carryover basis

It is axiomatic that one of the first duties of a fiduciary administering the estate of a decedent is to plan to meet the necessary cash requirements. Under present law this requires the fiduciary to ascertain the approximate date-of-death value of the decedent's estate. Using this figure as a guide, a relatively close approximation of administration expenses and death taxes can be made in a comparatively short time following the decedent's death. Debts can be ascertained, and, thus, cash requirements estimated. The prudent fiduciary begins at this point to raise the necessary cash. To wait until the alternate valuation date for the federal estate tax has passed, or until the cash must actually be spent, is to gamble with trust funds. A serious decline in market values, leaving the fiduciary compelled to sell an excessive percentage of the decedent's estate might well subject the fiduciary surcharge.

Now, however, assume that all assets formerly belonging to the decedent are held by the fiduciary with the decedent's basis, or with such basis increased by the amount of federal estate tax attributable to any appreciation in value. In either case, before sales can be prudently made for the purpose of raising cash needs, a determination of the decedent's basis for every asset must be made. Since the immediate sale of highly appreciated assets will greatly increase the estate's tax burden, as discussed above, good judgment requires that, where possible, those assets which have appreciated least be sold first. This fact produces two extremely undesirable results.

First, the desire to avoid incurring additional taxes may lead the fiduciary to sell the more stable, safer investments, and to retain the more speculative, those which have increased in value the most in the past, but which may decline the most in the event of a market decline. The sale of such stable assets, if there is a decline in remaining volatile assets, will assuredly be the subject of criticism, if not actual attack, by the beneficiaries of the estate. On the other hand, if the speculative assets are sold, and the stable investments retained, and there is no market decline, the unfortunate fiduciary is wrong again. He has incurred unnecessary tax expense, and the beneficiaries of the estate are equally disturbed.

Second, before any consideration can be given to which assets are to be sold, the basis of all assets in the estate must be known. Yet, where the assets have been acquired many years before, or have passed through several estates, always with a carryover basis, such determination will be extremely difficult, if not impossible. At the very least it will require a good deal of research by the fiduciary; research takes time. Until such time has been spent, sales will not be made, and the fiduciary will be unavoidably delayed in his imperative task of providing for the cash needs of the estate. Orderly estate administration will have been sacrificed on the altar of federal taxation.

A carryover basis poses serious problems for estate beneficiaries

If specific assets acquired from a decedent are required to take as their basis the basis in the hands of the decedent, serious inequities can result among the beneficiaries of an estate. For example, if a father has two children, one daughter and one son, whom he desires to treat equally, he may find it impossible to do so. Assume a $2,000,000 estate after payment of taxes, one-half consisting of stock in a closely held corporation in which the son is an active participant, one-half in bonds. Assume further that the stock has a basis of $200,000 and the bonds a

basis of $1,000,000. Under present law, equal treatment of son and daughter is a simple matter of leaving the stock to the son, the bonds to the daughter. The son is given the business interest which he desires, the daughter is given a readily marketable security. However, if the son were to take the stock with a $200,000 basis, or even with a $200,000 basis increased by the estate tax on $1,800,000 of appreciation, he would receive an asset substantially less in realizable value than the daughter whose bonds would have no appreciation subject to tax on disposition.

* * * * * * *

Apprcciation Would Be Taxed Higher in Small Estates Than in Large Estates

With a carryover basis, the same dollar amount of appreciation would bear a higher capital gain tax after passing through an estate of moderate size than it would after passing through a larger estate.

Assume three estates, each including a stock with a basis of $100,000 and appreciation of $900,000, with a date-of-death value of $1,000,000, with respective taxable estates of: A. $1,000,000; B. $5,000,000; C. $10,000,000. The stock in question is sold by the executor or heir.

A

Taxable estate	$1,000,000.00
Estate tax	303,500.00
Portion of estate tax attributable to appreciation (9/10 x 303,500)	273,150.00
Selling price	1,000,000.00
Basis:	
Original	100,000.00
Increase	273,150.00
Total	373,150.00
Capital gain	626,850.00
Tax thereon	204,887.50

B

Taxable estate	$5,000,000.00
Estate tax	2,430,400.00
Portion of estate tax attributable to appreciation (9/50 x 2,430,000)	437,472.00
Selling price	1,000,000.00
Basis:	
Original	100,000.00
Increase	437,472.00
Total	537,472.00
Capital gain	462,528.00
Tax thereon	147,374.80

C

Taxable estate	$10,000,000.00
Estate tax	6,042,600.00
Portion of estate tax attributable to apprecation (9/100 x 6,042,600)	543,834.00
Selling price	1,000,000.00
Basis:	
Original	100,000.00
Increase	543,834.00
Total	643,834.00
Capital gain	356,166.00
Tax thereon	110,146.10

In Many Instances the Effect of Carryover Basis Could be Avoided by the Astute

One of the primary and most substantial criticisms leveled at the present Internal Revenue Code is that its complexity and, to be frank, its frequent departures from what might be termed "commonsense law", render it a trap for the

unwary, while its more rigorous provisions can be avoided by those with astute tax counsel. So it is with the carryover basis provision.

Unless an average basis device is employed, a law requiring property acquired from a decedent to take the decedent's basis would work further hardships on some taxpayers while posing relatively little problem for others. For example, it would be a simple matter for a decedent possessing both appreciated and non-appreciated property to provide by will that the former pass to taxpayers in low tax brackets, while giving the latter to those in higher brackets. If a charitable bequest were involved, the appreciated property could be left to charity and the non-appreciated to the family. It would not even be necessary to specify the property to go to charity, if a general clause required satisfaction of the charitable bequest with the most appreciated assets. The tax results in such case would be the same as under present law. If the appreciated assets consisted of securities with a wide-spread market, and if the family felt that they would prefer to hold such securities rather than the assets left to them, they could sell their bequests of non-appreciated assets with relatively little capital gain and reinvest the proceeds in an open-market purchase of assets comparable to those left to the charity. Where such careful tax planning was not performed, however, the results for the family could be entirely different.

The Present Date-of-Death Provisions Are Not Always Beneficial to Taxpayers

As mentioned briefly above the present attack on carryover basis fails to take into account that the present provisions establishing date-of-death value as the basis of property acquired from a decedent are not an unalloyed blessing. It is entirely possible that assets may *decline*, rather than appreciate in value before the death of their orginal owner. In such case, the basis of property received from a decedent is, nevertheless, its value at date of death, and the beneficiaries of the estate are precluded from therafter claiming the benefits of a capital loss based on such decline. This is not a situation in the control of the original owner of the depreciated assets because the deductibility of capital losses is strictly limited and an unused capital loss carryover dies with the taxpayer. Thus, in a period of declining values a carryover basis would permit beneficiaries of estates to take losses and reduce their taxable income in a period when tax revenues were already falling. It is an historical fact that many of the present tax-free exchange provisions of the Internal Revenue Code were enacted in the Depression era when the Treasury was more concerned with eliminating the recognition of losses than in finding new ways to require gains to be recognized. To assume that this condition may not arise in the future is to be unduly optimistic, and to enact into law a provision which, with all of the faults discussed above, has only the virtue of increasing revenues in a period of rising prices would be most unwise.

Conclusion

It is submitted that the proposal for a carryover basis in the case of assets acquired from a decedent ignores the long legislative history of the present law, is unworkable and unjust, and adds a completely unnecessary complication to the Internal Revenue Code. Unrealized appreciate is not free of tax so long as the federal estate tax contains rates ranging as high as 77%. The suggested legislation is a disguised attempt to raise such tax rates in a discriminatory and unwise fashion. Appreciation over several generations would be subject to tax in the hands of the last owner, thereby subjecting him to the cumulative impact of inflation and a tax penalty which might make prohibitive a wise decision to dispose of the property. The imposition of a tax such as will result from the carryover basis proposal does far more than plug a non-existent "loophole". It would distort income, penalize growth, and discriminate among taxpayers. It should be defeated.

GENERATION-SKIPPING

A variety of suggestions have been made for a change in estate tax law to eliminate the present possibility of placing property in trust for successive generations without subjecting it to taxation on the death of the successive beneficiaries. [Some proposals have also suggested that outright transfers which skip generations be subjected to tax. These proposals are grounded in the concept that all property should pass through the grinder of taxation at least once a generation. For consistency, they should require payment of a tax on a periodic basis by those persons fortunate enough to live longer than the norm, and perhaps there should be a negative estate tax where a property owner dies too soon. I am not able to offer any substitute for such proposals. However, for those who feel merely that

the trust device lends itself too readily to estate tax avoidance, the following thoughts may be relevant.]

I submit that it remains to be proved that there is any significant amount of tax avoidance going on through the device of generation-skipping trusts. I would estimate that 99% of all the trusts which I have prepared—and that is a great many—have provided for payment either to the children or the grandchildren of the decedent at specified ages. The so-called "rule against perpetuity trust" is a rare bird, indeed, in my experience. Consequently, I am presently unconvinced that there is any necessity for a change in the present rules governing estate taxation of transfers in trust.

On the other hand, I am utterly convinced that the extreme complexity of such generation-skipping tax proposals are those advanced by the A.L.I., the Johnson Administration Treasury Studies, and Richard B. Covey will render them unworkable and traps for the unwary. The estate tax is an excise tax imposd on the privilege of transmitting property at death. If a tax is to be imposed on persons who do not, in fact, transmit any property at death, as the Covey proposals, an entire new concepts becomes involved. On the other hand, the difficulties of applying the tax at the time of the original transfer in trust are overwhelming.

If there is a genuine need for reform in this area—and I repeat that this has not been demonstrated—then it seems to me that a simpler approach, consistent with longunderstood trust law concepts should be carefully considered before this Committee endorses any drastic revision of the law. I submit that a trust to A for life, then to B for life, remainder to C, will almost never be created, and that no estate tax should be imposed on the death of A or of B, or because of the generation-skipping involved. On the other hand, if A or B is given, in addition, to the life, estate, significant control over the trust principal, the totality of the life tenant's rights may be little short of full ownership. Under present law, this type of trust may well also escape taxation on the deaths of A and B. It can be persuasively contended that this should not be so.

If it should not, then I suggest that consideration be given to tightening the existing provisions of the law. For example, elimination of the present $5,000 or 5% provision of section 2041 would significantly reduce the rights which a life tenant could possess before becoming subject to estate taxation. Again, a general power of appointment under section 2041 is so narrowly defined as to make it possible for a life tenant to possess virtually unlimited powers of appointment without becoming subject to estate taxation. Consideration could be given to providing that any power of appointment will be considered a general power, except one which is exercisable in favor of the decedent's spouse, children and spouses of children. This would eliminate the possibility of generation-skipping through the exercise of a power of appointment.

Perhaps the provision excepting from the definition of a general power of appointment a power limited by an ascertainable standard should be modified. Such a power if possessed by the beneficiary as sole Trustee might not be excepted. Greater integration of the estate tax rules with the standards for taxation of grantor trusts is another possibility.

The foregoing suggestions are not advanced as recommendations but merely as areas for the Committee to consider. I simply urge that such less drastic proposals may achieve 90% of the goal of tax "reform" urged by those advocating new taxes on generation-skipping transfers, but without an excessive sacrifice of "simplicity".

Mr. ULLMAN. You have brought a great deal of practical expertise to the committee. We appreciate that.

Are there questions?

Mr. Gibbons.

Mr. GIBBONS. Yes.

Mr. Sutter, does your statement cover that last point you made?

Mr. SUTTER. About the generation skipping? Yes, pages 40 to 43.

Mr. GIBBONS. I think you have made some very good suggestions.

Mr. SUTTER. Thank you.

Mr. BURKE. Mr. Collier.

Mr. COLLIER. Mr. Sutter, I want to compliment you on what I think is an excellent statement in this area. I think it is concise and logical, particularly in regard to the present law providing the tax.

Looking at page 22 of your statement, I think that is highly significant. I think the proponents of the carryover proposal seek to ignore the fact that there is a tax under the present estate tax rates on this gain that is left to an heir.

This seems not to have gotten across to many people, and it is obvious that if the estate increases through any capital gain, obviously there is a recoupment at the other end.

I think you have made a fine statement, Mr. Sutter.

Mr. SUTTER. Thank you, Mr. Collier.

That is, of course, true, and the fact is that the rate is higher than the capital gains tax rate.

Mr. ULLMAN. Are there further questions?

If not, thank you very much, Mr. Sutter.

Mr. SUTTER. Thank you.

Mr. ULLMAN. For the benefit of the witnesses and the committee, we will attempt to go through with the hearings at least until 1 o'clock before we recess.

Our next witnesses are Mr. Austin Fleming and Mr. William K. Stevens.

We welcome you before the committee, gentlemen. If you would further identify yourselves for the record, we would be happy to hear you.

PENNSYLVANIA BANKERS ASSOCIATION,
Harrisburg, Pa., September 6, 1977.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance, Room 2227, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: The Taxation Committee of the Trust Division of the Pennsylvania Bankers Association wishes to submit its views to the Committee on the problems created by carryover basis.

The carryover basis provisions are predicated upon the assumption that the decedent's income tax basis is readily ascertainable. Most indiviuals, human nature being what it is, do not maintain perfect records of the cost basis of their assets. An individual during his lifetime does not need his income tax cost basis unless he decides to sell an asset. While the individual is alive, he can be asked how the asset was acquired, when it was acquired and what it costs. As an individual ages, his recall begins to fade and the necessity for recordkeeping has less meaning to the person. The general population could not have anticipated the enactment of the carryover basis provisions of the Tax Reform Act of 1976. Under the prior provisions an individual assumed that his assets would be held until his demise so he did not concern himself with maintaining cost records for many of his assets. Upon the individual's death the executor-administrator is burdened with the impossible situation of locating the decedent's cost records. The Tax Reform Act of 1976 places the burden of locating these records, recreating them and distributing the information to the beneficiaries upon the executor-administrator. Further, the Act imposes substantial financial penalties if this information can not be furnished.

If cost records were not kept by the decedent, how will the executor-administrator arrive at a cost basis; and will the Internal Revenue Service arrive at the same cost? The Tax Reform Act provides that if cost can not be located, a reasonable method of determining cost basis can be used. If the asset is a security, the only evidence of the date of acquisition may be the issue date on the certificate. The executor-administrator can determine the value of the security on that date. This value, of course, could have no certain relationship to the decedent's cost basis. The security certificate could have been exchanged and reissued for various reasons other than an acquisition. The certificate could have been issued as a result of a stock split or merger of one company into another. New certificates could be issued, but there is no change in cost basis. If such an aproach were used, the executor-administrator would have no guarantee that the Internal Revenue Service would accept such a tenuous method of arriving at asset value for income tax purposes. It would create possible conflicts between the Internal Revenue Service and executor-administrator so as to prolong the administration of an estate for the protection of the fiduciary.

The problem of locating cost basis for tangible personal property is even greater. Rare is the individual who maintains records of the cost basis of jewelry, antiques and household goods. This is especially true since most people do not anticipate sales of their tangible property. So often jewelry is acquired through gifts where the donor never reveals the cost of such a gift. Over a lifetime such gifts could appreciate and become a substantial amount. No records of such items are kept. In the past there would be no problem. However under the Tax Reform Act of

1976, the cost basis of such items becomes exceedingly important. To alleviate the problem, the Tax Reform Act excluded $10,000 of tangible personal property from the carryover basis provisions. This provision places a burden upon the executor-administrator since there is no equitable way that the $10,000 can be allocate among several beneficiaries. If the value of the tangible personal property exceeds $10,000, the executor-administrator by allocating the limitation amount is forced to show preference over another and even cause litigation as to the proper allocation of the minimum basis for tangible personal property.

The fresh start adjustment was enacted to give relief for gain purpose. This was to avoid taxing gain that had been incurred prior to the enactment of the Tax Reform Act. This fresh start adjustment results in many assets acquiring two different cost bases for Federal Income Tax purposes. With so many States having State Income Taxes where the basis is other than the Federal Income Tax cost, the complications of the laws become more manifest. As mentioned, before it is difficult enough for an individual to keep a record of one cost basis. Three bases for the same asset would cause an individual to throw up his hands in dismay and refuse to keep any record. This would make enforcement of the Federal Income Tax Laws even more difficult. Some of the difficulty could be alleviated by permitting the fresh start adjustment for both gain and loss purposes. This could mean only one Federal Income Tax basis for each asset. Such an adjustment would lessen the problem of determining the cost basis of many assets that were acquired long before the enactment of the Tax Reform Act.

The fresh start adjustment for property other than listed securities creates another problem. The new law assumes a uniform rate of appreciation. Appreciation occurring in these type assets are not uniform. A closely held business is indicative of such asset. An individual in his younger days may have increased the value substantially. As he ages he finds it difficult to just maintain the same level. The Tax Reform Act places a larger burden of capital gain on his estate based on the longer the individual lives after December 31, 1976. The closer the individual would die to that date, the less capital gain his estate would pay on sale of the business; although there has been no increase in the value. This is unfair to the estate of an individual who has created an asset with his own labors rather than through the investment of financial wealth.

The minimum basis of $60,000 creates several problems. An estate that would not be subject to Federal Estate Tax because the credit is in excess of the tax on such estate has carryover basis problems since the "carryover basis" property may exceed $60,000. Further, a multi-million dollar estate with "carryover basis property" with a basis less than $60,000 receives an automatic increase in basis. If the intent of Congress was to alleviate some of the problems, it failed since the "carryover basis" problem is greater than the Federal Estate Tax effect. Because of the "carryover basis" provisions estates of under $100,000 will pay more income tax on the sale of assets than it did Federal Estate Tax under prior law.

The carryover basis provisions appear to apply to each separate acquisition of an asset. If the basis adjustments apply to each acquisition, the problem of adjustment requires extraordinary detail to arrive at the basis of each lot. The problem becomes more evident when considering an individual who has invested his funds in a monthly stock purchase plan over the past ten years. In that one security there would be 120 separate lots to which the carryover basis adjustments would have to be made. The adjustments in this case would involve adjustments to fractional shares where the mathematical calculations would be horrendous. Similar situations would arise in dividend reinvestment programs, coin collections and stamp collections. It is understood that the minimum $60,000 basis was meant to meet such a situation. However, with the rapid increase in the value of personal residences, the minimum basis would not apply and the multiple calculations would have to be made. A further complication relates to the holding period of proerty acquired from a decedent. Under prior law, Congress saw fit to provide automatic long-term capital gain treatment to sales by the estate since the Federal Estate Tax, state death taxes and payment of the administration expenses and debts of the decedent required the immediate conversion of assets into cash. Congress did not see fit to impose an income tax penalty of short-term treatment where the sales were forced by the death of the individual. The Tax Reform Act complicates the problem by imposing a "tack-on" of the decedent's holding period to the estate. This could reimpose the penalty of short term capital gain treatment on the estate since the executor-administrator might sell a recently acquired security before he learns the acquisition date. This does not seem to be the intent of Congress. It should be clearly stated in

the law that an estate would have long-term capital gain treatment on all assets acquired from a decedent.

If long-term capital gain treatment were clearly indicated, some of the problem of the complicated calculations could be lessened by permitting the executor-administrator to create just two tax cost lots in each asset. The lots would be a pre-12/31/76 lot and a post-12/31/76 lot. The carryover basis adjustments could then be applied to each of these lots rather than miniscule segments. The result would be an average basis for each asset. This would aid the equitable distribution of assets to beneficiaries. It would reduce the calculations necessary under the Tax Reform Act. It would simplify the tax cost information that would have to be supplied to the beneficiary and the Internal Revenue Service. It would reduce enforcement problems of the tax laws through less complicated records.

The allocation of a proportionate share of the Federal Estate Tax and state death taxes to the basis creates a problem in that there is no finality to the basis until the returns are accepted by the tax authorities. In many cases this occurs years after the decedent's death and long after an asset was sold to raise cash in the estate. These adjustments cause substantial mathematical computation. The volume of amended income returns, both fiduciary and individual, will increase significantly. The amended returns will deal essentially in the processing of overpayments since increases in the Federal Estate Tax and state death taxes will result in increases in basis of assets sold. The cost of processing these amended income returns should be substantial.

The problems of the carryover basis provisions are so numerous that an individual executor-administrator will find these provisions incomprehensible. A fiduciary income tax return could not be completed with finality until many years after it is filed. The audit process in this area will become a constant contest between the fiduciary and the Internal Revenue Service with basis differences occurring based upon the number of decimal points each carries the various adjustments. The income tax basis of an asset received from a decedent could be different based upon the method used to reconstruct, if the decedent had not kept adequate records. A substantial increase in cost to professional fiduciaries would be required to hire additional qualified personnel to assemble and maintain this newly-required information. For many smaller fiduciaries the cost would be prohibitive. These problems lead to the conclusion that the "carryover basis" provisions should be repealed and the old provisions be reenacted until a viable alternative be found.

I respectfully submit these comments on behalf of my committee.

Very truly yours,

JULIUS J. CIESIELKA, Jr.,
Chairman, Trust Tax Committee,
Pennsylvania Bankers Association.

STATEMENT OF SHIRLEY A. WEBSTER, ATTORNEY AT LAW, WINTERSET, IOWA, RELATIVE TO "CARRY-OVER-BASIS RULE"

Identity of Witness: Senior partner in Firm of Webster, Jordan, Oliver & Walters, Winterset, Iowa;

Engaged in general practice of law in Madison County, Iowa, since 1932 with majority of attention devoted to probate, taxation and property law;

Past President of the Iowa State Bar Association;

Chairman of Special Committee on Probate, Property and Trust Law, Iowa State Bar Association, for fifteen years;

Fellow American College Probate Council—past member of Board of Regents and former Treasurer of College;

Author of Law Review articles and HOW TO LIVE AND DIE WITH IOWA PROBATE.

Gentlemen, I wish to submit the following written testimony to your subcommittee in connection with its study of the Tax Reform Act of 1976. My references to Code Sections are to Internal Revenue Code sections as amended by the Tax Reform Act of 1976.

FIRST

All of the provisions of the 1976 Act relative to the "carry-over-basis rule" should be repealed retroactively and the old rule relative to basis as finally determined for federal estate tax purposes should be reinstated. Reasons for making these suggestions are as follows:

A. From a practical standpoint, the "carry-over-basis rule" is unworkable. This rule envisions that every person has a record showing the day, month and year that he acquired every item which he possesses at the time of his death. These records showing the date of purchase and the cost of every item of tangible personal property owned by the decedent at the time of death, if kept, would be voluminous. The average American citizen purchases thousands of items during his lifetime. He would have to be an experienced bookkeeper and systematically file the records of his purchases and continuously discard what had been used or disposed of during his lifetime. These records would have to be kept in such detail that individual items, such as small tools, individual calves and individual pigs in a herd, and each and every piece of tangible personal property would reflect the date acquired, the cost, if any, and sufficient description so that the item could be identified after the death of the owner. The requirement is simply beyond the ability of the average American citizen. Most of the people have enough difficulty in keeping records of the major items which they own such as real estate, stocks and bonds. In the absence of such records, the person who owned the property is deceased and there is no practical way for the executor or administrator, or the beneficiaries, to furnish the information required to determine the decedent's adjusted basis according to the rule. Any attempt to substitute an artificial rule as to estimated life, estimated date of acquisition and estimated cost is simply recognizing that the "carry-over-basis rule" is unrealistic and actually unworkable. It would be virtually impossible for Internal Revenue Service to audit this information with any degree of accuracy. If Internal Revenue Service is expected to audit the reported basis of every item of tangible personal property in the United States, it would take an army of Internal Revenue agents at a cost to the taxpayer far in excess of any amount of revenue which would be gained by applying the "carry-over-basis rule" provided in the 1976 Act.

B. Attorneys and accountants, who specialize in this field, have had nine months to study the Act, and freely admit that they do not understand the provisions—they state that it is the most complex, confusing and unfair tax act which they have ever studied. A mass of regulations will have to be adopted by Internal Revenue Service to interpret obscurities and solve ambiguities. In the meantime, no one really knows what the law means. How can the average taxpayer be expected to have any understanding of this complicated piece of legislation?

C. The Act discriminates against farmers. The average farmer's income tax return is filed on a cash basis. The basis of all his crops, cattle and hogs raised and kept for sale in the ordinary farming operation, all have a zero basis for income tax purposes. In order to provide liquidity in an estate and simply because hogs and cattle must be sold when they are ready for market, these items will ordinarily be sold during the administration of an estate, and the sale of these items will result in ordinary income in the estate and have a zero basis. Even with adjustment for death taxes in the estate, these items will result in ordinary income to the estate. This income being "bunched" in the estate will most often result in the estate paying income tax far higher than the income tax rate paid by the individual during his lifetime. The Act does not provide for income tax averaging nor some of the other concepts which tend to level off the tax of the individual. The income resulting from the sale of crops and livestock by an operating farmer is not subject to the same credit as income in respect to a decedent which could be claimed by landlords renting their land on a crop-share basis. In the higher brackets, these income tax provisions are actually confiscatory.

D. With the new unified tax rates provided under the 1976 Act, the effective percentage of federal estate tax starts at 30 percent in estates having net assets of a little over $120,000, and at $150,000 net value, the tax rate is 32 percent, and is progressive. It would seem that the restoration of the old basis whereby assets acquired a basis equal to market value as finally determined for federal estate tax purposes, is certainly high enough if we are to maintain anything resembling our present economic system, which has over the past 200 years made America the great nation that it is.

SECOND

If the so-called "carry-over-basis rule", as established by the 1976 Act, is not repealed in its entirety, then your committee is urged to consider the following specific recommendations by way of amendments to the 1976 Act:

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A. The increase in value of personal effects and household goods as provided in Section 1023(b)(3) should be automatically the fair market value of such items at the time of death without any election on the part of the executor, administrator, or heir. It is difficult to conceive of any situation where the executor or administrator handling an estate would not be required to make such election under the present statutory provisions. This election is unnecessary and simply creates additional burdens on the part of the fiduciary with the attendant reports to the Internal Revenue Service, all at public expense and without any appreciable increase in revenue.

B. All tangible personal property owned by the decedent should acquire a "carry-over basis" at its fair market value at the time of the decedent's death without any election. Tangible personal property constitutes a very small portion of the assets of an ordinary estate. There have been articles stating that only 2 percent of the estates of decedents will be subject to taxation with the present unified credit provided under the Act. This matter of requiring elections as to the value of personal effects and household goods and reports as to the value of tangible personal property is simply going to engulf 98 percent of the estates of decedents in a mass of paper work and subject the personal representatives to penalties, all of which are contrary to the announced policy of Congress to reform the Revenue Act and make the law simpler and fairer. The draftsmen of this Act apparently recognized that there would be widespread failure to conform to the reporting provisions and inserted Section 6694 providing for burdensome penalties for failure to notify the Internal Revenue Service and the distributees of the "carry-over basis" of all items of tangible personal property. It is well known that in the average estate the personal effects of the mother and father are usually divided by amicable agreement among the children. These items have an intrinsic value but very little market value, but yet the Act requires that each and every one of these items be valued and reported, and the failure to do so subjects the representatives to penalties. One source quotes the Internal Revenue Service as estimating that it would net $20,000,000 from collecting these penalties. Congress certainly did not intend to make the matter of penalties a revenue producing measure.

Recently, our office handled a matter where the decedent was a resident of a nursing home and had previously sold all of his household goods. He had less than $50 market value of personal effects in his room at the time of his death. These were divided by amicable agreement among four children, and it was necessary for the children to make an election under the provisions of Section 1023(b)(3)(C), file the same with the District Director of Internal Revenue and notify each of the children that they had a fresh-start basis of $12.50. This notice of distribution was also required to be furnished to the Treasury Department. The penalties provided by Section 6694 should be repealed.

C. From a practical standpoint, the statute should be amended to provide that when a federal estate tax return is not required to be filed, all of the decedent's estate will have a carry-over basis corresponding with the fair market value of the property at the time of the decedent's death without any notice or election on the part of the personal representative or the person taking charge of the assets of the decedent.

LA JOLLA, CALIF., *August 30, 1977.*

Hon: HARRY K. BYRD, Jr.,
(Attention: Michael Stern, *Staff Director.*)
Committee on Finance, Room 2227,
Dirksen Office Building, Washington, D.C.

DEAR SENATOR BYRD: I understand the House Ways and Means Committee will soon considers a clean-up bill" to correct the inequities of the 1976 tax law. Very great injustice will be done to myself and many other small business owners and their businesses if the tax law removes the long standing Section 303 treatment of Section 306 preferred stock.

In its wisdom many years ago, Congress recognizes the unique problems faced by the small businessman, his family and business at the time of the owner's death. It recognized that too many of these small businesses were being liquidated as the result of the necessity to pay the owner's estate taxes. Liquidated along with these businesses were also the available goods and services they supplied to our society and thousands of productive jobs made possible by the small business sector.

As a result, Congress granted relief to the small businessman through Section 303 of the Internal Revenue Code which provided, under strict rules, for relief from the danger of threatened liquidation and its resultant disastrous effects.

Now I am told that the new tax law removes much of this relief, and in effect, retroactively destroys my long standing estate plan.

My estate planning years ago was based entirely on this promise of the government to allow redemption of preferred stock for the payment of inheritance tax. I took out expensive insurance to provide for the redemption under this covering promise. If the government were now to renounce this, which I naturally regarded as a solemn promise, there would be disastrous consequences. In fact, it is preposterous that government could retroactively renege upon a promise upon which entire estate planning was built and which was carefully built up in the form of insurance and other plans over the years.

It is not a partisan matter, it is not a tax matter, it is just a matter of honesty and fair play that this matter of 303 redemption of Section 306 stock be acknowledged to be in full force when your new clean-up bill is finalized.

Thank you for your courtesy in this matter.

Sincerely yours,

ROBERT J. WILKIE.

COMMENTS AND RECOMMENDATIONS ON THE 1976 TAX LAW AND ITS EFFECT UPON GIFTS AND ESTATES, BY ARLEY J. WILSON, CHAIRMAN, PROBATE, PROPERTY AND TRUST LAW COMMITTEE FOR THE IOWA STATE BAR ASSOCIATION

This comment is limited to two areas of the 1976 tax law and in some instances to the practical difficulties that will arise out of the Technical Correction Act of 1977 which is now before the House Ways and Means Committee as H.R. 6715. My comments are primarily addressed to matters concerning the agricultural community and will be limited to qualifications required for special use valuation of real estate used in farming and the carryover basis in its application to property used in the farming enterprise.

FIRST

Initially I would like to address my remarks to that part of 2032A of the 1976 tax law. Admittedly there must be limitations on special use valuation to prevent that which would not be desirable in the farming community, that is to say, that foreign money would be introduced in the farm community to hide from estate taxes to the extent that it would produce an artificial valuation of land used for farming in the farming community. However, those limitations set out in the Act would apparently be adequate to build sufficient gates to prevent such influx of foreign money and to accomplish the purposes expressed by the Act if there was an omission of one of the limitations. That remedy is material participation by the decedent or a member of the decedent's family in the operation of the firm or other business for a period of 5 of the last 8 years. This unfortunate use of "material participation" creates substantially more problems than it solves.

The theory expressed by the Congressional Committees in passing this legislation was to enable families to keep and maintain family farms. The language which will hereafter be ferred to as "material participation" to a great extent defeats this purpose and discriminates against women and senior citizen farmers. The way this discrimination comes about is as follows. For years one branch of the government, namely the Social Security Administration, has desired to cover farmers. If this "material participation" concept remains in the Internal Revenue Act referred to above, a farmer will have to choose in a great many instances whether or not he wants to take social security or remain eligible for special use valuation since the eligibility for social security benefits and the eligibility for special use valuation are incompatible concepts. The only retired farmer to whom this delimma will not be presented is one who has a male heir who is actively engaged in the operation of the farm. A retired farmer without any children, a widow without a son actively engaged in running the farm or a retired farmer with daughters will ordinarily not qualify. In my own practice we do more than 1,000 farm returns and in only one instance do I have a farm wife who qualifies as a "material participant" in the farming enterprise. In most instances retired farm operators on a crop share basis drawing social security

would not qualify either. In no instances would a retired farm landlord on a cash rent basis qualify. Congressional intent as reflected in the original Committee report, to benefit and preserve the family farm, is not going to be served if "material participation" is retained in the Act as an essential condition of the eligibility of the special use valuation. In addition, "material participation" does not add any safeguards to the area that Congress was trying to consider that are not already provided by the percentage ownership requirements in the Act.

"Material participation" has historically been a social security concept for social security income purposes which has no significance in the estate and gift tax area. This Act purports to incorporate this concept in an estate tax concept without fully considering the ramifications which prior planning for social security purposes will have in its estate tax application and thus the compliance with the social security requirements entraps the social security recipient in a locked-in position from which he is unable to extricate himself. Therefore, this works actively as a restriction against the senior citizen retired farmer. The point which I would like to emphasize is that an operator farmer facing retirement is going to be forced to make a choice between receiving social security benefits on the one hand or allowing his estate to be eligible for special use valuation on the other.

The Act automatically discriminates against women. In the instance above cited where in over 1,000 farm returns we only have one female who falls within the "material participation" qualifications, farm wives not having materially participated even though they have worked on the farm, have been expressly excepted by Section 3121(b)(3) of the 1977 Code, even though they have ridden the tractor, fed the hogs, helped make the hay and helped harvest the commodity and have been totally involved in the operation of the family farm. Therefore, even though the wife has been an integral part of the family farm operation, if she dies the husband would likely be able to qualify for the special use valuation. However, if the husband dies leaving the wife, her chance of qualifying would be very remote.

The farm family daughter is less likely to be able to assume an attitude of material participation than is the farm family son. Therefore, the farm family daughter is placed at a disadvantage because the average daughter who inherits farm land would have to operate through agency. As long as the "material participation" concept is in the Act, operating through an agency will not qualify as "material participation". Generally speaking, surviving female heirs will find it difficult to retain the benefit of the special use valuation because the customary method of operation of agricultural real estate by women involves the use of agents and under the present rules this would not qualify as "material participation." [Section 1402(a)(1)].

If material participation is to be left in the statute, serious problems of interpretation arise in the following areas:

a. Trusts.

Trusts by their very nature are agencies for the administration, preservation and distribution of property and there are many existing family farms controlled by the typical two trust will.

b. The family farm corporation.

All corporations operate through agents or employees and therefore under the current rules cannot well fall within the area of material participation" per se.

c. The estate.

The fiduciary in an estate is again an agency situation and because of that situation a qualified person who has participated for 5 of the last 7½ years, becomes a decedent and might well become disqualified if the estate retained the property for a period of longer than six months and therefore the property would no longer be qualified for special use valuation.

The Committee Report makes it very clear that the benefit of special use valuation is supposed to be available to various indirect methods of ownership but the very fact that they are indirect almost mandates that you have to have agency involved so we have a marked conflict between the intention of Congress to make this available in indirect ownership and the social security concept that says that you cannot use agency. (See Page 24 of the Report of Ways and Means Committee on H. R. 14844, second paragraph.)

SECOND

Without commenting on the feasibility from a policy standpoint of the carryover basis rule, the manner in which Congress has seen fit to implement the rule has created virtually insurmountable difficulties and created substantial expense in the administration of the typical farm estate with which I deal.

Congress attempted to equate fresh start in the case of nonmarket property with property easily valued on the stock exchange. However, it is not that easy. The various formulae used in the determination of carryover basis are in their practical application extremely cumbersome and affect so many items in the ordinary farm or small business situation that there is literally no economically feasible way of compliance.

The first conclusion made that there would be a readily available record of acquisition date and cost of business assets is not necessarily true. One sizeable area where this premise is not true when dealing with farmers is in the area of raised livestock used for dairy or breeding purposes or any other raised livestock, to say nothing of a person in the chicken, fish hatchery or beekeeping business.

Keeping in mind that the Act requires the executor to furnish a report to the beneficiary and the Commissioner or his delegate of the basis of each item, item by item, and that if he does not, he can be penalized or fined up to $7500 in each estate. Bear in mind that this applies to each share of stock acquired at a different time in a mutual fund, each stamp acquired at a different time in a stamp collection, each coin acquired at a different time in a coin collection, each cow acquired at a different time in a dairy or breeding herd, each book acquired in an office such as mine, and each improvement that has been made in regard to any other capital asset including a residence. Thus in the instance of the average farm, the executor need to know the acquisition date of each string of tile that has been laid, of each feeding floor that was constructed, of each addition to the barn, of each drying facility and of his fences. This also applies to automobiles. For example, a decedent who has regularly traded in automobiles will have included as a portion of the basis a substantial amount of the basis in the old car and the basis of each predecessor. Thus we may need to determine what Grandpa paid for his Model T Ford so that we may know the basis of his 1976 Ford.

With regard to trade and business assets, it has been the practice and continues to be the practice of many small businessmen and farmers to eliminate from their depreciation schedules any item on which depreciation is no longer available. Thus many farmers and some businessmen have a great deal of equipment that because of the fact that it has no book value would not give rise to any depreciation. The information as to cost and date of acquisition has been discarded. Few people have retained their tax returns more than five years since it has been thought that was all that was necessary under most circumstances.

To make the computations necessary to arrive at the basis in the hands of the heirs, it is necessary to have original cost and date of acquisition of property as well as other information. As a practical matter cost and date of acquisition will be available quite rarely unless the property was a trade or business asset subject to depreciation and was not fully depreciated at the date of death. A simple change of record-keeping in the future will not suffice to relieve the absolute dearth of this sort of information presently existing. It is quite likely that no records will be available for 9 out of 10 items included in the decedent's estate. In most estates this figure will be even higher, particularly when the decedent did not directly engage in a trade or business.

The Tax Reform Act of 1976 not only requires computations which in many instances will be physically impossible but also contains several so-called penalties, which are in reality criminal sanctions, for failure to produce this information. The fresh start adjustment for carryover basis property which has an unknown cost as set forth in the proposed amendments at Section (3)(c)(1) of H.F. 6715 addressed to Section 1023 of the Code is not acceptable administratively. In the first instance, it presupposes appreciation to the date of death at the rate of 8 percent per annum on an arbitrary basis, which at the end of 12½ years will completely eliminate all basis and there is absolutely no provision corresponding for depreciation in value due to whatever circumstances, and in our particular area farm land since the passage of this Act has decreased from 10 percent to 15 percent or more in many, many instances. What an inequitable result it is to assume that nondepreciable property having substantial value on December 31, 1976 would have no basis in the hands of an heir who received it

12½ years later. In many instances family residences and their improvements could be reduced to a no-basis asset merely by the reason of the inability of the fiduciary to satisfy the Internal Revenue agent because he was unable to locate the decedent's records attributable to basis. Many well-kept records are not available to a fiduciary or discoverable by him after lengthy illness of the decedent and the invasion of his household by well-meaning or uninformed people and members of the family who are not acquainted with the import of the records. As a practical matter, it is a rare situation where you have to go back for records for 5 to 6 years and you are able to find anything except in a well-organized and well-run operating company.

When we use an arbitrary diminishment of basis such as proposed in the Act, we immediately are confronted with what happens when there is a distribution of property where there is a negative basis, that is to say, A inherits property with a carryover basis of $70,000, a date of death value of $110,000 and a mortgage obligation of $100,000 which is required to be assumed by the distributee. Assuming that the assumption of debt greater than basis rule still holds, distribution of the property to A would probably trigger an immediate taxable event in the estate of the decedent. The propositions cited above fall far short of a practical solution of how to treat with this problem. In fact, the problem is magnified as time passes.

The concept heretofore accepted was that there was no distinction between cash basis accounting and accrual accounting. The Act and its proposed amendments do not relieve the cash basis taxpayer from an unreasonable multiplicity of taxation. If the taxpayer were living, he would at least have the advantage of income tax averaging and if he were an accrual basis taxpayer his estate would have been diminished by the amount of the previously paid income tax. The cash basis taxpayer has been entrapped through no fault of his making and represents probably in excess of 90 percent of the taxpayers engaged in farming or small business wherein services are rendered. The Act should be extended if carryover basis, or the lack of it, is to be retained to provide relief from or for some credit from taxes paid by the fiduciary. The apparent objective of the carryover basis rule was to assure Congress that an appreciation in value subsequent to December 31, 1976, of assets would be subjected to the income tax notwithstanding the transfer of that property at the time of death and to encourage free alienability of property during his lifetime where it was otherwise suspected that taxpayers would retain property they might otherwise sell because they knew it would take on a higher basis at the time of death. It is submitted that the carryover basis approach is administratively unworkable and if this objective is to be accomplished, it should be accomplished through methods other than carryover basis approach such as herein proposed.

Carryover basis has made the equitable distribution of property in an estate virtually impossible unless all property is distributed in fractional basis. This is an inevitable result causing inherent liabilities for income tax for each distribution.

Because of the adjustment to carryover basis attributable to estate and inheritance taxes paid on appreciation in value, it is physically impossible to determine in the early steps of administration of an estate the income tax result of the distribution of property. This will compel taxpayers to file inaccurate income tax returns in the estate and prohibit an advisor to an estate from making an intelligent recommendation to a fiduciary regarding the tax effect of a particular distribution or sale for each distribution is generally based on value at the time of distribution because basis is significantly different, that is, some of the property may be of low basis but of high market, and some of the property may have a high basis with a commensurate market equal to the low basis property. Ordinarily we would value the property at the time of distribution and distribute the same to the respective heirs. Now it will of necessity be a fractional distribution if equity is to be achieved and this will lead to litigation in so-called partition suits and will unquestionably trigger a taxable event to all parties. Some property in such cases of distribution will bear a disproportionate amount of the income tax liability. Some property will carry with it a federal lien and recapture unless it is maintained for a significant period of time. The bonding provisions provide for low interest rates on the taxes which are delayed in payment [as provided in H.R. 6715. Section 3(d)(5)] are academically remedial and are not practical in application. Anyone who would underwrite such a bond would charge more for the premium on the bonds than would be saved by the postponement of payment of the tax, and while it is nice to pro-

vide for a bond, the limits of the bond are ordinarily prescribed as a part of the requirements of the bond, whether the bond would be actual, whether the bond would be twice the amount of the debt, or whether the bond would be one and one-fourth the amount of the debt is not spelled out and the use, if at all possible, depends on the arbitrary decision of someone other than the Congress and the Congress should fix this responsibility and determine the amount of bond required.

The severe penalties imposed for failure to return basis on each particular item are so severe that no person can leave out any item in any estate with any assurance that such person has done a good job. Ordinarily the fiduciary in a family farm estate is the surviving spouse or a member of the family. The surviving spouse or member of the family quite often would find themselves in a position of utter hopelessness. To assess the fiduciary who happens to be mama in the estate, with a $7500 penalty in addition to the funeral expenses, the medical expenses, the probate expenses, the income tax expenses, both state and federal accelerated as they may well be, the federal estate tax, the state inheritance or estate tax, and the truma of the loss of a loved one is an unconscionable act and the omission of even the smallest of items may trigger a liability in excess of five or more times the value of such item. This is not only administratively unpopular but leads to an administrative nightmare. Academically it appears to be within the scope of required reporting but in practical application of such reports and the ultimate value, is of questionable nature. The warehouses of the United States government will increase dramatically and the bytes on computers will be used up at an inconceivably rapid rate.

In dealing with farmers and the business people of the Midwest, as we have heretofore pointed out, it would seem to be almost impossible in many, many instances to acquire the necessary information to make the computations required by the Act. Even in those instances where the information can be acquired, the process of the computation will add considerable expense to the administration of estates and may in all likelihood require a computer to make the computation. One example, recently a trust department in Tennessee spent 26 hours to calculate the carryover basis in respect of the mutual stock of one company for the shares of a decedent in a single mutual fund where the decedent died with shares acquired in a number of different lots.

It is the best judgment of those members of the Iowa State Bar Association who have considered this matter in depth that the carryover basis concept as originally enacted, including the amendments as proposed in the Technical Correction Act, is an unworkable concept with inherently inequitable results to the taxpayer and if preserved constitute a substantial possibility of impairing the effective administration of a federal tax law. In any event, there is no question but what this provision if preserved will create major increases in the cost of the administration of estates. At a time when the legal profession has been charged with the responsibility to hold down the cost of legal services to the public, this provision alone will compel us to increase the cost of administration of estates without in our opinion a corresponding benefit to the revenue of the United States.

(See attached addendum for simple example of preparation necessary in calculation of carryover basis in each item of an estate—if there are 200 items in an estate this presents an unmanageable situation. You will note that the cowherd is presented in bulk, if it is required to be presented cow by cow the problem compounds itself to magnificent proportions and it is quite likely the cost of calculation would well exceed in many items the value of the basis calculated.)

Section 3(c)(3) of H.R. 6715, the Technical Correction Act, in our opinion does not effectively spell out adequately the intent. It is obvious that it is intended that there be only one carryover basis allowed in any sequence of events. However, the wording of the statute when read might imply that the carryover basis would be reduced to zero and not follow through the second estate.

The recommendations of the Iowa Bar are:

1. That "material participation" be dropped as a requirement for a special use valuation.

2. That carryover basis be discarded or substantially revised because of its present cumbersome nature in determination, the impractical reporting because of detail and the tremendous expense involved in estate administration cost by such reporting and because it provides an utterly unplanable tax consequence for estates, decedents and distributees.

3. That because of the apparent inability of the drafters of the Act to relate to the actual consequences of the drafted bill and its administrative problems, there should be some method whereby those people charged with the responsibility of preparing the Act could coordinate their activities with those people charged with the responsibility of trying to interpret the Act at its application level in estates at the county level.

ADDENDUM

CALCULATING CARRYOVER BASIS [1]

Example: A farmer acquired a farm for $190,000 on January 1, 1971. A portion of the purchase price was allocated to the land and a portion to depreciable buildings, fences and tile lines. Depreciation of $9,000 was claimed each year on a straight line basis. At the former's death on January 1, 1981, the property was valued at $360,000. The calculation of carryover basis may be handled in five steps as follows:

Step 1: Determine gain at death:	
Fair market value	$360,000
Adjusted income tax basis at death ($190,000-(10×$9,000))	100,000
Gain at death	260,000
Step 2: Determine appreciation of property during holding period net of depreciation, depletion or amortization:	
Total gain at death	260,000
Depreciation claimed to date of death	90,000
Net appreciation to date of death	170,000
Step 3: Determine net appreciation for holding period before 1977:	
Number of days in holding period for farm in total	3,650
Number of days in holding period for farm before 1977	2,190
Fraction of total holding period before 1977—2,190 over 3,650 equals 3/5.	
Net appreciation of property before 1977 3/5×$170,000	$102,000
Step 4: Determine depreciation, depletion and amortization attributable to the period before 1977: Depreciation for period before 1977	$54,000
Step 5: Determine carryover basis adjustments to income tax basis of property:	
Adjusted basis at date of death	$100,000
Net appreciation prior to 1977	$102,000
Depreciation prior to 1977	54,000
Total	156,000
Income tax basis of property	256,000

CARRYOVER BASIS—ADJUSTMENT FOR FEDERAL ESTATE TAX [1]

Example: Returning to the example of a farm with a calculated carryover basis of $256,000 and a fair market value of $360,000, assume the decedent's federal estate tax calculations were as follows:

Gross estate	$785,000
Deductions	35,000
Adjusted gross estate	750,000
Marital deduction	375,000
Charitable deduction	10,000
Taxable estate	365,000
Tentative tax	109,900
Unified credit (death in 1981)	47,000
Total	62,900

[1] Prepared by Neil E. Harl, Charles F. Curtiss, Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; Member of the Iowa Bar.

Credit for State death tax	$5,680
Federal estate tax due	57,220

For the adjustment process, three values must be found:

1. Federal estate tax due (no State estate tax applicable)	57,220
2. Net appreciation in value of the property in question:	
Fair market value	360,000
Carryover basis	256,000
Total	104,000
3. Fair market value of property subject to the tax:	
Gross estate	785,000
Less: marital deduction	375,000
Subtotal	410,000
Less: Charitable deduction	10,000
Total	400,000

[1] Prepared by Neil E. Harl, Charles F. Curtiss, Distinguished Professor in Agriculture and Professor of Economics, Iowa State University, Member of the Iowa Bar.

With those three values known, the fourth, the adjustment for federal estate tax attributable to the net appreciation in value of the property can be computed:

Adjustment factor over Federal estate tax equals net appreciation over FMV of all property subject to tax.

A.F. over $57,220 equals $104,000 over $400,000.

A.F. equals .26 ($57,220).

A.F. equals $14,877.

Thus, the adjustment factor for federal estate tax is $14,877, to be added to the carryover basis for the farm:

Carryover basis	$256,000
Plus: adjustment factor	14,877
Total	270,877

CARRYOVER BASIS—ADJUSTMENT FOR MINIMUM $60,000 [1]

Example I: Farmer A, a widower, dies owning three assets: a farm, a bank account and stored grain. The gross estate totals $475,000 as indicated:

Asset	FMV	Carryover basis	Federal and State estate tax adjustment
Farm	442,000	2,000	72,320
Bank account	8,000	8,000	0
Grain (1977 and 1978 crops)	25,000	0	4,410
Total	475,000	10,000	76,730

No further adjustment is possible because the aggregate basis of carryover basis property exceeds $60,000.

Example II: Farmer B, a widower, dies owning three assets: a farm, a bank account and a small beef cow herd. The gross estate totals $142,500 as indicated:

Asset	FMV	Carryover basis	Federal and State estate tax adjustment
Land	130,000	32,000	0
Bank account	2,500	2,500	0
Cattle	10,000	0	0
Total	142,500	$1,500	

[1] Prepared by Neil E. Harl, Charles F. Curtiss, Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; Member of the Iowa Bar.

With the aggregate basis of $34,500 on carryover basis property, the difference between that figure and $60,000 is available for allocation among items of carryover basis property: $60,000 minus $34,500 equals $25,500.

The amount of $25,500 may be allocated in a two step procedure as follows:

Step 1: First, determine net appreciation in value—

For the land, the net appreciation in value is the fair market value minus the carryover basis—$130,000 minus $32,000 equals $98,000.

For the bank account, the net appreciation in value is figured using the same formula—$2,500 minus $2,500 equals 0.

For the cow herd, the net appreciation in value is—$10,000 minus 0 equals $10,000.

The total net appreciation in value for all assets is—$98,000 plus 0 plus $10,000 equals $108,000

Step 2: Allocate the available basis amount ($25,500) among the carryover basis assets:

For the land—

$$= \frac{\text{Net appreciation in land}}{\text{Net appreciation of all property}} \times \text{Basis available for allocation.}$$

$$= \frac{98,000}{108,000} \times 25,500$$

$$= 0.9074 \times 25,500$$

$$= 23,139$$

Thus, the new adjusted carryover basis for the land would be—

$$= \$32,000 + 23,139$$

$$= 55,139$$

For the cow-calf herd:

$$= \frac{\text{Net appreciation in herd}}{\text{Net appreciation of all property}} \times \text{Basis available for allocation.}$$

$$= \frac{10,000}{108,000} \times 25,500$$

$$= 0.0926 \times 25,500$$

$$= 2361$$

Therefore, the cow-calf herd has a new adjusted carryover basis determined as follows—

$$= 0 + 2361$$

$$= 2361$$

The income tax basis of the bank account of $2,500 is not adjusted because there is no net appreciation in that asset. To recapitulate, the income tax basis of assets in Farmer B's estate would be:

Land	$55, 139
Bank account	2, 500
Cattle	2, 361
Total	60, 000

Carryover Basis—Adjustment for State Inheritance Tax [1]

Example: Returning to the previous example, assume the land, the bank account and the cattle are all inherited by the son who pays a state inheritance tax of $4325. The asset value and basis are as follows.

Asset	FMV	Carryover basis	Federal estate and State estate tax adjustment	Minimum aggregate basis adjustment	Basis before 3d adjustment
Land	130, 000	32, 000	0	23, 139	55, 139
Bank account	2, 500	2, 500	0	0	2, 500
Cattle	10, 000	0	0	2, 361	2, 361
Total	142, 500	34, 500	0	25, 500	60, 000

The amount of $4325 in state inheritance tax would be allocated among the assets as illustrated in the following three step procedure—

[1] Prepared by Neil E. Harl, Charles F. Curtiss, Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; Member of the Iowa Bar.

Step 1: Determine the net appreciation in value for each item of property. This is defined as the excess of fair market value above the adjusted basis including all adjustments made to this point. Specifically, it includes the adjustment for federal estate and state estate tax and the minimum aggregate $60,000 as well as the carryover basis amount.

For the land, net appreciation would be: 130,000—55,139=74,861.

For the bank account, net appreciation would be: 2,500—2,500=0.

For the cow-calf herd, net appreciation would be: 10,000—2,361=7,630.

Step 2: Determine the fair market value of all property acquired by the son which is subject to state inheritance tax:

Land	$130,000
Bank account	2,500
Cattle	10,000
Total	142,500

Step 3: Allocate the state inheritance tax among the assets:

Adjustment to land basis:—

$$\frac{\text{Net appreciation in value}}{\text{Fair market value of all property}} \times \text{State inheritance tax paid.}$$

$$\frac{74{,}861}{142{,}500} \times 4{,}325 =$$

$$0.52534 \times 4{,}325 = 2{,}272.$$

Adjustment to basis of bank account:—

$$\frac{\text{Net appreciation in value}}{\text{Fair market value of all property}} \times \text{State inheritance tax paid.}$$

$$\frac{0}{142{,}500} \times 4{,}325 = 0.$$

Adjustment to basis of cow-calf herd:—

$$\frac{\text{Net appreciation in value}}{\text{Fair market value of all property}} \times \text{State inheritance tax paid.}$$

$$\frac{7{,}639}{142{,}500} \times 4{,}329 =$$

$$0.05361 \times 4{,}325 = 232.$$

As a final recapitulation, the income tax basis of assets in the hands of Farmer B's son would be:

Land	$57,411
Bank account	2,500
Cattle	2,593

Those figures are derived from the three overall adjustments and the carryover basis as follows:

Asset	FMV	Carryover basis	Federal estate and State estate tax adjustment	Minimum aggregate basis adjustment	State Inheritance tax adjustment	Basis to son
Land	130,000	32,000	0	23,139	2,272	57,411
Bank account	2,500	2,500	0	0	0	2,500
Cattle	10,000	0	0	2,361	232	2,593
Total	142,500	34,5000	0	25,500	2,504	62,504

ROBBINS & BOHR, INC.,
Chattanooga, Tenn.

Subject: New capital gains tax.

Senator HARRY F. BYRD, Jr.,
Committee on Finance,
Dirksen Office Building,
Room 2227,
Washington, D.C.
(Attention Mr. Michael Stern, Staff Director).

DEAR SENATOR BYRD: I am enclosing herewith a résumé of the effect of the carryover basis enacted in the 1976 Tax Reform Act. I think this carryover basis should be eliminated entirely. It is very destructive of estates and is totally unfair in its impact.

I will appreciate your doing everything you can to have the carryover basis repealed.

Sincerely yours,

FRANK M. ROBBINS, Jr.

NEW CAPITAL GAINS TAX IMPOSES IMPOSSIBLE BURDENS ON FAMILY CORPORATIONS

The 1976 Tax Reform Act provides, for the first time, that when an individual dies the cost basis of his property will "carry over" to his estate and his heirs. Congress cased the immediate impact of this law by providing a "fresh start" on December 31, 1976, but for new businesses started after 1976 the effect of the new law is to impose a capital gains tax at death on all future sales of appreciated assets, even when they are sold to raise money to pay estate and inheritance taxes and expenses of administration. This tax would be added on top of the present estate tax, which starts at a 30 percent rate. The serious impact of these combined death taxes on one's incentive to start and build a family business is graphically demonstrated by the following figures:

1. Assume a $100,000 business *started after 1976*, which at the time of the founder's death is worth $3,000,000, no marital deduction and no other assets:

Funeral and administrative expenses	$125,000
Estate taxes and inheritance tax credit	1,225,000
Capital gains tax (after adding the proportion of estate and inheritance tax to basis)	267,000
Minimum tax on capital gain	40,000
Total taxes and expenses	$1,657,000

There is not one medium-size family business out of 100 that could come up with this amount of money without wrecking the business. Nor could such a company afford to purchase enough life insurance to pay such taxes. And the installment payment provisions will merely serve to convince the founder that building such a business is not worth the effort.

But this is not all. Section 303 is not available to provide funds to pay the two capital gains taxes. But they must be paid. The corporation can only pay them by declaring a dividend. But the estate must pay income tax on the dividend. Calculations will demonstrate that a dividend of at least $870,000 will be needed to pay all the income taxes, both ordinary and capital gain. Thus $2,220,000 will have to come from the $3,000,000 corporation to pay administration expenses, death taxes and income taxes.

2(a). Assume the same $100,000 business *organized after 1976*, which is worth $3,100,000 at death, a maximum 50% marital deduction and no other assets:

Funeral and expenses of administration	$130,000
Estate taxes and inheritance tax credit	501,000
Capital gains tax	172,000
Minimum tax on capital gains	27,000
Total death taxes and expenses	830,000
Plus additional dividend to pay ordinary income tax on $199,000	368,000
Total taxes and expenses	$1,198,000

2(b). When the wife dies later on, the expenses, death taxes and income taxes on her $1,485,000 estate would aggregate $870,000.

Total administration expenses, estate and inheritance taxes, an income taxes on both estates would amount to over $2,000,000, thus leaving less than $1,000,000 to represent the lifelong efforts of the founder of the business.

It must never be forgotten that the carry-over basis also applies to "old" family businesses, i.e., those organized or acquired before 1977, pursuant to an arbitrary formula that prorates total appreciation between the period before 1977 and the period after 1976. If, for example, the business was organized in 1967 and the owner died in 1987, one-half the appreciation would be taxable. Thus, *the amount of capital gains tax will increase automatically* as each year goes by, regardless of whether there is actually any appreciation.

There are only two possible solutions:

1. The best step would be to eliminate the "carry-over basis", which (a) causes serious multiple administrative and tax problems never foreseen; (b) destroys the incentive to build medium-sized businesses; and (c) would produce no meaningful revenue during the next two decades.

2. The only alternative, as we see it, is to provide that the basis of assets be stepped up in an amount that would equal the total of the following estate liabilities by (a) funeral expenses, administration expenses; (b) estate taxes, and (c) inheritance taxes. These are the same items as those listed in Section 303, which authorizes the redemption of sufficient stock in a family corporation to raise funds to pay them. To be fair, this step-up of basis should apply to all estates, whether Section 303 can be used or not. Perhaps the best and most easily understood solution would be to let the executor select assets having a value equal to the Section 303 liabilities.

Looking at the realities of the situation there is no other solution, if Congress is to give effect to its oft-stated view that family businesses constitute the fundamental basis of our private enterprise system.

INDUSTRIAL SOAP CO.,
St. Louis, Mo., September 2, 1977.

HON. HARRY K. BYRD, Jr.,
U.S. Senator,
(Attn.: Michael Stern, Staff Director).
Committee on Finance,
Room 2227, Dirksen Office Building,
Washington, D.C.

GENTLEMEN: After thoughtful reflection concerning the 1976 Tax Reform Act, it is our strong belief that since Congress' attention had been consistently for many months on the income tax changes, it is probable that few members of Congress outside the Revenue Committee really understand just how drastic the new tax changes are with regard to decedents' estates.

For example, the impact of the new capital gains tax at death and the 15 percent minimum tax on family business is, to say the least, devastating.

As we see it there are two possible solutions to what really has become a horrendous problem:

1. The best step would be to eliminate the "carry-over basis", which (a) causes serious multiple administrative and tax problems never foreseen; (b) destroys the incentive to build medium-sized businesses; and (c) would produce no meaningful revenue during the next two decades.

2. The only alternative, as we see it, is to provide that the basis of assets be stepped up in an amount that would equal the total of the following estate liabilities by (a) funeral expenses, administration expenses; (b) estate taxes, and (c) inheritance taxes. These are the same items as those listed in Section 303, which authorizes the redemption of sufficient stock in a family corporation to raise funds to pay them. To be fair, this step-up of basis should apply to all estates, whether Section 303 can be used or not. Perhaps the best and most easily understood solution would be to let the executor select assets having a value equal to the Section 303 liabilities.

Looking at the realities of the situation there is no other solution, if Congress is to give effect to its oft-stated view that family business constitute the fundamental basis of our private enterprise system.

Yours very truly,

ROBERT D. SHAPIRO, *President.*

STATEMENT OF AMERICAN BANKERS ASSOCIATION

The Trust Division of the American Bankers Association, composed of 4,000 banks authorized to administer estates and trusts, wishes to express its deep concern over the new carryover basis rules, the way they work and the burdens they impose, and to urge that the subject be restudied at an early date with view to repeal.

ESTABLISHING THE DECEDENT'S BASIS

We are certain that you have heard from many sources the great difficulties which fiduciaries are experiencing in establishing cost data of assets received in the estates of deceased persons. We attach Appendix A with a number of actual situations already encountered by member banks where difficulties have arisen; these cases are the "early returns." Within a year or two we are certain that the number of similar cases will mulipiy a hundred fold. Acquisition dates and facts (such as whether the asset was acquired by purchase, gift, inheritance. accretion or spin-off) are notoriously lacking in the case of decedents largely because the tax laws have heretofore not attached any particular signficance to them. The longer the asset has been held, the greater the difficulties are of ascertaining acquisition dates and related information.

The December 31, 1976 "fresh start" provisions (Code Sec. 1023(1)) do not alleviate the difficulties of proof of basis. The values on December 31st for listed securities are useful only if there has been appreciation in the value over original cost; they are of no assistance if there has been a loss. At the closing of an estate, the executor has no way of knowing whether the assets he turns over to the heirs or other distributees will eventually be sold at a gain or a loss. The conseqeunce is that the executor must provide the heirs or distributees with basis information for gain and loss as to each pre-77 asset distributed to them. Thus, he cannot stop with December 31, 1976 values on marketable securities. He must ferret out and furnish to the heirs and distributees both the December 31, 1976 values and original cost information as to each marketable security. As regards nonmarketables (such as residences, partnerships, closely-held businesses and farms), original costs as well as costs of improvements over the years may be even more difficult to determine and tabulate on an asset-by-asset basis. Yet this is necessary to apply the "time-apportionment" rule for determining the December 31, 1976 values of each such property.

To illustrate the difficulties, consider the case of an individual, who during the 25-year period before his death, owned three homes at different times; one in New York, one in Connecticut and one in Florida, each of the latter two being acquired in part by the reinvestment of the proceeds of the previously owned residence and repeat the same adjustment procedure as to the third. In each with respect to each home. At his death, his executor must determine the original basis of the first home, then roll over that basis, with adjustments, into the next residence and repeat the same adjustment procedure as to the third. In each instance he must identify expenditures made in connection with each residence and assign them to one of three categories; maintenance and repair, ordinary improvements and "substantial improvements." Those assigned to the first category are ignored for purposes of basis; those assigned to ordinary improvements are added to basis; and those in the "substantial improvements" category (Sec. 1023(h)(2)(D)) must be identified as a separate asset for Sec. 1023 adjustment treatment. This enormously difficult task must be done at least on a tentative basis before sale by the executor or distribution to the heirs or other distributees. If the last residence is held in joint tenancy with right of survivorship, the executor must provide basis information almost immediately to the survivor.

The task of ascertaining a decedent's costs, even as to marketable securities is bound to be time-consuming, expensive and often frustrating. If the decedent's records are insufficient or nonexistent, transcripts of certificate activity may be the next best evidence. But many transfer agents destroy certificate activity records after a limited period and record keepers change, making it virtually impossible in some cases to trace activity to a previous record keeper. Obtaining desired transcripts can take anywhere from several weeks to several months or may never be received. If the decedent maintained a custody account with one or more brokers and the securities were held in "street" name, the transfer agent's records would be of no help and the necessary cost data may be virtually

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impossible to obtain. It will thus be seen that the business of gathering information required by carryover basis rules will require expensive people to assemble and expensive systems to correlate and preserve.

Even when the cost information of a decedent's assets has been obtained, many estate distributees will be unable to cope with multiple cost figures which the Code is not clear whether an asset worth more than $10,000 can be selected for a heirs and distributees will receive information concerning two bases as to each pre-77 asset distributed to them, one for gain and one for loss. The task of explaining the meaning and application of each set of figures will be difficult, and after the executor has done this, neither he nor the Government has any assurance that the explanation will be understood or correctly applied by anyone not a professional accountant.

PROBLEMS OF AN EXECUTOR APPLYING CARRYOVER BASIS RULES

The adoption of carryover basis rules, with their many exceptions and adjustments, imposes a number of new and difficult judgment decisions, as well as mathematical determinations, on executors and administrators.

Code Sec. 1023(b)(3) provides that an executor or administrator may elect to exempt $10,000 of chattel items from the operation of the carryover basis law for personal and household effects. The application of the $10,000 limit creates many practical problems for the executor or administrator in selecting the items to be excluded. The time and expense required to assemble information necessary to make the selection will frequently be out of proportion to the importance and worth of the items in relation to the overall estate.

Stamps and coin collections, jewelry and clothing, present particular difficulties in tracing original costs and current values. Even when the executor or administrator has established cost figures, the determination of current values must of necessity be approximations based on the opinions of appraisers and are subject to question and revaluation by an IRS agent on audit. The language of the Code is not clear whether an asset worth more than $10,000 can be selected for a kind of "proportionate" Sec. 1023(b)(3) exemption. Neither is it clear what the effect is if the executor reports an item of jewelry at, say $9,000, and the agent on audit finds it worth $13,000. Moreover, the selection of personal and household effects for the purpose of the $10,000 exception must be made before the time the estate tax return is filed.

The proper funding of marital deduction and residuary trusts creates considerable uncertainty for an executor or trustee in selecting assets to satisfy such bequests where the testator or grantor has died since January 1, 1977. No guidance has been given by the IRS on the subject and professional corporate fiduciaries and their attorneys are far from unanimous as to the course to be followed. In drafting new wills attorneys are unclear as to whether specific directions should be given to the legal representative in regard to funding marital formula bequests or whether the choice of assets may, or must, be left to the executor's discretion and if the latter, what liability the representative may incur if he makes a non-prorata allocation of high and low basis assets or if he violates state rules on fiduciary impartiality. In view of recent decisions holding the legal representative to be a virtual guarantor of success in the outcome of his tax decisions, the responsibilities of the representative are indeed frightening. See Barbara K. Lundergan, "Increased Duties & Liabilities of Fiduciaries under Tax Reform Act of 1976", 65 Ill.B.Journal 464 (Mar. 1977).

RULES ARE PRODUCTIVE OF CAPRICIOUS RESULTS

Carryover basis rules are capable of producing capricious results never intended by the Congress. For example, when an heir inherits property subject to a liability that exceeds the carryover basis from the decedent, the heir may suddenly discover that he has a potential income tax liability greater than the net worth of the property inherited. For example, assume A purchases property for $10,000 in 1940. The property appreciates in value to $100,000 by 1976 when A mortgages the property for $80,000. He dies in 1978 when the property has a value of $100,000 and the mortgage is still outstanding in the amount of $75,000. Assuming the computation of the "fresh-start" adjustment results in a basis for gain of $20,000 and assuming also that the property is sold in 1978 by the heirs for $100,000, they will realize taxable income of $80,000 which at a 35 percent capital gain rate will generate a tax liability of $28,000. After paying the mort-

gage of $75,000 they will have only $25,000 left but have a tax liability for $28,000.

Another example is presented by Code Sec. 1023(g) (4) wherein the adjustment for estate taxes attributable to appreciation under Sec. 1023(c) is made dependent on the form of the encumbrance on property. If it is satisfiable only out of the subject property, the basis adjustment attributable to net appreciation will be greater than if the encumbrance may be satisfied by recourse to other assets of the decedent. Stated differently, the denominator of the fraction making the Sec. 1023(c) adjustment will be larger if the property is subject to an indebtedness satisfiable out of the general assets of the decedent (i.e., recourse) than where the indebtedness is non-recourse, and its value is stated net of the debt. The effect is to provide greater benefits in the latter situation with the smaller risk and to emphasize form over substance. A similar capricious result will obtain when Sec. 1023(g) (4) is applied in connection with Sec. 1023(d) and (e). The effect is to provide greater benefits in siutations with smaller risks.

We recognize that some of the problems mentioned would be eliminated by changes in the law proposed in H.R. 6715, the Technical Corrections Act of 1977. Other problems may be resolved by regulation. Nevertheless, we believe that statutory changes and regulations cannot solve the inordinate complexity surrounding carryover basis. The only satisfactory solution is total repeal.

APPENDIX A

EXAMPLES OF ACTUAL CARRYOVER BASIS PROBLEMS IN EXISTING ESTATES

1. An asset in an estate of a recently deceased widow is an 8-unit apartment building. Ownership of the apartment building passed to the decedent as surviving joint tenant on the death of her husband in 1962. Neither a federal nor a state death tax return had to be filed at the death of the husband; no appraisal was made of the property at that time nor was the depreciation basis altered. In order to apply the "fresh start" provisions of Section 1023(h) (2), the executor is now confronted with the task of securing an appraisal of the real estate as of the death of the husband in 1962.

2. Securities owned by the decedent were held in street name by broker A. Broker A acquired decedent's account when broker B was merged into the successor firm. The records of broker A are sketchy for many of the securities as to both date of acquisition and cost. Since the securities are in street name, it is not possible to secure any of this information from the transfer agents.

3. Decedent owned certain stocks and bonds which were acquired through his broker during the period of 1955–1965 and were held by his broker. On the decedent's death, it was discovered that the broker was not able to produce any information respecting actual acquisition dates and cost. It appears that the rules of the SEC only require brokers to maintain copies of statements for 6 years and copies of confirmations for 3 years.

4. The estate of a recently deceased widow contains a large holding of stock of a publicly traded company which was received many years ago in a tax-free exchange for the shares of a privately held company. Some of the shares of the privately held company owned by the decedent were the subject matter of a gift to the decedent from her husband who died 10 years ago. No records appear to be available to permit a determination of the basis of the original shares.

5. Decedent acquired a 2-percent interest in a partnership in 1968 for $10,000 and an additional one-half percent interest in 1970 at a cost of $3,000. The value of the decedent's partnership interest on 3/1/77, the date of death, was $20,000. The following is a summary of the partnership income allocable to the decedent's interest and of his withdrawals:

Taxable year ending	Share of income	Withdrawals	Net
Dec. 31, 1968	($250)	$1,000	($1,250)
Dec. 31, 1969	(250)	1,000	(1,250)
Dec. 31, 1970	(300)	1,200	(1,500)
Dec. 31, 1971	(100)	1,200	(1,300)
Dec. 31, 1972	100	1,300	(1,200)
Dec. 31, 1973	500	1,500	(1,000)
Dec. 31, 1974	1,500	1,700	(200)
Sept. 30, 1975	2,000	1,500	500
Sept. 30, 1976	2,500	1,500	1,000

How are the Section 1023(h)(2) adjustments to be calculated? For example, is the net increase in the decedent's account for the partnership taxable year ending 9/30/75 to be deemed to be a separate asset for purposes of Section 1023(h)(2) * * * as if it were similar to a building?

6. In a very large estate, there is a Florida residence valued at approximately $3,500,000 and a Cleveland residence valued at approximately $1,250,000. The land for the Florida residence was acquired in 1894. The original structure was put up in 1920. There have been major additions to the property from 1920 to the present. The original architect is deceased. The original and subsequent building plans are available, but incomplete. Preliminary drawings are difficult to distinguish from the final plans used. The cost records are incomplete and they are difficult to document because the family archives contain numerous records for five substantial residence properties owned by the decedent over a period of seventy years. Consequently, both the cost of the original property and construction and the history of the improvements and additions are virtually impossible to document. Yet the executor has substantial monetary consequences at stake with respect to the cost of the original structure and improvements.

7. A decedent has died since January 1, 1977 with approximately $1 million in personalty, consisting of numerous items of furniture, pictures, jewelry, silverware, china, etc. maintained in four separate homes and acquired from innumerable sources, including substantial gifts and inheritances from a long line of family members during the lifetime of the decedent who died at age 94. Cost records for these items are incomplete, and since some were acquired by gift, they may well trace back to more than 100 years. Any attempt to list and define anything approaching an accurate cost for those items could well lead to the expenditure of 100 or more manhours of the Executor's time.

8. A sampling of trust accounts at Bank X in which the Grantor has died after January 1, 1977 indicates that even when cost figures are available, there will be extensive adjustments to basis required which will be time-consuming and complicated. For example, in one trust, there are 84 different securities represented by 98 different blocks. In another trust, there are 62 securities represented by 97 different blocks. Under current law, the executor may therefore be required to make 196 and 194 adjustments for death taxes on the appreciation element in each block. If a separate fraction is developed under the Technical Amendments Act for state death taxes, these figures may be increased respectively to 392 and 384 adjustments. These are representative normal trust accounts in which Grantors have died, and it is apparent that TRA 76 has injected enormous complexity into what used to be routine accounts.

LOS ANGELES, CALIF., *August 26, 1977.*

Hon. MICHAEL STERN,
Staff Director, Committee on Finance, Room 2227, Washington, D.C.

DEAR SIR: I submit the following simplified analysis concerning the average small business I deal with in my law practice for your consideration.

1. It is our alleged public policy to encourage small businesses to remain small, and to avoid a concentration of most enterprises in the hands of a few corporate giants.

2. Small businesses can frequently be carried on after the founder's death by children, in-laws, or other relatives.

3. Small businesses are not permitted to accumulate income unreasonably (IRC § 531). Saving money to pay estate taxes is not an acceptable purpose from an income tax point of view.

4. Section 303 contemplates the redemption of stock of a closely held corporation to provide funds for the payment of estate and inheritance tax. However, the qualification for this section was made more difficult in 1976. Nevertheless, as indicated in paragraph three above, a corporation may not save money for purposes of implementing the redemption.

5. The accumulated earnings tax makes an exception for earnings accumulated after the date of death. However, when a key man dies, profits are likely to tumble and it is highly unlikely that corporate funds will become available for a redemption. For the same reason, the privilege of paying the estate tax over ten or fifteen years is of very little help.

6. Without a corporate stock redemption, the ten or fifteen year pay out is of little help because of (1) the high interest rate, (2) the typical owner of a

closely held business is unable to accumulate funds outside of his corporation for the payment of taxes, and (3) the survivors need to eat and otherwise be supported.

7. The carry-over basis provisions further aggravate these problems by imposing an additional tax upon property sold to meet the death tax liability. Even a § 303 redemption requires payment of capital gains tax, but funds may not be withdrawn from the business under § 303 for the payment of capital gains tax, as opposed to death tax.

8. The traditional recapitalization shifting part ownership to members of the younger generation has been made less practical because preferred stock retained by the owners constitutes § 303 stock, depending upon what happens to the technical amendments act of 1977. Thus, the normal capital gain payable at redemption is converted to ordinary income.

9. Under IRC § 2036, the Congress undid the Supreme Court's decision in the *Byrum* case so that a shareholder has difficulty making gifts while retaining the voting control so essential to the operation of a closely held business.

In short, the relief given to small business over the years exists only in someone's imagination. The owner of stock in a public corporation has full liquidity, pays only capital gains tax, has no concern with voting control. How this burdensome taxation of small business is acceptable in a Country fighting unemployment is beyond the comprehension of the undersigned.

Very truly yours,

JOHN R. COHAN.

ENNING, S. DAK., *August 23, 1977.*

DEAR SIRS: I am writing to you in regards to the Tax Reform Act of 1976. This new law makes selling land within the family or inheriting land next to impossible. Because of gift tax laws land cannot be bought and sold for reasonable prices and because of inheritance taxes, real etstate has to be sold out of a family to pay the taxes.

Land prices have shot up in recent years while prices farmers and ranchers receive for agricultural products have not. This situation makes paying one hundred fifty dollars per acre for land producing fifty dollars per acre payments impossible. This is made worse by present gift tax laws which do not allow the sale of land for a practical price without paying enormous gift taxes. This is because if a piece of land is sold for fifty dollars per acre, which is what the land is capable of making payments on, the seller has to pay taxes on the difference between that price and the "highest and best use" valuation. Since the tax percentage is so high most of what the seller receives from the buyer goes to the government with the selller in effect getting nothing for his land.

As with land prices before being in an estate, the "highest and best use" valuation causes problems. If this method of valuation is used in an estate, in most cases the land will have to be sold out of the family because there are not sufficient liquid assets to pay the taxes outright. Also unless the decedent inherits all the land outright, and in many cases this won't happen, even an extension of the time to pay the inheritance tax will not help.

The "current use" valuation rather than "highest and best use" valuation has important future restrictions attached. The heir will be committed to this special use for several years with a very stiff tax penalty for changing his mind.

The tax "reform" act only took the tax situation from bad to worse. The new law should have lowered the tax rates and had more provisions to keep tax credits and deductions abreast with inflation. The current use valuation should have been more on an individual farm basis and should have been in some way applicable to gift taxes related to sales of inflated land used for agriculture.

Since gift taxes and inheritance taxes make the passing of land from father to son impossible, there is the very real danger of the family farm system disappearing.

Because the family farm has provided the cheapest food in the world for this country for so many years, I believe farm people deserve a few tax breaks so they can continue. Otherwise, corporations or the government will gain control of the land resulting in the skyrocketing of food prices and individuals losing control of the land.

Thank you,

RICHARD MURPHY.

WILLIAMS, PARKER, HARRISON, DIETZ & GREEN,
Sarasota, Fla., August 29, 1977.

MICHAEL STERN,
Staff Director, Committee on Finance,
Room 2227, Dirksen Senate Office Building,
Washington, D.C.

DEAR MR. STERN: Enclosed are five copies of a statement regarding the difficulty of a related trustee becoming a deemed transferor when serving as a trustee of a parent's trust. Although there are many items in the Tax Reform Act which are of concern and may create new administrative problems and inequities, this is an area of considerable concern to the undersigned. It creates a mousetrap for the unwary and limits an otherwise extremely appropriate tool which we should be able to use without creating another unanswered problem.

If we can provide any further or additional information, we will be happy to do so.

Sincerely,

MONTE K. MARSHALL.

Enclosures.

STATEMENT ON GENERATION SKIPPING LEGISLATION AND IMPACT ON TRUSTEE

This statement relates to the impact of Chapter 13 of the Tax Reform Act of 1976, commonly called the generation-skipping trust chapter, and proposed H.R. 6715 modification of the Chapter upon a child serving as a trustee.

Under the provisions of Chapter 13 and particularly § 2613(d), a child who is the trustee of a trust for the benefit of the child's parent can be a deemed transferor and if the child predeceases the parent or perhaps even resigns as trustee, the trust assets are taxable in the child-trustee's estate. This would be the case if the trust contained normal language allowing a trustee to use principal for the benefit of the surviving parent. This appeared to be the law in the original Chapter 13 and is further defined in proposed H.R. 6715.

If a corporate trustee is used instead of a child, the child is not a deemed transferor if the child should predecease the parent. At least this would appear to be the intent of Chapter 13 and particularly as further defined by H.R. 6715.

The factual background occasioning this statement is as follows: The writer's firm is located in Sarasota, Florida, one of the retirement areas of the United States. A large number of persons retiring to Florida redraft their estate programs. Many of these programs involve the use of trusts for a spouse. In addition to the classical marital-residual trusts, many parents will establish a trust for the surviving parent to assist the surviving parent in the administration of their assets. This is particularly common when the surviving parent is becoming incapable of management of their assets.

Over the course of the last 10 years, there has been an increasing reluctance to appoint a corporate trustee to manage the assets. This has occurred for a variety of reasons, one of which is the fact the stock market has been flat for a number of years and whoever is managing the assets receives the blame for a general lack of performance and another reason is to reduce the expense of trust administration. Because of the reluctance to name a corporate trustee, many persons wish to name one or more of their children to administer the trust for the surviving spouse.

Under the Tax Reform Act generation-skipping provisions, there is a mousetrap if the parent names a child as trustee. If the child should predecease the surviving parent or perhaps even resign as trustee, the trust assets are taxable in the child's estate, apparently postponed until the death of the surviving parent. Such would not be the case apparently if there is a corporate trustee and specifically would not be the case under H.R. 6715.

Causing a tax in the estate of the child-trustee appears inappropriate when we consider:

1. No tax if a corporate trustee, and
2. Inequitable results, particularly if the ultimate beneficiaries are other than the trustee-child's own children. In addition to the likelihood of an inappropriate result because of the difficulty of apportioning the tax in the child-trustee's estate, it would be very inequitable to tax other children or the parent just because a child-trustee happened to die or resign before the surviving parent.

There would appear to be no reason to distinguish between a corporate trustee and a child as trustee. Our experience has indicated that the child will properly administer the trust for the surviving parent, will oftentimes employ a bank trust company or accountant-C.P.A. to maintain the books and records and in general, will do nothing to the detriment of the trust operation nor the Federal Government's interest in the trust assets.

We know of no valid reason either expressed or implied why Congress believes it should encourage the use of corporate trustees instead of family member trustees when a trust is an appropriate tool to assist a surviving spouse.

It is of concern to those of us assisting parents in the planning of their estates and the management of the estate for the surviving spouse that the new Act limits the use of a reasonable and oftentimes requested administration tool in providing reasonable answers for our retired citizens.

CLARK, CLARK & HASTINGS,
Ames, Iowa, August 4, 1977.

Re carryover basis rule of Tax Reform Acts of 1976.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN. As attorneys practicing in the heart of America's farmland, we have a definite interest in estate tax policy. Our practice involves substantial work in the probate and estate planning area. We advise numerous farmers on these matters. Of all the changes made by the Tax Reform Act of 1976 the Carry-over Basis Rule is perhaps the most detrimental to the farmer and his decendants. We believe that it is also detrimental to several other goals that the tax laws ought to attempt to reach.

First of all, the Carry-over Basis Rule is a very complicated idea when one considers the record keeping and record discovering functions that must be carried out to comply with it. Very often it is impossible to discover the original purchase price of farmland in Iowa because it was purchased by grandfathers, great grandfathers and great great grandfathers of the decedent. Often the person that would have been the most able to provide the most information is the decedent himself.

This rule is going to require substantial expenditure of time and man hours by the Internal Revenue Service if it is going to be administered fairly and effectively. No longer will we be able to center our discussions with the IRS on current market value which has the advantage of being susceptible to proof by available information. Rather we will be arguing over dusty records and people's inaccurate memory.

I believe one of the most unwanted effects of this act is an effect which probably was far from the minds of Congress when they passed the Carry-over Basis Rule. How often have we heard the cry that farmers ought to own their own land and not lease it from an absentee landlord? The idea of absentee landlords owning large portions of the farmland of Iowa is an unpleasant thought to almost anyone who is familiar and interested in the farm situation. Yet, the Carry-over Basis Rule will have that precise effect. When the decedant farmer dies, if, as often happens, all of his children have moved off of the farm and are now working elsewhere, we are bound to have an absentee landlord or landlords. This is because the children will not be able to afford to sell the farm because their basis in it will be so low. There are many instances when there is no longer a son or daughter who wishes to carry on farming after the father dies. When that happens, the children normally would dispose of the farm. Under the new Carry-over Basis Rules, we would have to advise them to think very hard before they do so. The tax that they would have to pay in many of our estates would be so great that it would simply not be advisable to consider selling. If Congress is at all concerned about absentee lanlordism, and is at all concerned about encouraging the small farmer to own his own farm, then we would urge them to repeal the Carry-over Basis Rule as soon as possible and hopefully, retroactively. Thank you for your consideration of our opinion.

Very truly yours.

GEORGE H. CLARK, Jr.
CRAIG R. HASTINGS.

DUMONT, IOWA, *August 29, 1977.*

MR. MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: Please add my name to the list of many objectors to the "carry-over-basis rule".

Sincerely,

WILLIAM W. NOLTE,
Attorney at Law.

ANDERSON & LARCHE,
Fort Lauderdale, Fla., August 26, 1977.

MR. MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: I understand that your Committee is investigating the problems being experienced by practitioners and trust officers under the Tax Reform Act of 1976.

I recently attended a Seminar sponsored by The Florida Bar dealing with the accounting procedures necessary for executors and trustees under the new law. One of the topics covered was the tremendous burden placed on these fiduciaries by the 1976 Tax Reform Act, particularly in requiring that an estate and its beneficiaries continue to use the same income tax basis for each asset as the decedent with four adjustments for each asset. I have taken the liberty of xeroxing the applicable provisions of the lecture outline and enclose the same herewith so that you may see the practical outworkings of this law.

I have been advised on good authority that this new law was never introduced before either House of Congress for study, but actually came in through the "back door" via the Joint Committee and that the entire 1976 Tax Reform Act was actually in your hands for a period of less than ninety minutes before you were required to vote on it, although it is a law some six hundred pages in length with extremely complex provisions. I recognize how these things can happen, but I now ask that you sit back and take a hard look at this portion of the law which Congress passed and the practical outworkings of it.

In a nutshell, the executor has the really impossible burden of having to find the decedent's cost basis for every single one of his assets (other than his household goods, if they are of fairly nominal value). It is true that the law provides that if you can't locate the decedent's cost basis then you can make an approximation based upon the year in which the decedent acquired the asset, but this is often just as impossible to determine. We have clients with collections of various types who have no idea what the various items cost them or even when they acquired them. This includes some stamp collections, coin collections, collections of china, bric-a-brac, silverware, various antiques, etc., etc. I recognize that exemption of $10,000.00 of household goods affords relief for the smaller estate; but it offers no relief in estates with any sizeable amount of personal property since the executor must obtain this information on all these assets in order to know which to elect to include within the $10,000.00 exemption.

If you don't think that this is a problem, talk with any conscientious Trust Officer of a bank (or an individual who is serving as executor) of a sizeable estate for a person who has died this year (but check with someone honorable who doesn't want to cheat). Aside from the practical difficulties of discovering the basis, there are also the rather monumental four calculations relating to adjusting basis of each asset, which are thrust uopn the executor by the new law as illustrated by the enclosed excerpts from the course which I mentioned. Probate costs are high enough without this further burden which must ultimately fall upon the widow and children.

Finally, and perhaps most importantly, there is the basic philosophy involved. Prior to this time, Congress has always declined to enact laws of double taxation. As I understand it. that was the basic reason under prior law for giving a decedent's estate a basis equal to the date of death value of the assets. The estate tax is, of course, extracted a that time. To also tax the capital gains is to tax the gains twice, once as they are included in the estate tax, and then again sep-

arately for capital gains purposes. Other income which a decedent earned before death (or capital gains incurred before death) but which are not received until after death are not taxed doubly; rather a separate credit is given for estate taxes paid on such income (known technically as "Income in Respect of a Decedent") so that the double tax is deliberately avoided. Why Congress felt it necessary to depart from this time honored rule of not taxing the same item twice and then taxing it in a way which has involved us in the multitude of calculations and problems which are inherent in the new law is a mystery to me. I can only assume that this is the work of a theoretician who has never practiced law, or was never actively involved in administering an estate. I also honestly fear that it may be the work of a small group which is comprised of people with little, if any, experience in earning money through private employment or self-employment and which (perhaps subconsciously) is baseball antagonistic to the rights of individuals to accumulate any substantial capital. Certainly, when estate taxes can take Seventy Percent (70 percent) of a person's estate and then taxes on capital gains take another Forty-nine (49 percent) (when considering the minimum tax, maximum tax, and other ramifications), the taxpayer's family has very little left to show for his abilities, hard work and thrift which, in the past at least, have been recognized as desirable character traits which were largely responsible for the success of our nation and rewarded as such. Note again that these capital gains were already taxed once in the tax on the overall capital of the estate itself and then when assets are sold to raise money to pay the Estate tax there is the immediate double tax on the capital gain itself and so additional assets must be sold to pay the tax on that gain also.

If this rather tremendous burden of double taxation on the same asset, was intended by Congress, then why not take away the credit for tax paid on Income In Respect of a Decedent at the same time? If revenue is the answer, why not simply increase the estate tax rates even further—anything but putting us through the problems created by the new carry-over basis rules.

It will, no doubt, be suggested by your advisers that the new law alleviates the situations I have described by increasing the basis of the asset by the amount of estate tax attributable to the gain, but this is a far cry from giving credit on the capital gains income tax for the actual estate tax paid on he gain. It is credit on tax which is necessary if double tax and consequent confiscation of capital is to be avoided.

I surely hope that you will give serious consideration to the Bill which I understand has been introduced to repeal this section of the law imposing the carry-over basis rules. Surely there must be some other way to obtain revenue if that really is essential, without the unfair double taxation, and without the administrative nightmare which has been created.

Very truly yours,

Boyd H. Anderson, Jr.

Enclosure.

* * * * * * *

VII. TAX BASIS OF PROPERTY RECEIVED BY ESTATES AND TRUSTS (CARRYOVER BASIS)

A. For assets purchased, the basis is generally cost; IRC § 1012, et seq.

B. For assets received as gifts, there are special rules, depending on when the property was gifted, and whether the computation is for the purpose of computing gain or loss; IRC § 1015.

1. For gifts prior to 1921, the basis equals the fair market value on the date of the gift; IRC § 1015(c).

2. For gifts made after 1920, there are different rules for gain and for loss; IRC § 1015(a).

(*a*) For determining gain: it is the same as it was for the donor (carryover basis).

(*b*) For determining loss; it is the fair market value at the date of the gift.

(*c*) If the property is sold at a price higher than the fair market value at the date of gift but lower than the donor's basis, then it is within the "grey area" and neither gain nor loss is recognized.

Example from Regs. § 1.1015-1(2)(2):

Facts:

Donors basis at date of gift	$100,000
Fair market value at date of gift	90,000
Selling price 3 years later	95,000

Result:

No gain or loss, computed as follows:

Gain computation:

Selling price	95,000
Basis for gain	100,000
Gain	None

Loss computation:

Selling price	95,000
Basis for gain	100,000
Loss	None

(*d*) For gifts on or after 9/2/58 or still held by the donee as of 9/2/58, but before 1/1/77, there is an increase in basis for the entire amount of the gift tax paid on the gift, *but* not higher than the fair market value at the date of gift; IRC § 1015(d).

(*e*) For gifts made after 12/31/76, the increase in basis for gift tax paid applies only to the gift tax on the appreciation in value, if any; i.e. the excess of fair market value over donor's basis, IRS § 101(d)(6).

C. For assets acquired from a decedent, there are different rules, also depending on when the decedent died and whether the computation is for the purpose of calculating gain or loss.

1. Reference is generally to assets included in the decedent's estate tax return (Form 706) as part of his estate. But it does *NOT* include IRC § 691 income in respect of a decedent (IRD); IRC § 1014(c) and § 1023(b)(2)(A).

2. For decedents who died prior to 1/1/77, the assets' basis equals fair market value on the date of death or applicable alternate valuation date; IRC § 1014. But there is an exception if recipient sold or disposed of the asset before decedent's death (eg. gift in contemplation of death). This rule is for both gain and loss.

3. For decedents dying after 12/31/77 there is a carryover basis from the decedent with certain adjustments; IRC § 1023 added by the Tax Reform Act of 1976, discussed more fully below.

D. Carryover basis under the 1976 Tax Reform Act for assets acquired from a decedent, IRC § 1023.

1. Certain items of property are excluded from the new rules and are governed by pre-existing law IRC § 1023(b). These exclusions are:

(*a*) Income in respect of a decedent (IRD) described in § 691.

(*b*) Proceeds of life insurance described in § 2042.

(*c*) Joint and survivor annuities where the surviving annuitant is taxable under § 72.

(*d*) Distributions under deferred compensation plans to the extent such payments and distributions are income taxable to decedents' beneficiaries.

(*e*) Property included in decedent's estate under § 2035, 2038, or 2041 which was disposed of before decedent's death in a taxable transaction.

(*f*) Stock or stock options passing from decedent to extent income from such is includible in gross income under § 422(c)(1), 423(c), or 424(c)(1).

(*g*) Foreign personal holding company stock described in § 1014(b)(5).

(h) $10,000 worth of personal or household effects, those items designated by personal representative.

2. The new rules for property which the decedent acquired after 12/31/76: for the purpose of computing both gain and loss in the hands of his estate or beneficiaries use the decedent's basis, *plus* certain adjustments, but not to exceed fair market value, as follows:

(*a*) Federal and State estate taxes attributable to the appreciation in carryover basis assets; IRC § 1023(c).

(i) Determined asset by asset, no netting to determine unrealized appreciation on the estate as a whole.

(ii) Only property subject to tax, so marital deduction assets and charitable deduction assets get no such adjustment.

(iii) Property subject to tax is calculated after reduction for indebtedness secured by such property (i.e. net of mortgages).

(iv) Multiply Federal and State estate taxes by a fraction; numerator is net appreciation in the particular asset; denominator is total value of all property subject to estate tax.

(v) Example:

Facts: Asset purchased after 1/1/77 had a basis at decedent's death of $90,000 and a fair market value of $120,000. Federal and State estate taxes were $108,000 and the value of all assets subject to estate tax was $500,000.

Solution: Fraction = net appreciation of $30,000 divided by $500,000 = 30/500 = 6/100. Multiply fraction by 108,000 = $6,480. Basis is increased from $90,000 to $96,480.

(*b*) $60,000 minimum basis allocated among all appreciated carryover basis property on ratio of net appreciation of each such asset to total of all such appreciation; IRC § 1023(d).

(i) Does not apply to the estate of a nonresident alien.

(ii) Special rule for personal or household effects: basis cannot exceed fair market value.

(*c*) State succession taxes paid by beneficiary attributable to net appreciation on property; IRC § 1023(e). (We do not have this in Florida).

(i) Applies only to property subject to tax.

(ii) Computed asset by asset, for each beneficiary.

(iii) Multiply total state succession taxes paid by such beneficiary by fraction; numerator is net appreciation of that asset and denominator is fair market value of all property received by that beneficiary subject to those taxes.

(iv) Mortgage rule applies here also, value of property is reduced by indebtedness.

(*d*) Example from House Committee Report (ignoring "fresh start" rule discussed later).

Facts: Decedent dies in 1977 owning the following assets—

Basis:	
Personal effects	$50,000
Stock	39,000
FMV:	
Personal effects	10,000
Stock	390,000
Gross estate	400,000

Assume there are no funeral or administration expenses and entire estate is left to wife; also assume that the State death taxes paid by widow (not the estate) are $400, and that the entire amount is subject to the State death tax. The executor elected to exclude all personal assets from carryover basis property.

Computation of estate taxes:

Gross estate and adjusted gross estate	$400,000
Marital deduction	250,000
Taxable estate	150,000
Basic Federal estate tax	38,800
Less unified tax credit	30,000
Federal estate tax	8,800
Less: State death tax credit (maximum computed based on adjusted taxable estate of $150,000 minus $60,000 or $90,000)	400
Net Federal estate tax	$ 8,400

Result:

Carryover basis property subject to tax:

Gross estate (from above)	$400,000
Less, marital deduction not subject to tax	250,000
Balance	150,000

Less, personal effects ($10,000 times $150,000 over $400,000)	3,750
Carryover basis property at FMV	146,250
Decedent's basis of carryover basis property is ($146,250 times $39,000 over $390,000)	14,625
Appreciation of carryover basis property	131,625
(i) Adjustment for estate taxes:	
$131,625 multiplied by $8,400 estate tax over $150,000 subject to tax	7,371
Plus original basis	39,000
Basis after first adjustment	$46,371
(ii) $60,000 minimum basis adjustment:	
Total allowable	$60,000
Basis after first adjustment (stock only, because executor elected to exclude personal effects)	46,371
Increase for second adjustment	13,629
Adjusted basis after second adjustment	$60,000
(iii) State tax paid by recipient adjustment:	
Appreciation of carryoved basis property for State death tax purposes is $330,000 computed by reducing the $39,000 FMV by the $60,000 (old exemption)	$330,000
Portion of State death tax allocable to this is $330,000 divided by $400,000 multiplied by $400 State death tax, adjustment	330
Adjusted basis after third adjustment	60,330

3. The new rules for property which the decedent acquired before Jan. 1, 1977, are the same as in paragraph 2, immediately above, for the purpose of computing LOSSES.

(*a*) This applies when value for estate tax purposes exceeds decedent's basis.

(*b*) If property is sold at price higher than adjusted basis for loss, but lower than adjusted basis for gain, then it is within the "grey area" and neither gain nor loss is recognized.

4. The new rules for property which the decedent acquired before Jan. 1, 1977, for the purpose of computing GAINS; begin with decedent's adjusted basis, plus the following adjustments:

(*a*) Fresh start adjustment, when fair market value at Dec. 31, 1976, exceeds adjusted basis at Dec. 31, 1976, increase basis by such excess; IRC § 1023(h);

(i) For marketable bonds and securities use actual value at Dec. 31, 1976, to determine increase in basis.

(ii) For other property use an arbitrary formula to allocate appreciation to periods before and after Dec. 31, 1976.

(iii) When applicable, use of formula is mandatory regardless of actual fair market value on Dec. 31, 1976.

(iv) Formula is total appreciation multiplied by fraction; numerator is number of days of holding period before Jan. 1, 1977, and denominator is total number of days in holding period.

(v) Depreciation, amortization, and depletion adjustments are also prorated, but these are allocated using actual amounts attributable to periods before Jan. 1, 1977.

(vi) Increase basis for property other than marketable bonds and securities by the sum of: (1) formula allocated increase in value net of all depreciation, amortization, and depletion; and (*b*) actual depreciation, amortization, and depletion attributable to holding period before Jan. 1, 1977.

(vii) Example of fresh start adjustment:

Facts: Decedent dies on Jan. 1, 1981 owing depreciable property with a fair market value of $36,000. He had purchased said property on Jan. 1, 1971, for $19,000. Depreciation deductions were taken on the straight line method of $900 per year.

Computations:

(1) Adjusted basis at death:

Original cost at Jan. 1, 1971	$19,000
Depreciation (10 yrs. times $900)	9,000
Basis to decedent	10,000

(2) Excess of FMV over basis:

FMV	36,000
Basis to decedent	10,000
Excess	$26,000

(3) Excess reduced by depreciation, amortization or depletion:

Excess	26,000
Depreciation-total	9,000
Total appreciation from purchase to death	17,000

(4) Applicable fraction:
Days before Jan. 1, 1977 over total number of days equals 2,190 over 3,650 equals 6 over 10 equals 60 percent.

(5) Appreciation allocated to period before Jan. 1, 1977 by formula:

$17,000 times 60 percent	10,200

(6) Depreciation actually deducted before Jan. 1, 1977: $900 times 6 years — 5,400

(7) Fresh start addition to basis:

Appreciation in value allocated by formula	$10,200
Plus depreciation prior to Jan. 1, 1977	5,400
Total addition	15,600

(viii) Special rules for fresh start adjustment to be covered by regulations:

(1) Substantial improvements to be treated as separate property

(2) Treatment where part of gain is ordinary income (IRC §§ 306, 1245, 1250, etc.)

(3) Property held by a trust or partnership in which decedent was a beneficiary or a partner

(b) Federal and State estate taxes attributable to the appreciation in carryover basis assets; IRC § 1023(c), discussed above at VII D.2.a)

(c) $60,000 minimum basis allocated among all appreciated carryover basis property; IRC § 1023(d), discussed above at VII. D.2. b)

(d) State succession taxes paid by beneficial attributable to net appreciation on property; IRC § 1023(e), discussed above at VII. D.2. c)

E. Other Rules Related to Basis Imposed by the 1976 Tax Reform Act

1. If decedent's basis is unknown, then it is assumed to be the fair market value of the property as of the (approximate) date it was acquired by the decedent or the last preceding owner who did not have a carryover basis; IRC § 1023(g) (3).

2. Personal representative of decedent's estate or person in possession of decedent's property has additional responsibilities and liabilities:

(a) Information regarding carryover basis of property acquired from a decedent must be furnished to both IRS and to the beneficiary; IRC § 6039A.

(b) Failure to furnish such information may result in penalties under II § 6694:

(i) Information to IRS: $100 per failure, up to a total of $5,000; and

(ii) Information to beneficiary: $50 per failure, up to a total of $2,500.

3. Limitation of gain recognized on satisfaction of pecuniary bequest with appreciated carryover basis property; IRC § 1040

(a) gain is recognized only to the extent of any increase of FMV on date of distribution over value used on Form 706

(b) rule applies to estates as well as inter vivos trusts used as Will substitutes

(c) basis of property in hands of recipient is same as basis before the distribution plus any amount of gain recognized because of the distribution

4. Appreciated assets transferred to a trust after 5/21/76 and sold by the trust at a gain within 2 years after such transfer will be taxed at grantor's income tax rates (not the trust's rates) for the year of sale; IRC § 644.

(a) tax is computed separately from trust's other tax

(b) grantor's income tax rates include minimum tax

(c) character of gain is determined by the activities of the transferor

(d) such gain is excluded from trust's taxable income by IRC § 641(c) to avoid double taxation; and therefore it is neither reflected in DNI nor in any accumulation distributions

(e) special rules and exceptions; IRC § 644(d), (e), and (f)

VIII. ACCUMULATION DISTRIBUTIONS OF TRUSTS "THROWBACK" RULES (IRC §§ 665 666, 667)

A. Purpose of these rules is to prevent the saving of taxes by high bracket trust beneficiaries. Such savings might arise by the trustee avoiding the distribution of taxable income from the trust to higher income tax bracket beneficiaries, having the trust pay the income tax on the accumulated income, and later distributing such accumulated income to the beneficiaries with the taxes on such income already paid.

B. Throwback rules apply only to trust which accumulate income, but not to estates, even if estates do accumulate income.

C. Example of tax savings available to beneficiaries of estates because throwback rule doesn't apply.

Facts: during 1977 and 1978, the Jones Estate has AT&T bond interest income of $10,600 each year and no expenses. The Estate reports using a calendar year and has only one beneficiary who is in the 70 percent income tax bracket. No distributions are made in either 1977 or 1978. The estate is terminated and all corpus and accumulated income distributed on January 1, 1979.

Testimony of Milton E. Meyer, Jr., on the Subject of Repeal of Section 2005 (Carryover Basis) of the Tax Reform Act of 1976

I am Milton E. Meyer, Jr., a practicing attorney in Denver, Colorado. I am a principal in the law firm of Hindry & Meyer, P.C., 2300 First National Bank Building, Denver, Colorado 80293, a medium-size law firm which I founded in conjunction with the late Hayes R. Hindry in 1956. I have been actively engaged in the practice of estate planning and taxation law for some 27 years. During that time I have written a number of published articles on tax and estate planning subjects and have been a frequent lecturer before tax and estate planning groups.

Our firm has approximately 1,000 estate planning clients. At any one time, we are handling 15 to 30 decedents' estates with a full-time staff of two lawyers, two paralegals and specialized secretaries exclusively engaged in this activity.

I urge that the Congress repeal Section 2005 (carry-over basis provisions) of the Tax Reform Act of 1976 for the following reasons:

1. "STEPPED-UP BASIS" IS NOT A "LOOP HOLE"

Historically, estate and gift taxes have not been significant revenue producers. In 1974, they constituted 2.7 percent of all taxes collected by the federal government. Consequently, there is no compelling revenue need, at this stage of the development of the Internal Revenue Code, no tax appreciation at death or, alternatively, require that it be taxed at a later date in the hands of heirs. One is required to look elsewhere for the justification for carry-over basis. It cannot properly be found in "closing tax loop holes."

The death of an estate owner typically causes substantial bereavement and hardship to the family. The payment of estate and inheritance taxes, often accompanied by forced liquidation of family assets, is a further burden that comes with death. Why does still a third level of deprivation have to be imposed at death—the immediate or deferred taxation of unrealized appreciation?

Why is not the non-voluntary and unsought condition of death, coupled with substantial death taxes where applicable, enough price to pay for stepping-up basis of estate assets to fair market value?

Who has suffered as a result of this prevailing tax rule during the past 63 years that it has been in effect? What group of tax payers (voters) is clammering for this change in long-standing tax policy?

The Committee reports accompanying Section 2005 complains about the "lock-in" effect following from the tendency of persons who might otherwise sell assets to hold on to the assets until death in order to obtain the benefit of "step-up" at death, thereby "distorting allocation of capital between competing sources." I frankly do not understand that last quoted phrase. However, the "lock-in" that allegedly existed under the old law at least ended at death. The "lock-in" prompted by the new concept could go on for generations.

Congress now has achieved, at least in theory, a tax (estate tax) each generation (Section 2006 of the Tax Reform Act of 1976). What is wrong in continuing a "fresh start" so far as tax basis is concerned each generation? Particularly when one contemplates the economic hardships and administrative burdens and expenses that accompany the carry-over basis alternative?

2. CARRYOVER BASIS IMPOSES SUBSTANTIAL ECONOMIC HARDSHIP

While the full economic impact of the enactment of Section 2005 is delayed in most instances by the effects of "fresh-start," it is absolutely clear that the ultimate burden on estates and private capital formation will be extremely severe—and growing worse as Congress continues to erode away the preferential tax treatment of capital gains.

Unless one's view of the desired relationship between private capital and public capital is radically different from mine and that of most of my clients, one has to wonder how the national interest is well-served by a system that subjects the assets of a decedent's estate to estate taxes and then to a second "capital tax" represented by imposing a capital gains tax on that portion of previously unrealized appreciation related solely to *inflation*. It seems abundently clear that a significant to substantial part of every "capital gain" in the past decade or two is the result solely of inflation and not economic gain and that the taxation of such inflation constitutes a permanent removal of capital in the private sector of the economy. Was it the conscious intention of Congress to accelerate this trend by passage of Section 2005 and by further increase in the effective rates (now ranging up to 49.125 percent) of the capital gains tax? Does the Sixteenth Amendment sanction the taxation of capital under the guise of taxing income?

Congress has attempted, in the Tax Reform Act of 1976, to ease the burdens on the estates of farmers and small businessmen in meeting estate tax requirements at death. However, the beneficial effects of such IRC provisions as Sections 303, 306, 6166, 6166A and 2032A have been largely emasculated by the superimposition of Section 2005. Ironically, a class Congress intended most to assist—the farmers—have been most injured by Section 2005. Please note the hypothetical example of the estate of an Iowa farmer prepared by another attorney attached hereto as Exhibit A. Observe that, in a $545,000 taxable estate, an ordinary income tax burden of $233,712 is incurred solely because of the effect of Section 2005. I submit this is not a rational result.

Where is the elemental fairness in requiring that a tax be incurred in the raising of funds to pay a tax? This is the inevitable result now faced by nearly every estate having insufficient cash on hand at the decedent's death to meet death taxes.

Many estate owners have been effectively lopped off the estatate tax rolls by other features of the Tax Reform Act of 1976. Their gratitude to Congress will be tempered by the ultimate discovery of the fact that the tax burdens and/or administrative complexities of Section 2005 apply to the estate or heirs of *every* owner of an appreciated asset, however modest.

3. CARRY-OVER BASIS IMPOSES EXTREME ADMINISTRATIVE COMPLEXITY

The belated concept of "fresh start" included in Section 2005 has no doubt served to blunt the protest of older estate owners and to defer the immediacy of the economic burdens (and, therefore, recognition of the problem) of carry-over basis to younger estate owners and future generations. However, the administrative burdens imposed by "fresh start" and the other required adjustments to historic basis prescribed in Section 2005 are almost mind-boggling.

Attached as Exhibit B is a worksheet developed by a Denver trust officer for the determination of carry-over basis for gain and for loss as required by Section 2005. You will observe it denotes 61 separate steps actually or potentially required—for each estate asset! And, before this series of calculations can be undertaken, there must first be a determination of historic basis as a starting point. Against a 63 year background of not requiring the maintenance and preservation of cost data related to assets which an owner intends to retain until death, how will estate administrators and their representatives cope with the new requirement to ferret out such historic costs?

At a time when many state governments are attempting to simplify probate, thereby reducing administrative costs associated with dying, Congress moves in the opposite direction. The administrative costs of trying to cope with Section 2005 will prove staggering!

Attempts to comply with all of these new administrative requirements will be made against a background of severe financial penalties imposed by Section 2005 unless "everything reasonable" has been done by the estate administrator to produce and communicate to the federal government and to the effected heirs, accurate basis data. Parenthetically, one is free to speculate whether the felt necessity to impose such specific penalties on estate administrators—many of them being corporate and individual professionals bent on nothing more ominous than discharging a desirable social function—is itself an admission by Congress or the draftsmen of Section 2005 that the administrative requirements of that Section exceed recognized standards of reasonableness.

In addition to the foregoing, estate administrators now face still another set of problems and liabilities—how to distribute assets having disparate amounts of built-in taxable appreciation among eligible heirs and devisees?

4. IRREGULAR LEGISLATIVE METHOD BY WHICH SECTION 2005 WAS ADOPTED BY CONGRESS

The method by which the estate and gift tax reform provisions of the Tax Reform Act of 1976 were enacted by Congress—without prior adoption of a bill in the House of Representatives—has already come under criticism on constitutional grounds. Even more bizarre, I submit, is the method whereby Section 2005 was added to the same estate and gift tax provisions.

My research indicates that the estate and gift tax provisions added for the first time to H.R. 10612 by the Senate on July 23, 1976 as Title XXII did *not* include a carry-over basis provision. Similarly, when the Senate passed H.R. 10612 on August 6, 1976, the bill still did not contain a carry-over basis provision. This provision was added for the first time in Conference, being contained in the House and Senate Conference Report filed on September 13. On September 16, 1976, H.R. 10612, as so altered, was passed by both Houses.

It is therefore clear that a fundamental concept of U.S. Tax Law ("step-up" of the basis of assets at death) that had been in the law since 1918 was repealed and replaced by an economically and administratively oppressive new concept ("carry-over basis") which will have an inevitably adverse effect on capital formation in this country in a legislative procedure which denied to both Houses of Congress the opportunity to separately study and consider the matter.

What conditions of urgency facing the country could possibly justify such action? Did the architects of Section 2005 fear that the concept could not survive prior public and Congressional scrutiny?

I submit that Congress should feel neither defensive nor protective about preserving an item of legislation adopted in the manner above described.

In conclusino, I earnestly urge Congress to repeal totally Section 2005 of the Tax Reform Act of 1976. It is not the kind of provision which merits "improving" or otherwise tampering with.

I do not mean to be disrespectful, but I cannot believe many members of Congress can take pride or satisfaction from either the substantive content of Section 2005 or from its method of legislative adoption.

MILTON E. MEYER, Jr.

Exhibit A

104th Annual Meeting, The Iowa State Bar Association
June, 1977
Probate Workshop Addendum

BELIEVE IT OR NOT - (NOT BY RIPLEY, BUT BY CONGRESS)

Jim Jones, age 55, died December 1, 1977 - a widower, a tenant farmer leaving all his property to his son, Bob Jones, age 30. Jim was on a cash basis, he farmed 1200 acres, his son worked as his hired hand.

His inventory was as follows:

Item	Bracket	Rate			
1. Machinery & cash on hand net of expenses of last illness and burial and cost of administration				$120000.00	
2. 100,000 bu. of corn @ 2.25 per bu. (raised in 1977)				225000.00	
3. 20,000 bu. of beans @ 10.00 per bu. (raised in 1977)				200000.00	
TAXABLE ESTATE				545000.00	
Federal Estate Tax	500,000 @		$155800.00		
	45,000 @	37%	16650.00		
Gross Tax (REFORMED)			172450.00		
LESS STATE CREDIT					
	440,000 @		10000.00		
	45,000 @	(4%)	1800.00		
			11800.00		
LESS UNIFORM CREDIT			30000.00		
NET ESTATE TAX (REFORMED)					$130650.0
Iowa Inheritance Tax Gross			545000.00		
Less Federal Estate Tax			130650.00		
Less Exemption			30000.00		
Taxable				384350.00	
TAX	150,000 @		7825.00		
	234,350 @	8%	18748.00		
TOTAL INHERITANCE TAX					+26573.
TOTAL DEATH TAXES					157223.
INCOME TAX (SIMPLIFIED)					
Corn & beans sold at inventory value			425000.00		
Basis Fed. 425,000 x 157,223.00 / 545,000			122605.00		
Adj. Gross Gain Fed.				302395.00	
Fed. Inc. Tax	100,000 @		55490.00		
	201,795 @	70%	141256.00		
Total Federal Income Tax					196746.
Iowa Income Tax					
Basis same as Federal			122605.00		
Net gain Iowa				302395.00	
	75,000 @		7420.00		
	227,395 @	13%	29561.00		
Total Iowa Income Tax					36966.
TOTAL INCOME TAX					233712.
TOTAL TAXES IN ESTATE (GOVERNMENT SHARE)					390935.
SON'S TOTAL SHARE					-154065.
TOTAL PERCENTAGE OF TAX ON LAST 45,000 INHERITED		124%			

If the gross estate had been $200,000 less, the son's total share would have been $137,951 or approximately $16,114 less. IN OTHER WORDS, OF THE LAST $200,000 INHERITED, THE GOVERNMENT SHARE IS APPROXIMATELY $[illegible],000.

WHEN IS IT WISER NOT TO INHERIT?

BEST COPY AVAILABLE

EXHIBIT B

C-1

COMPUTATION OF CARRYOVER BASIS

(As of May 15, 1977) (1)

William R. McDonald

Trust Officer

First of Denver

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) / 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) ______

EXHIBIT B

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). ____________ (%)
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 estate:
    a. Federal estate tax ____________
    b. State death taxes ____________ ____________
24. Overall tax rate (line 23 divided by line 22) ____________ (%)
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

C-3

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 of 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 line 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 non-excluded personal and household goods lesser of line 1 or line 49. For property subject to non-recourse 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:
   (1) Treating estate taxes on income items in the estate as an addition to basis.
   (2) Ignoring non-recourse debts against the property
   (3) 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 sucession taxes, for which the estate is liable, actually paid by the estate to any state or the District of Columbia.

MATTHIAS, TYLER, LEVIN & NUZUM,
Newton, Iowa, August 29, 1977.

Re: carryover basis rule.

MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Room 2227, Washington, D.C.

DEAR MR. STERN: I am writing you and ask that you put this letter before the committee. As a county-seat lawyer in Iowa, I am very concerned about the horrendous amount of work which this rule will throw on me in handling estates.

For example, I now have an estate where Mrs. Breed died in February of 1977, shortly after the rule became effective. Among her assets is a farm, now worth over $250,000.00, but which was bought around 1926 for $28,800.00. There are other assets of this estate, but I will ignore them for present purposes.

The income tax law became effective prior to 1926, and in making basis adjustments we must allow for depreciation "allowed or allowable". But my senior partners advise me that most farmers did not even file tax returns until after World War II, so there would be perhaps 20 years of "allowable" depreciation not shown on any tax return or depreciation schedule.

And what of post-war depreciation? The oldest tax return we currently have in our file is for 1971, leaving maybe 25 years of "missing" returns in addition to the maybe 20 years of no returns at all. If that wasn't bad enough, many of our older returns merely show an amount for total depreciation, and state that a depreciation schedule is available on request. Of course, after some years went by, those schedules were discarded since the returns were beyond the statute of limitations on audits and such.

Do I even need to mention improvements? The problems of the depreciation area apply equally well to the purchase of improvements, and obviously anyone living on a farm from 1926 to 1976 would be in a continual process of adding improvements. Even if we had 50 years of cancelled checks, which we do not, can you imagine having to slowly pore through and try to single out the purchase of improvements? And how much of each has been or should have been depreciated?

After I have guessed my way through all this, and file a tax return, the Internal Revenue Service gets its opportunity to guess at things, and if it is decided that my guesses were "negligent" and understated the tax due, then the IRS will assess a $100.00 penalty. "Willfull" understatement would cost me a $500.00 penalty. And what if I protect myself by overstating the tax due? My clients would then have an excellent chance at collecting damages from me for malpractice (the so-called "California disease") for not properly protecting their interests.

While I agree that the carry-over basis rule is quite logical when considered as an abstract question, the realities of putting it into practice are absolutely mind-boggling. Even if it were only put into effect for property purchased after 12-31-76, the record keeping that would be required would be beyond the ability of the small business people and farmers with whom I am familiar. I urge you to retroactively repeal the "carry-over basis rule".

Very truly yours,

BRUCE J. NUZUM.

FIRST NATIONAL BANK OF ABILENE,
Abilene, Tex., August 22, 1977.

Re: Hearings concerning 1976 Tax Reform Act.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

GENTLEMEN: In reference to your request for comments concerning the Tax Reform Act, we offer the following:

The methods and rules for computing carryover basis and "fresh start" basis pursuant to the Tax Reform Act of 1976 have generated an unfair and unjust burden of double taxation which will arbitrarily impose substantial tax based on arbitrary formulas, and will further increase the fees of professional corporate executors, attorneys, and accountants to the small and middle sized estate.

The rules are so cumbersome to interpret and calculate, that even an estate which is not required to file an estate tax return will be affected. Executors will be required to report to each beneficiary of an estate his carryover basis.

with the penalty for failure to do so, being $50 per failure. In an estate with twenty or more beneficiaries, the potential liability will cause the professional executor and the accountant for the estate to be extremenly cautious in calculating these costs, with the attendant increase in time consumed and fees incurred. It is little wonder that this act is jocularly referred to as the "Attorneys' and Accountants' Relief Act of 1976."

In addition to the previously cited inequity, these minute calculations, once made, place the property in jeopardy of double taxation. The property is still included in the decedent's estate for estate tax purposes at its appreciated date of death value, being the difference between the decedent's cost and date of death value. Thus the appreciation is taxed under estate tax rules. The property then is taxed to the estate's beneficiary under income tax rules, again on its appreciation, less the actual average estate tax paid. The net result is that the same property is effectually taxed by the same body twice under two sets of rules. The resulting combined tax rate is confiscatory in some cases.

I am quite aware that the tax is not legally levied on the property itself, but rather on the two taxable entities of estate and beneficiary. However, these bequests are normally intra-family situations, and a confiscatory tax on an intra-family transaction is a situation which is to be deplored and, if possible, repealed.

The act further places tax sanctions on the time period when a person dies. The beneficiaries of those persons who die many years after December 31, 1976 will have a proportionately higher tax than those who die soon after 1976, simply because the fraction used to calculate the basis becomes smaller each succeeding year on any given asset, and as this fraction becomes smaller, the resulting carryover basis becomes lower and the resulting tax on the beneficiary becomes higher. Therefore, this tax computation method produces a tax based, not on whether there is actually income by way of appreciation, but rather on when a person dies, and the number of years he held an asset prior to 1977.

Although the above cited problems are only a small fraction of those engendered by this legislation, I'm quite sure you will receive comments on many other problems from other sources. I therefore submit that this piece of legislation which was rather obviously passed for political reasons in the heat of a presidential election, be repealed, in toto, and that some meaningful and practical legislation be enacted which will effectively reform the estate and gift tax laws.

Sincerely,

TOM MCMICHAEL,
Vice President and Trust Officer.

STATEMENT OF LUTHER J. AVERY, ESQUIRE

This statement has been prepared and submitted by me, as an individual, and not on behalf of any organization or client.

I am a lawyer certified as a Tax Specialist by the Board of Legal Specialization of the State Bar of California, a Regent of the American College of Probate Counsel, a former Chairman of the ABA Section of Real Property, Probate and Trust Law, and a lawyer experienced in probate, taxation and estate planning. I am submitting this statement in the earnest hope that the Senate Finance Committee will reexamine the entire area of the federal estate and gift tax and give thought to substantive tax reform that will accomplish socially desirable objectives and will abandon the type of disastrous tinkering with the law that arose out of the so-called Tax Reform Act of 1976.

I enclose, for your consideration, a study summary of the American Assembly on Death, Taxes and Family Property (1976), and I request that that summary statement be attached as a part of my statement before the Committee and be made a part of the record.

In essence, it is my position that the federal and state tax systems are causing unnecessary cost and delay in the family estate settlement process and that it is necessary that the tax system and the wealth transmission system be integrated and that the two of them be designed to minimize the cost of wealth transmission at death and to achieve prompt transmission of wealth at death with a minimum of legal and other unnecessary complications. Therefore, it would be my recommendation that the federal government totally abandon the federal estate and

gift tax system and that the federal government adopt policies and legislation which would also remove the states from the death tax business (and thus also eliminate state gift taxes). There are a number of social policies involved in the area of wealth transmission and taxation which are discussed in the summary report attached. I support the views of that report that in lieu of a federal estate and gift tax and, hopefully, also in lieu of the state death tax system, that there could be substituted either a revision of the income tax systems which would make windfalls such as excess inheritance subject to income tax or, in the alternative, that there would be consideration of the adoption of a so-called accessions tax. It should be the objective of the Congress to coordinate the federal activities and state activities to achieve objectives of married and single decedents so that there will be less of the costs and delays that we presently have in our probate and wealth transmission systems.

If it is a necessary objective of the taxing system to continue to receive the taxes raised by the estate and gift tax, those fiscal objectives can be obtained through an accessions tax or an income tax. If it is an obective of the tax system to destroy vested wealth or to eliminate large ownership of property or great wealth, those can be accomplished on a much simpler system than the presently existing system.

It is not appropriate in a statement such as this to submit more than the basic principles which I am advocating, and those principles which are set forth in the attached Final Report of the American Assembly on Death, Taxes and Family Property. However, if the Committee wishes to explore any of the substantive areas of law that would need development if there were to be consideration of such things as getting the federal government entirely out of the death tax business, there have been written treatises which cover this subject and the papers which were background papers written and discussed at the American Assembly on Death, Taxes and Family Property, will be published in book form and would be submitted to all members of the Finance Committee if that were of interest.

LUTHER J. AVERY.

Enclosure.

FINAL REPORT OF THE AMERICAN ASSEMBLY ON DEATH, TAXES, AND FAMILY PROPERTY, ATLANTA, GA., DECEMBER 2-4, 1976

PREFACE

The report which follows is the result of the deliberations of 33 Americans from 14 states and the District of Columbia who comprised The American Assembly on *Death, Taxes and Family Property*. The participants—from the legal profession (bench, bar and law school), business, communications, government, education and other pursuits—met at the Emory University Law School, Atlanta, Georgia, December 2-4, 1976, under the sponsorship of The American Assembly of Columbia University and the Real Property, Probate and Trust Law Section of the American Bar Association.

The discussions were based on a series of papers, prepared as advance reading for the Assembly under the editorial supervision of Professor Edward C. Halbach, Jr. of the University of California (Berkeley) School of Law:

1. The Law of Succession in Social Perspective by Lawrence Friedman
2. Death, Property, and Ideals by Thomas L. Shaffer
3. The Aims of Death Taxation by Gerald R. Jantscher
4. An Economist's Perspective on Estate Taxation by Michael J. Boskin
5. Taxation of Wealth Transmission: Problems and Reforms by Max Gutierrez, Jr.
6. Fundamental Alternatives to Present Transfer Tax Systems by John K. McNulty
7. Restraints Upon the Disinheritance of Family Members by Paul G. Haskell
8. The Dead Hand and the Law of Trusts by Gareth H. Jones
9. Probate Reform by Eugene F. Scoles
10. The English System: Simplified Probate in a Similar Context by William F. Fratcher
11. Probate and Estate Planning: Reducing Need and Cost Through Change in the Law by Edward C. Halbach, Jr.

The findings and recommendations which follow emerged from the discussions of the participants in their private capacities. As a nonpartisan educational forum, The American Assembly takes no stand on matters it presents for public

consideration. Likewise, American Bar Association involvement extends only to its role as a sponsor, and none of its intricate endorsement procedures have been invoked as to the report.

The Assembly is indebted to the West Publishing Company for printing this report: William P. Cantwell; Dawson, Nagel, Sherman & Howard, Denver, Colo.; Clifford C. Nelson, President, The American Assembly, Cochairmen.

At the close of their discussions, the participants in the American Assembly on *Death, Taxes and Family Property* reviewed the following statement in plenary session. The statement represents general agreement, although it must not be assumed that every participant subscribed to every recommendation.

Americans who acquire and hold property express themselves in the way they deal with it: using it, spending it, saving it, giving it away. The social order around us tends to honor our choices on the basic theory that private decision-making is better than public control. To hold property and to have wide discretion over it are cloey associated with our concepts of freedom.

One's property rights, however, are not absolute and accommodations must be made to the interests of others in society. Care must be taken that wealth does not give rise to excessive power—that is, the power unduly to limit economic opportunity or to govern the lives of others.

One aspect of private property, and a traditional area of free choice, has occupied this Assembly's attention: the right of succession and the freedom to dispose of property during life and at death. The Assembly has examined the extent to which that right and that freedom should exist or be limited.

Intervention by society is justified to curtail harmful concentration and perpetuation of economic power. In addition, freedom of testation may be regulated so that property is not given to persons or in forms that are believed unfair to family members or otherwise socially undesirable.

Some Basic Premises

Much of the law of succession has origins in the past, some of which are no longer compelling or relevant. We are concerned that much of today's law and even some recent legislation, including tax legislation, has developed without adequate analysis of fundamental reasons for or against public intervention.

Our systems of wealth transfer can be appreciated, or properly altered, only after their premises, structures and procedures have been subjected to philosophical inquiry, testing them against economic, social and political values of today. The Assembly has attempted that, with particular emphasis on the transfer of substantial wealth from one generation to another.

The institution of succession serves a variety of values cherished by a free society. These include reinforcement of family ties and responsiilities, economic and social pluralism, and encouragement of private philanthropy to improve the quality of life.

At the same time, transfers of substantial wealth tend to conflict with other basic social values, including equality of opportunity, dispersal of economic power, reward according to merit, and avoidance of rigid class distinctions.

Perhaps at a more fundamental level, the institution of succession is a proper response of society to elemental motives, ranging from concern for one's immediate family to a desire to extend one's personality beyond death. In fact, establisted patterns of inheritance may be the least objectionable means of deciding property ownership on a person's death.

Excessive unearned wealth, however, may arouse deep-seated resentment, and possibly alienation from society, over someone's "getting something for nothing."

Examined from an economic perspective, the right to transfer wealth has the positive values of fostering incentives in the form of rewarding industry, ingenuity and creativity, encouraging capital formation through saving and investment, permitting continuity of on-going enterprise, and supporting diversity in priorities. In addition, such transfers are, indeed, often justified by significant, if not always evident, economic contributions by those who receive them.

There also may be adverse economic implications in permitting significant wealth transfers, including loss of potential tax revenues, tolerance of continuing concentrations of economic power, inefficiency in investment resource allocation and reduced incentives to productivity among heirs.

It should be noted that there was not in this Assembly, any more than there is in American society as a whole, a consensus concerning the amount of individual

wealth to be considered objectionable when one weighs the particular positive and negative qualities enumerated here. It was frequently suggested that the impact of those qualities may vary considerably depending upon the character and dispersion of the wealth transfers involved. It would appear that limitations on wealth transmission ultimately will be set by political judgments rather than solely by a process of reasoning and logic.

Transfers of "human capital" were also recognized. Education, home environment, genetic and nutritional differences, and family tradition and status confer important economic and social advantage. Society should not intervene to prevent these transfers but should try to extend similar advantages to those who do not receive them by private transfer.

Transfers and the Future

The character of and need for wealth transfers may be altered by an array of changing conditions. Those who plan or legislate concerning wealth transmission must take account of future developments, much as they must appreciate the impact of today's values and realities.

New forms of wealth are evolving out of employment relationships and social policies. Much wealth may now be understood as a 'bundle of entitlements," different from traditional property. The fact and amount of its acquisition tend to be standardized (e.g., social security and pension plans) and often involve some limitation on and standardization of disposition at death.

The nature and even definition of the family is changing. Long-term "singlehood," the one-parent family, the permanently childless couple, the two-worker family, the family group not bound by conventional marriage—all reflect basic change in the traditional nuclear family.

Within the family, roles and rights (including those of children born out of wedlock) are changing markedly and rapidly. Notable is the growing recognition of the family property rights of the wife whose work is in the home.

The average age of the population is rising, with a potentially profound impact on succession law and practice

Geographic mobility of persons and their property creates increased cost, uncertainty and complexity due to diversity of state laws governing succession.

Seemingly perpetual inflation, and with it the generation of new forms of investment and assets, suggests the need for innovations in estate planning and raises questions about the transfer tax structure.

Taxation of Wealth Transfers

There will continue to be a call for the relatively modest revenues generated by transfer taxes, but a realistic assessment of the justification for these taxes must focus on their role in redistribution of wealth. This fact, however, does not lead us to a conclusion that the goal of redistribution, in light of other relevant social and economic considerations, now justifies either an increase or a decrease in the present levels of death and gift taxation.

In enacting the Tax Reform Act of 1976, Congress has dealt with several of the traditional problems of the estate and gift tax system:

The dual tax system, allowing the wealthy to reduce taxes unduly through gifts, was replaced by a unified credit and rate schedule.

The marital deduction, thought to be inadequate in some situations, was increased significantly for moderate-sized estates.

Tax avoidance through "generation-skipping" trusts has been severely curtailed.

Main concerns about the transfer tax system as it still exists include:

Its unacceptable complexity in terms of tax administration, the probate process, taxpayer compliance and planning to avoid inequities, insufficiently justified by tax policy objectives.

Its lack of neutrality and unnecessary intrusiveness into the planning of estates and private financial affairs, fostering manipulation and inequities.

These defects are aptly illustrated by the new rules for item-by-item carryover of basis as a means of solving long-standing concerns over the taxation of appreciated assets at death. The problem requires another solution and at least the carryover of an averaged basis should be considered seriously.

Basis alternatives.—The inefficiency of and widespread dissatisfaction with the present transfer tax system, and the unlikely prospect of significantly improving a system of the present type, now demand serious consideration of a variety of basic alternatives. A broad array of alternative approaches was dis-

cussed, with the conclusion that the adoption of a tax structure which looks to the person receiving the donative transfer should be considered fully as a replacement for the existing transferor-based system. Among the transferee-based alternatives worth careful study are:

application of an "accessions tax" to wealth received from all donors over a transferee's lifetime; and

treating gifts and inheritances as income, subject to income taxation like other receipts.

Special Problems of Free Testation

Basic questions persist over two fundamental aspects of the American law of succession: the commitment to freedom of the donor to choose those family members or others who are to receive transfers, and the scope of that freedom when transfers are in trust.

Regarding the first, several areas requiring study were identified:

Most jurisdictions assure the surviving spouse a specific fraction (typically, one-third) of the estate, regardless of the donor's expressed wishes and regardless of the spouse's need, the size and sources of the estate, or the duration of the marriage. Particularly to be considered are flexibility provisions rather than fixed percentages. (Incidentally, it also was noted that the rights of the surviving spouse, in the event of death without a will, are generally too little to reflect what most property-owners wish to make for spouses, as shown by empirical studies.)

There may be a need for additional optional arrangements spelled out by statute which a married couple could, perhaps by contract, choose as a private arrangement establishing the extent and form of their ownership rights in property acquired during the marriage.

Some support obligation should be imposed to provide for minor children of a decedent where an obligation of support existed during life.

Regarding the freedom to transfer by trust (and its counterparts) it was concluded:

The law should be liberalized to more readily permit modification and termination of trusts (and counterpart arrangements) by beneficiaries or by courts in the best interest of beneficiaries. This applies both to administrative and distributive provisions when such action appears to follow the probable intention of the donor.

Estate Services for the Public

The public should be offered greater variety and efficiency and more choice in estate-planning services (including identification and coordination of probate and non-probate assets) and services connected with the administration of estates.

In addition, there is a need for more public education about estate planning, and this should be provided by the bar and others competent in the field. Better public understanding would also be promoted by uniformity of state laws of succession.

Estate planning.—In particular, it is desirable that readily available options in statutory or other form be developed to permit the simplified and inexpensive creation of both trusts and non-trusts dispositions by will in a manner analogous to but more diverse than present legislation concerning gifts to minors.

The bar is urged to make estate-planning services more widely available by providing them at reasonable cost through the use of group legal services, prepaid legal insurance, increased technology and similar means.

In addition, accepted definitions of "practice of law" should be re-examined carefully and seriously, looking to the possible performance by nonlawyers of some functions that have been classified traditionally as practice of law, with appropriate safeguards, particularly in connection with the drawing of wills.

Probate.—The bar should encourage the trend toward various devices permitting settlement of estates with little or no court involvement (in the absence of controversy) and with only minimally necessary involvement of lawyers. The development of procedures for transferring property without administration should be encouraged, as should "do-it-yourself" techniques.

The use of informal estate procedures suggests a need for standardized processes, official assistance to laymen handling estates, and for innovative approaches to investment. The latter may require the law to be clarified to reflect modern practices in low-cost market fund operations.

American Assembly on Death, Taxes and Family Property

Participants

Byrle M. Abbin, Arthur Andersen & Co., Chicago.
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Richard V. Wellman, Alston Professor of Law, The University of Georgia.
Judith T. Younger, Professor of Law and Deputy Dean, School of Law, Cornell University.

Statement of John P. Whitesell

The carry-over-basis rule should be completely discarded. The rule adds horror to the already hideous body of tax law.

Even with the advent of computerized society, there is no way in which any organization or bureau, much less any individual, can properly interpret and administer the carry-over-basis rule. To attempt to propose regulations with regard to it can only add chaos to an already catastrophic situation. We must all realize that the carry-over-basis rule has to be the result of reasoning done in a fitful nightmare.

The penalties that will result because of inadequate record keeping by a decedent from which one must furnish information to IRS is such that no sane person should ever accept the position of executor. The carry-over-basis rule will only cause people to look for ways in which to protect themselves from the IRS, and thus, add to the amount of forms and claims that will be filed in order to avoid the traps that are built into this unrealistic and unprofitable approach to setting a basis on property.

The record keeping alone is staggering and for no good purpose except to satisfy a very foolish, ill-conceived rule. Much of the property people have acquired over the years has been obtained without any thought or consideration

given to preserving records such as are required under this rule. It is far too simplistic to take a position that if the basis is unknown it will be presumed to be the fair market value at time of acquisition. Querry—What is the fair market value of the old tractor purchased years ago from a neighbor in a sale consisting of a number of items for a lump sum? Recourse to old literature and books as to pricing is not going to be either obtainable or acceptable.

In summary, the best that can be said for the carry-over-basis rule is that it is as its initials show a COB job.

VANCE, VANCE & WILCOX, S. C.,
Fort Atkinson, Wisc., September 23, 1977.

Hon. HARRY F. BYRD, Jr.,
(Attn: Michael Stern, Staff Director of Committee on Finance, Room 2227, Dirksen Office Building, Washington, D.C.)

DEAR SENATOR BYRD: As an attorney, I have been concerned with the serious adverse effect of various aspects of the 1976 Tax Reform Act. I have recently received the enclosed brochure from Northwestern Mutual Life Insurance Company, and that sets forth better than I could the problems that are involved for small businesses.

In addition to what is set forth in the brochure, I might comment that this Act creates a very serious problem with regard to valuation of real estate as well as small businesses for inheritance and subsequent income tax purposes.

Yours very truly,

SHELDON VANCE.

Enclosure.

[From the Estate and Tax Letter]

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NEW CAPITAL GAINS TAX IMPOSES IMPOSSIBLE BURDEN ON FAMILY CORPORATIONS

The 1976 Tax Reform Act provides, for the first time, that when an individual dies the cost basis of his property will "carry over" to his estate and his heirs. Congress eased the immediate impact of this law by providing a "fresh start" on December 31, 1976, but for new businesses started after 1976 the effect of the new law is to impose a capital gains tax at death on all future sales of appreciated assets, even when they are sold to raise money to pay estate and inheritance taxes and expenses of administration. This tax would be added on top of the present estate tax, which starts at a 30 percent rate. The serious impact of these combined death taxes on one's incentive to start and build a family business is graphically demonstrated by the following figures:

1. Assume a $100,000 business started after 1976, which at the time of the founder's death is worth $3,000,000, no marital deduction and no other assets:

Funeral and administration expenses	$125,000
Estate taxes and inheritance tax credit	1,225,000
Capital gains tax (after adding the proportion of estate and inheritance tax to basis)	267,000
Minimum tax on capital gain	40,000
Total taxes and expenses	1,657,000

There is not one medium-size business out of 100 that could come up with this amount of money without wrecking the business. Nor could such a company afford to purchase enough life insurance to pay such taxes. And the installment payment provisions will merely serve to convince the founder that building such a business is not worth the effort.

But this is not all.—Section 303 is not available to provide funds to pay the two capital gains taxes. But they must be paid. The corporation can only pay them by declaring a dividend. But the estate must pay income tax on the dividend. Calculations will demonstrate that a dividend of at least $870,000 will be needed to pay all the income taxes, both ordinary and capital gain. Thus $2,220,000 will have to come from the $3,000,000 corporation to pay administration expenses, death taxes and income taxes.

2(a). Assume the same 100.000 business organized after 1976. which is worth $3,100,000 at death, a maximum 50 percent marital deduction and no other assets:

Funeral and expenses of administration	$130,000
Estate taxes and inheritance tax credit	501,000
Capital Gains Tax	172,000
Minimum tax on capital gains	27,000
Total death taxes and expenses	830,000
Plus additional dividend to pay ordinary income tax on $199,000	368,000
Total taxes and expenses	1,198,000

2(b). When the wife dies later on, the expenses, death taxes and income taxes on her $1,485,000 estate owuld aggregate $870,000.

Total administration expenses, estate and inheritance taxes, and income taxes on both estates would amount to over $2,000,000, thus leaving less than $1,000,000 to represent the lifelong efforts of the founder of the business.

It must never be forgotten that the carry-over basis also applies to "old" family businesses, i.e., those organized or acquired before 1977, pursuant to an arbitrary formula that prorates total appreciation between the period before 1977 and the period after 1976. If for example, the business was organized in 1967 and the owner died in 1987, one-half the appreciation would be taxable. Thus, the amount of capital gains tax will increase automatically as each year goes by, regardless of whether there is actually any appreciation.

There are only two possible solutions:

1. The best step would be to eliminate the "carry-over basis", which (a) causes serious multiple administrative and tax problems never foreseen; (b) destroys the incentive to build medium-sized businesses; and (c) would produce no meaningful revenue during the next two decades.

2. The only alternative, as we see it, is to provide that the basis of assets be stepped up in an amount that would equal the total of the following estate liabilities by (a) funeral expenses, administration expenses; (b) estate taxes, and (c) inheritance taxes. These are the same items as those listed in Section 303, which authorizes the redemption of sufficient stock in a family corporation to raise funds to pay them. To be fair, this step-up of basis should apply to all estates, whether Section 303 can be used or not. Perhaps the best and most easily understood solution would be to let the executor select assets having a value equal to the Section 303 liabilities.

Looking at the realities of the situation there is no other solution, if Congress is to give effect to its oft-stated view that family businesses constitute the fundamental basis of our private enterprise system.

SAN MARINO, CALIF., *August 11, 1977.*

MICHAEL STERN,
Staff Director, Committee on Finance,
Room 2227, Dirksen Senate Office Building, Washington, D.C.

DEAR SIR: The purpose of this letter is to voice my objection to the "carry-over basis rules" which became effective on 1-1-77.

In the 1920's a small family corporation sold more than 400 acres of land to the State of California. This land is now the campus of the University of California at Los Angeles. When I last heard of it, the selling corporation was still in existence and had 13 stockholders. Nine of those stockholders had received their stock by gift, subsequent to 1920, so that their present holding period now approaches 100 years. For purposes of determining loss, their basis is that of the original stockholders. For purposes of determining gain, the basis of the stock cannot be less than its fair market value on March 1, 1913. This is just one of hundreds (perhaps thousands) of small family corporations with similar problems. Does any member of the Senate really expect those nine stockholders to have the necessary records to establish basis on either of the above dates?

A former client of mine merged a family-owned business into a publicly owned corporation whose stock is listed on the New York Stock Exchange. I calculate that the carry-over basis rule would subject the several million dollars worth of stock to capital gains tax to the extent of 99.95% of the value of the stock (before basis adjustments of the 1976 Act) as well as 100% being subject to Federal estate tax. Is not the Federal estate tax high enough without subjecting the same asset to an additional tax of much magnitude? Your attention is invited to the fact that most of the so-called capital gain in this case is, in my

opinion, due to devaluation of the dollar rather than to any actual appreciation in value.

Finally, the basis adjustments provided in the 1976 Tax Reform Act are so complex that I doubt that there is a single member of either the Senate or the House of Representatives capable personally of apply those provisions to a given problem. Even experts disagree on the application of such adjustments. Should such complexity be in the law?

I recommend that the cary-over basis provisions of the 1976 TRA be immediately and retroactively repealed.

Very truly yours,

CLARK J. E. HUNT,
Certified Public Accountant.

RICHARDSON & RICHARDSON,
Austin, Minn., August 9, 1977.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

I hope that Senator Byrd's Subcommittee on Taxation will recommend that the carry-over basis rule set out in the Tax Reform Act of 1976 be repealed and that the old rule be reinstated.

The carry-over basis rule will create too many problems and will be an undue burden on the taxpayer and the representatives of the estates of deceased taxpayers. I can see no way for the rule to be modified so as to simplify it.

Yours very truly,

PHILIP RICHARDSON.

PR/mj

NAPIER, NAPIER & WRIGHT,
Fort Madison, Iowa, August 19, 1977.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR SIR: Our District Representative Congressman, Jim Leach, is cosponsoring a bill which I understand is designed to make certain needed adjustments in the Tax Reform Act of 1976. Most important, perhaps, is its repeal of the "carry-over-basis rule" with respect to property passing through an estate.

A considerable portion of my practice is devoted to probate and estate planning. In the past 8 months, I have had some experience in working with these new rules. It's becoming increasingly apparent that the carry-over-basis rule will require accounting and legal advice and assistance that will present a considerable burden on the taxpayers in this country.

In estate planning procedures, this new rule has had a demoralizing effect on persons who have struggled for decades trying to acquire estates that would make them independent in their retirement, and perhaps leave something to their children.

This rule, more than any I can recall, has given the impression to the vast majority of people that ultimately our government intends to take it all.

I have observed extreme and emotional reactions to the recordkeeping requirements that are imposed by this rule. Keeping detailed records is an unpleasant task for most people, and an impossible task for others. This is especially true of people who have acquired their property decades ago, and have long since forgotten or destroyed the necessary information. Some thought that they had made an intelligent decision to destroy old records, believing that their basis would change at death anyway.

I can envision nothing but trouble resulting from this rule. I don't know what revenue it purports to raise, but I cannot imagine a more cumbersome method of obtaining tax dollars.

Finally, the citizens are keenly aware that most "socalled" capital gains are the result of inflation which many believe is the responsibility of our Federal government. They recognize that the purchase power of the resulting "gains" is frequently less than the original cost. They are, therefore, taxes upon a "gain" which does not exist.

I strongly urge your committee to promote the repeal of the carry-over-basis rule in the next session of Congress.

Very truly yours,

WM. H. NAPIER.

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