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ADVOCATING A CARRYOVER TAX BASIS REGIME

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For close to a century, an important (but unfortunate) feature of the Internal Revenue Code has been a rule that the tax basis of any inherited asset is made equal to its fair market value at the time of the decedent's death. Notwithstanding the substantial revenue losses associated with this rule, Congress has retained it for reasons of administrative convenience.

But from three different vantage points, pressure has been mounting to change what is commonly referred to as the "step-up in basis rule." First, politicians and commentators have historically tied the step-up in basis rule to the estate tax on the theory that income be taxed only once, rather than twice. However, with the recent emasculation of the transfer tax regime, no estate tax is levied in most cases, while taxpayers routinely capitalize on the step-up in basis rule. On another front, technological advances have greatly simplified tax basis identification and record keeping, making a carryover tax basis regime eminently feasible, which it previously was not. Finally, in an era of growing income inequality, retention of a clearly defective rule that primarily benefits the wealthy seems wholly unjustified.

Congress essentially has two different reform options to consider; namely, a deemed realization rule or a carryover tax basis rule. While a deemed realization rule has many advantages, it appears to be politically unachievable, at least for the time being, due to liquidity and administrative concerns. On the other hand, in light of the fact that a carryover tax basis rule is widely utilized, vetted, and accepted in the related context of inter vivos gifts, extending its application to transfers at death appears entirely feasible. Its institution would have many virtues, including improved administrability, equity, and revenue generation.

Introduction

The U.S. income tax system generally adheres to the basic precept that all wealth accretions are subject to tax,[1] tempered by a realization principle that provides that income recognition is deferred until a point at which there is a sale or exchange.[2] When a sale or exchange occurs, the difference

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1 I.R.C. § 61(a) (2012); Comm'r v. Glenshaw Glass Co., 348 U.S. 426 (1955).

2 I.R.C. § 1001(a), (c); Helvering v. Horst, 311 U.S. 112, 116 (1940) (realization requirement is "founded on administrative convenience"); *see also* Richard Schmalbeck, Lawrence Zelenak, & Sarah B. Lawsky, Federal Income Taxation 263–64 (4th ed. 2015) (noting that several provisions of the Code would likely be unconstitutional if the realiza-

between the amount realized and the asset's adjusted basis gives rise to either a gain that must be recognized and taxed (barring an applicable exception) or a loss that must be allowed as a deduction (subject to certain limitations).[3] Since the inception of the federal income tax, the centrality of the wealth accretion concept combined with the realization principle have been part of its fundamental fabric.

But the Internal Revenue Code ("Code") also contains a rule in § 1014 that constitutes a significant departure from the concept of taxing wealth accretions and, more specifically, to the realization principle. When a taxpayer dies, the tax bases of assets in the hands of those who inherit them are deemed to be equal to fair market value at the date of the decedent's death,[4] eliminating any gains or losses accumulated during the decedent's life from the tax base. This basis rule, despite its fundamental deviation from the norm, has achieved a grudging acceptance. Historically, it was defended by the tacit acknowledgement that, upon a taxpayer's demise, accurate asset tax basis identification would be extraordinarily challenging,[5] often marred by a lifetime of poor record keeping.[6]

Notwithstanding the administrative convenience associated with the step-up in basis rule,[7] the rule violates fundamental tax principles and, accordingly, there have been repeated calls for its repeal.[8] In its place, the academic community has spoken with an unusually uniform voice, urging

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tion requirement were still constitutionally required, as found in *Eisner v. Macomber*, 252 U.S. 189 (1920)). *Compare* Fred B. Brown, *"Complete" Accrual Taxation*, 33 SAN DIEGO L. REV. 1559 (1996), *with* David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111 (1986).

3 I.R.C. § 1001(c). Loss limitation rules are sprinkled throughout the Code (e.g., contained in *id.* §§ 165, 469, 1211).

4 *Id.* § 1014(a). Executors may in some circumstances elect an alternate valuation date under § 2032, in which case assets still remaining in the estate six months after the death of the decedent are valued as of that later date. In such cases, the new basis is the value as of the date six months after the decedent's death. *Id.* § 1014(a)(2).

5 *See, e.g.*, Lawrence Zelenak, *Taxing Gains at Death*, 46 VAND. L. REV. 361, 388 (1993) ("During the hearings that led to the repeal of carryover basis, many opponents of Section 1023 cited the need to determine a decedent's basis in his assets as the single biggest practical problem with carryover basis—even for assets acquired after the effective date of the legislation. Many argued the problem was so serious as to make carryover basis impractical." (footnote omitted)).

6 *See generally* Joseph M. Dodge & Jay A. Soled, *Debunking the Basis Myth Under the Income Tax*, 81 IND. L.J. 539 (2006).

7 The authors would prefer to use the term "basis equal to fair market value" rather than "step-up in basis" because tax basis can be and occasionally is reduced at death rather than increased. However, increases in basis at death are far more common, as explained *infra*, and the "step-up in basis" nomenclature is widespread. We therefore accede to the standard usage.

8 For a comprehensive articulation of this position, see Joseph M. Dodge, *A Deemed Realization Approach Is Superior to Carryover Basis (and Avoids Most of the Problems of the Estate and Gift Tax)*, 54 TAX L. REV. 421 (2001).

Congress to adopt a deemed realization at death rule.[9] If a deemed realization rule were enacted, then upon a taxpayer's death all unrealized gains and losses would be recognized and reported on the decedent's final income tax return or, alternatively, on a separate stand-alone return.[10] Academics advocating such a rule argue that it has the twin virtues of fostering economic equality and facilitating tax system administrability.[11]

Yet, despite the putative virtues associated with a deemed realization rule, Congress has never passed legislation incorporating its principles.[12] The reasons for congressional hesitancy are essentially threefold. First, a deemed realization rule violates the Code's deeply seated realization principle insofar as death does not—and, at least in many taxpayers' minds, should not—constitute a "sale or exchange."[13] Second, valuation concerns, particularly those with respect to closely held businesses, farms, and tangible personal property, diminish its attractiveness.[14] Finally, its implementation suffers from enormous issues of complexity.[15]

In lieu of a deemed realization rule, Congress has twice chosen an entirely different reform path; namely, the institution of a carryover tax basis regime. Under such a regime, the tax basis of an inherited asset is deemed to be the same as it was in the hands of the decedent.[16] Congress instituted the

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9 *See, e.g.*, *id.*; Charles O. Galvin, *To Bury the Estate Tax, Not to Praise It*, 52 TAX NOTES 1413 (1991); Michael J. Graetz, *Taxation of Unrealized Gains at Death—An Evaluation of Current Proposals*, 59 VA. L. REV. 830 (1973); Thomas L. Waterbury, *A Case for Realizing Gains at Death in Terms of Family Interests*, 52 MINN. L. REV. 1 (1967); Zelenak, *supra* note 5. Some academics, admittedly, have advocated a carryover tax basis rule. *See, e.g.*, Calvin H. Johnson, *The Elephant in the Parlor: Repeal of the Step-Up in Basis at Death*, 121 TAX NOTES 1181 (2008); Edward J. McCaffery, *A Progressive's Silver Linings Playbook: Repeal Stepped-Up Basis*, 138 TAX NOTES 969 (2013).

10 *See* Dodge, *supra* note 8.

11 *See infra* Part III.

12 On a few occasions, Congress has considered the feasibility of a deemed on death realization rule. *See, e.g.*, H. COMM. ON WAYS AND MEANS AND S. COMM. ON FIN., 91ST CONG., TAX REFORM STUDIES AND PROPOSALS 331, 331–51 (Comm. Print 1969). More recently, President Clinton entertained the idea. *See* Rick Wartzman, *Clinton Suggestion of Possible Capital Gains Tax upon Death Stirs Ire Among Powerful Interests*, WALL ST. J., Jan. 5, 1993, at A16. During his administration, President Obama did as well. *See* TREASURY DEP'T, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2017 REVENUE PROPOSALS 155–56 (2016), https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2017.pdf.

13 I.R.C. § 1001(c) (2012); *see also* Helvering v. Horst, 311 U.S. 112, 115 (1940) ("From the beginning the revenue laws have been interpreted as defining 'realization' of income as the taxable event, rather than the acquisition of the right to receive it. And 'realization' is not deemed to occur until the income is paid."); Byrle M. Abbin, *Taxing Appreciation Hits Everything up Front: Retirement Benefits, Deferred Compensation, and . . .*, 58 TAX NOTES 1659, 1660 (1993) (noting that because death is involuntary, it should not be treated as a realization event).

14 *See infra* Section III.B.

15 *See infra* Section III.B.

16 *See infra* Part II.

first carryover tax basis regime in 1976;[17] however, due to its unpopularity with banks, trust departments, and other institutional executors, Congress initially deferred its effective date[18] and then retroactively repealed it in 1980.[19] In 2001, Congress instituted a second carryover tax basis regime, effective in 2010, when the estate tax was to be suspended for one year; this second attempt to institute a carryover tax regime was largely successful, albeit perhaps in large part because this regime was temporary and of limited application.[20]

Since the time that Congress experimented with these two carryover tax basis regime initiatives, several fundamental changes have transpired that enhance the viability of a permanent carryover tax basis regime and underscore the need for reform. First, technological advancements have grown at a rapid pace,[21] and these advancements greatly facilitate tax basis record keeping and retention. Second, during the course of the last decade, Congress has come to appreciate the need for accurate tax basis reporting and, to this end, has instituted third-party safeguard measures to ensure proper tax basis identification.[22] The combination of enhanced record-keeping capabilities and third-party basis reporting now make a carryover basis regime eminently more feasible than it was in years past.

Additionally, the current economic climate requires nimble investing which is unimpeded by the so-called "lock-in" effect.[23] Code § 1014 exacerbates this lock-in effect by offering taxpayers an opportunity not merely to defer taxation of gains but to avoid it altogether.[24] A carryover basis regime, on the other hand, would mitigate distortions caused by § 1014.

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17 Tax Reform Act of 1976, Pub. L. No. 94-455, § 2005, 90 Stat. 1520, 1872 (codified as amended in scattered sections of 26 U.S.C.).

18 Revenue Act of 1978, Pub. L. No. 95-600, § 515, 92 Stat. 2763, 2884 (codified as amended in scattered sections of 26 U.S.C.).

19 Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-223, § 401(a), 94 Stat. 229, 299 (codified as amended in scattered sections of 26 U.S.C.).

20 Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 501, 115 Stat. 38, 69 (codified as amended in scattered sections of 26 U.S.C.).

21 For a concise description of the so-called Information Age and the exponential rate at which machines and computers are advancing, see generally ERIK BRYNJOLFSSON & ANDREW MCAFEE, THE SECOND MACHINE AGE: WORK, PROGRESS, AND PROSPERITY IN A TIME OF BRILLIANT TECHNOLOGIES (2014).

22 *See, e.g.*, I.R.C. § 6035(a)(1) (2012) (requiring estate executors who are required to file a federal estate tax return to furnish to both the secretary and the heir a statement identifying the fair market value of each interest in the inherited property, which, under § 1014, becomes the adjusted tax basis of such property); *id.* § 6045(g) (requiring third-party brokers to retain and report the tax bases taxpayers have in their marketable securities).

23 The "lock-in" effect refers to the powerful disincentive on realizations created by making them the trigger of taxability. *See generally* Charles C. Holt & John P. Shelton, *The Lock-In Effect of the Capital Gains Tax*, 15 NAT'L TAX J. 337 (1962).

24 *See, e.g.*, Sean P. McElroy, *A New Estate Tax: Eliminating the Step-Up in Basis at Death*, 148 TAX NOTES 985, 986 (2015) ("Assume an individual has amassed an enormous net worth, mostly through the appreciation of capital assets that she inherited when relatively

Further, aside from the foregoing technological, political, and economic changes, the relaxation of the estate, gift, and generation-skipping taxes (collectively, transfer taxes) that began in 1976 and continues today[25] makes the institution of a carryover tax basis regime imperative. Due to the gradually increasing size of the applicable exclusion amount[26] (currently, in 2017, equal to $5,490,000)[27] and the generation-skipping exemption amount[28] (also currently equal to $5,490,000),[29] transfer taxes apply only to the tiniest sliver of the taxpayer population—the lowest percentage of decedents in the history of our transfer tax.[30] In years past, wealth transfer taxes were promoted as a backstop of sorts that served to mitigate the revenue loss and unfairness created by the step-up in basis rule.[31] Because transfer tax application is now extremely limited, that backstop is no longer reliably effective, and the step-up in basis rule enables vast amounts of income to escape taxation completely.

As the transfer tax system continues to ebb in importance, Congress should institute a permanent carryover tax basis regime. Part I of this Article provides a short historical overview of the two prior carryover tax basis regimes and the catalysts that led to their adoption. Part II explains why the tax system is now ready for a permanent carryover tax basis regime—one that overcomes the mistakes of its predecessors and places a premium on simplicity and administrability. Part III details the strengths and shortcomings of a

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young. If she sells any of those assets during her lifetime, she will pay a substantial capital gains tax—just about 20 percent of her gains over basis. She thus has a strong incentive to hold onto her gain property until death.").

25 *See, e.g.*, Karen C. Burke & Grayson M.P. McCouch, *Estate Tax Repeal: Through the Looking Glass*, 22 VA. TAX REV. 187, 188 (2002) ("In recent years the federal estate, gift, and generation-skipping transfer taxes have come under sustained attack."). For an excellent overview of the history of the U.S. estate tax, see Darien B. Jacobson et al., *The Estate Tax: Ninety Years and Counting*, IRS STATISTICS OF INCOME BULLETIN 118–28 (2007), https://www.irs.gov/pub/irs-soi/ninetyestate.pdf.

26 I.R.C. § 2010(a).

27 *Id.* § 2010(c)(3)(B); Rev. Proc. 2015-53, § 3.33, 2015-44 I.R.B.

28 I.R.C. § 2631(a).

29 Rev. Proc. 2015-53, § 3.33, 2015-44 I.R.B.

30 STAFF OF JOINT COMM. ON TAXATION, JCX-52-15, HISTORY, PRESENT LAW, AND ANALYSIS OF THE FEDERAL WEALTH TRANSFER TAX SYSTEM 1 (2015), https://www.jct.gov/publications.html?func=startdown&id=4744 ("In 2013, the most recent year for which final numbers are available, there were 2.6 million deaths in the United States, and 4,700 estate tax returns reporting some tax liability were filed. Thus, taxable estate tax returns represented approximately one-fifth of one percent of deaths in 2013. By comparison, in the mid-1970s taxable estate tax returns exceeded six percent of all deaths.").

31 *See* 2 BORIS I. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS 41-32 (2d ed. 1989) (first articulating the argument that the basis equal to fair market value rule is "paid for" by the estate tax and then criticizing it); Stephen Vasek, *Death Tax Repeal: Alternative Reform Proposals*, 92 TAX NOTES 955, 962 (2001) ("The estate tax may thus be viewed as a surrogate for income tax of the gain realized by the decedent on the transfer of appreciated property . . . .").

deemed realization regime and reasons why, at least for now, Congress should not adopt it.

I. Historical Overview of Prior Carryover Tax Basis Regimes

Surprisingly, the step-up in basis rule may have come into being by way of a misunderstanding. With the passage of the nation's first constitutionally sanctioned income tax in 1913,[32] the Treasury Department was charged with promulgating regulations; however, the enabling legislation was silent as to the issue of death and its effect upon the tax bases heirs held in their assets.[33] Lacking clear guidance one way or the other, the Treasury Department crafted the step-up in basis rule,[34] probably basing its position on either the laws of the United Kingdom (which, at the time, did not tax capital gains) or trust law, in which capital gains are assigned to principal rather than income.[35]

Whatever the case, the Treasury Department's decision came at a substantial price. As a general matter, inflation and growth in economic productivity cause most investments to increase in nominal value.[36] Combine this observation with two other propositions—that selective realizations allow taxpayers to claim their losses while deferring their gains, and that wealthy taxpayers own more valuable assets than do less wealthy taxpayers[37]—and it is no surprise that the step-up in basis rule will predictably produce two deleterious effects. First, the vast majority of decedent-owned assets receive a "stepped-up" (rather than a "stepped-down") tax basis, resulting in enormous revenue losses to the government.[38] Second, rather than applying equitably

32 Revenue Act of 1913, Pub. L. No. 63-16, 38 Stat. 114, 166–81.

33 *See* Louis M. Castruccio, *Becoming More Inevitable? Death and Taxes . . . and Taxes*, 17 UCLA L. Rev. 459, 460–61 (1970) (stating that in the legislative history, there was no particular justification offered for I.R.C. § 1014's adoption); Lawrence Zelenak, *The Tax-Free Basis Step-Up at Death, the Charitable Deduction for Unrealized Appreciation, and the Persistence of Error*, 71 Tax L. Rev. (forthcoming 2017) (same).

34 *See* T.D. 2690, 20 Treas. Dec. Int. Rev. 128, art. 4, ¶ 44 (1918) ("The appraised value at the time of the death of a testator is the basis for determining gain or profit upon sale subsequent to the death after March 1, 1913."). Congress subsequently codified this regulation into law. Revenue Act of 1921, Pub. L. No. 67-98, ch. 136, § 202(a)(3), 42 Stat. 227, 229.

35 *See* Zelenak, *supra* note 33.

36 *See generally* Burton G. Malkiel, A Random Walk Down Wall Street: The Best Investment Advice for the New Century (1999). Note that even if asset values do not appreciate over time, I.R.C. § 1014 may still afford taxpayers income tax advantages. Consider the fact that the Code provides for robust depreciation deductions under § 168 and "bonus depreciation" under § 179. I.R.C. §§ 168, 179 (2012). With respect to assets used in a trade or business, these deductions often result in assets with low adjusted tax bases, but with values that may remain high.

37 *See generally* Thomas Piketty, Capital in the Twenty-First Century (2014).

38 For 2017, the Treasury Department projects the revenue loss associated with § 1014 to be approximately $36 billion annually. U.S. Dep't of the Treasury, Tax Expenditures 206 tbl.14–1, item 72 (2015), https://www.treasury.gov/resource-center/tax-policy/Documents/Tax-Expenditures-FY2015.pdf. An estimate of similar magnitude was issued in an

to all taxpayers, the financial benefits of § 1014's application inure disproportionately to taxpayers of wealthy families.[39]

An example illustrates § 1014's application, and its defects. Suppose Taxpayer *X* purchased a farm in 2010 for $1 million and that the farm is worth $10 million in 2017. If Taxpayer *X* sells the farm, he will incur a tax on the $9 million gain (i.e., $10 million amount realized less $1 million cost basis).[40] Instead, suppose that Taxpayer *X* dies in 2017 and he bequeaths the farm to Taxpayer *Y*. If Taxpayer *Y* subsequently sells the farm, say for $10 million, she will incur no tax on the disposition (i.e., $10 million amount realized less $10 million adjusted basis)[41] due to § 1014's application.[42]

Consider, too, that one of the primary justifications for retention of § 1014 has long rested on the commonly held belief that income should not be taxed twice—once under the income tax regime and another time under the transfer tax regime.[43] There are deep flaws in this belief, as the income

earlier report. Office of Tax Analysis, U.S. Dep't of the Treasury, Tax Expenditure for Exclusion of Capital Gains at Death (2014), https://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/Step-Up-Basis-2014.pdf. These estimates appear to be based on the revenue that would be generated from a deemed realization rule, i.e., if built-in appreciation were taxed at the time of death.

39 *See* David M. Herszenhorn, *Consensus on Need to Revise Tax Code, but Partisan Split on Specifics*, N.Y. Times (Feb. 21, 2016), https://www.nytimes.com/2016/02/21/business/yourtaxes/consensus-on-need-to-revise-tax-code-but-partisan-split-on-specifics.html (quoting Vice President Biden saying stepped-up tax basis benefits "two-tenths of 1 percent of the population that is already very wealthy, does not need it, [and] does not indicate they will invest it in any way that will improve the economy differently"). Based on the 1998 Survey of Consumer Finance, one study estimates expected unrealized capital gains at death represent 36 percent of total expected value of estates. For estates worth at least $10 million, unrealized capital gains at death represent 56 percent of the value of estates. For this group of estates, the largest component (72.3%) of unrealized gains is estimated to be attributable to unrealized capital gains on active businesses of decedents. James M. Poterba & Scott Weisbenner, *The Distributional Burden of Taxing Estates and Unrealized Capital Gains at Death*, *in* Rethinking Estate and Gift Taxation 422–49 (William G. Gale, James R. Hines Jr. & Joel Slemrod eds., 2001).

40 I.R.C. § 1001(a).

41 *Id.*

42 *Id.* § 1014(a).

43 The origin of this belief may have stemmed from a statement made by economist Thomas S. Adams, who was among the most influential players in configuring the initial landscape of the Code. *See* Zelenak, *supra* note 33 (manuscript at 11–12). In explaining why the permanent elimination of capital gains from the tax basis at death was permissible, Adams stated that it was "because the estate or inheritance tax has been imposed. That is the thought behind that." *Revenue Act of 1921: Internal Revenue Hearings on H.R. 8245 (Part I) Before the S. Fin. Comm.*, 67th Cong. 27 (1921) (statement of Dr. T. S. Adams, Tax Adviser, Treasury Department). For a more recent piece that articulates this same position, see Stephen Moore, *Obama Estate Tax Plan: Die Once, Get Taxed Twice*, Heritage Found. (Feb. 3, 2015), http://www.heritage.org/research/commentary/2015/2/obama-estate-tax-plan-die-once-get-taxed-twice (criticizing the Obama estate tax proposal as leading to double taxation). For an analysis discrediting the double-tax argument, see Richard Schmalbeck, *Does the Death Tax Deserve the Death Penalty? An Overview of the Major Arguments for Repeal of Federal Wealth-Transfer Taxes*, 48 Clev. St. L. Rev. 749, 760–61 (2000).

tax pertains to wealth accretions over an annual period, while the transfer tax pertains to the act of transmitting wealth to people other than surviving spouses and charitable entities.[44] Nonetheless, this single-tax sense has provided theoretical cover for § 1014's existence. If assets are subject to transfer tax, the argument goes, then the step-up in basis rule functions much as any other "tax basis" rule does; that is, as a safeguard against a redundant application of tax. But as Congress has gradually emasculated the transfer tax system,[45] it has correspondingly subverted one of § 1014's pivotal (albeit faulty) justifications.

Identifying the shortcomings of Code § 1014 is easy; addressing them has proven far more challenging. Congress has essentially three choices: (i) concede its inability to alleviate these shortcomings and retain the status quo, (ii) institute a deemed realization regime, or (iii) institute a carryover tax basis regime. For the reasons stated, retaining the status quo is unattractive. And instituting a deemed realization regime violates traditional income recognition principles, which require a "sale or exchange"[46] and would surely require significant expansion of the appraisal industry to ascertain the fair market value of real estate, closely held businesses, and other hard-to-value assets owned by decedent taxpayers.[47] Thus, by a process of elimination, the only viable option worthy of institution is a carryover tax basis regime.

Fortunately, the institution of a carryover tax basis regime is not uncharted territory: over the course of the last century, taxpayers who have made gifts and the recipients of those gifts have become intimately familiar with it. Section 319 of the Revenue Act of 1924 instituted a tax basis regime

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44 The income tax system pertains to wealth accretions over a regular, typically annual, period. *See generally* HENRY C. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY (1938); Robert Murray Haig, *The Concept of Income—Economic and Legal Aspects*, *in* THE FEDERAL INCOME TAX 1, 7 (Robert Murray Haig ed., 1921). The transfer tax system is an excise tax on an act: the transmission of wealth at the taxpayer's death. *See generally* Louis Eisenstein, *The Rise and Decline of the Estate Tax*, 11 TAX L. REV. 223 (1956). The purpose of an income tax is to produce revenue from taxpayers according to their ability to pay; the purpose of wealth-transmission taxes is explained in many different ways, but most usually as a means of controlling dynastic accumulations of wealth. *See* Schmalbeck, *supra* note 43. In light of the two different natures and tax bases, the two systems of taxation are wholly unrelated.

45 *See* Burke & McCouch, *supra* note 25.

46 I.R.C. § 1001(c); *see* Jeffrey L. Kwall, *When Should Asset Appreciation Be Taxed?: The Case for a Disposition Standard of Realization*, 86 IND. L.J. 77, 78 (2011) ("The realization requirement is one of the most basic elements of the United States income tax. Due to this requirement, any increase in the value of a person's property is not taxed when it occurs. Rather, the tax on asset appreciation is deferred until the occurrence of a realization event; that is, until the property is transferred in exchange for money or other consideration.").

47 *See, e.g.*, James R. Repetti, *It's All About Valuation*, 53 TAX L. REV. 607 (2000) (explaining the problems posed by valuation issues in an entirely different context, namely, a mark-to-market system).

with respect to gifts.[48] When it applies, with few exceptions,[49] an asset's adjusted tax basis in a donee's hands is the same as it was in the donor's.[50] (In the prior example, if Taxpayer *X* had instead given the farm to Taxpayer *Y* while *X* was still alive, the farm's tax basis in Taxpayer *Y*'s hands would have been $1 million.) Throughout its decades of duty, § 1015's application has proven administrable, efficient, and equitable; and, as such, its extension into the sphere of bequests seems immediately viable.

On two separate occasions, in 1976 and in 2001, based upon the carryover tax basis regime's vetted history in the context of inter vivos transfers, Congress enacted a similar regime related to testamentary transfers. For the reasons set forth below, however, the 1976 regime never actually came into being, and the 2001 regime was by intention short-term in nature. Section I.A explores the 1976 reform effort, and Section I.B explores the 2001 reform effort.

A. 1976 Carryover Tax Basis Regime

Approximately four decades ago, Congress decided to double the amount that could pass free of estate tax, thereby significantly narrowing its application.[51] Simultaneously, as a form of financial parity, Congress sought to reduce the revenue lost and strengthen the integrity of the income tax by curtailing the application of § 1014.[52] It therefore instituted a carryover tax basis regime, limiting the applicability of § 1014 to transfers from decedents dying before December 31, 1976.[53] In a nutshell, the enacted carryover tax basis regime would, in the long run, have provided that the tax basis of an asset acquired from a decedent would be the same as the basis had been in the hands of the decedent taxpayer immediately before death.[54]

Implementation of this new carryover tax basis regime necessitated the introduction of three new Code sections. First, § 1023 embodied the central substantive rule and applicable exceptions.[55] Second, § 6039A introduced a

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48 Revenue Act of 1924, Pub. L. No. 68-176, §§ 319–324, 43 Stat. 253, 313–16 (codified as amended in scattered sections of 26 U.S.C.).

49 *See* I.R.C. § 1015(a) ("[I]f such basis . . . is greater than the fair market value of the property at the time of the gift, then for the purpose of determining loss the basis shall be such fair market value."); *id.* § 1015(d)(6) (providing a tax basis adjustment equal to the gift tax paid attributable to the appreciated portion of property).

50 *Id.* § 1015(a).

51 *See* Tax Reform Act of 1976, Pub. L. No. 94-455, § 2001, 90 Stat. 1520, 1846–50 (codified as amended in scattered sections of 26 U.S.C.) (creating a unified rate schedule for estates and gifts and raising the exemption).

52 H.R. REP. NO. 94-1380, at 36–37 (1976), *reprinted in* 1976 U.S.C.C.A.N. 3356 (explaining this give-and-take dynamic); *see also* Thomas J. McCusker, *Carryover Basis*, 11 CREIGHTON L. REV. 719, 719 (1978) ("[A]ccording to Chairman Ullman, the increases in the marital deduction and the exemptions provided by the Tax Reform Act of 1976 were in exchange for the carryover basis rules.").

53 Tax Reform Act of 1976, § 2005.

54 I.R.C. § 1023(a) (1976).

55 *Id.* § 1023.

new requirement that an estate executor issue information returns to decedent's beneficiaries identifying the tax basis each would have in the decedent's assets.[56] Finally, § 6694 set forth a new civil tax penalty related to an estate executor's failure to issue timely and correct information returns.[57]

The long-term idea embodied in § 1023(a) was straightforward: eventually, recipients of so-called "carryover basis property"[58]—defined as all property acquired or passed from a decedent[59]—would retain the decedent's tax basis in such property. To illustrate, if a decedent had a farm with a $10 million fair market value and a $1 million adjusted tax basis, such property would have the same $1 million tax basis in the recipient's hands.

When crafting § 1023, Congress appeared to be primarily concerned with equity. Evidence of this concern is found in four critical carryover tax basis adjustments that Congress wove into the legislation. Below are the four adjustments and the salient attributes and purposes of each.[60]

1. Fresh Start Adjustment. For the first time since 1918, under the proposed carryover tax basis regime, death would not necessarily trigger a tax basis adjustment; instead, embedded asset gains and losses were to be preserved. To enable taxpayers to acclimate themselves to this reform, in a spirit of magnanimity, Congress decided that it would allow a so-called fresh start adjustment with respect to asset tax basis determinations made as a result of death. Applicable only for purposes of computing gains (not losses), an asset's carryover tax basis was to be increased by the excess of its fair market value on December 31, 1976 (the day prior to the statute's effective date), over its adjusted basis on that day.[61] For example, if on December 31, 1976,

56 *See id.* § 6039A.

57 *See id.* § 6694.

58 However, certain property was excluded, including income in respect of a decedent, life insurance proceeds, joint and survivor annuities, and personal and household effects with a fair market value of up to $10,000. *Id.* § 1023(b)(2), (3).

59 *Id.* § 1023(b)(1) ("'[C]arryover basis property' means any property which is acquired from or passed from a decedent (within the meaning of section 1014(b)) and which is not excluded."). *See generally* Philip R. Stansbury & Doris D. Blazek, *Revamped Basis Rules for Inherited Property Have Far-Reaching Implications*, 46 J. TAX'N 14 (1977).

60 For elaborate detail of these adjustments, see THOMAS J. MCGRATH & JONATHAN G. BLATTMACHR, CARRYOVER BASIS UNDER THE 1976 TAX REFORM ACT (1977).

61 *See* I.R.C. § 1023(h) (1976). If the asset in question were a marketable bond or security and if its fair market value on December 31, 1976, exceeded its adjusted basis, then the adjustment would equal the difference between these two monetary figures. *Id.* § 1023(h)(1). For example, suppose that (i) a taxpayer purchased one share of AT&T stock for $45 on December 31, 1970; (ii) the stock was worth $60 on December 31, 1976; and (iii) when the taxpayer died on December 31, 1980, the stock was worth $100. Under these circumstances, there would be a $15 (namely, $60 less $45) tax basis adjustment, making the carryover tax basis $60 (i.e., $45 plus $15).

In cases of all other property, to determine the adjustment amount, a ratable appreciation rule applied. *Id.* § 1023(h)(2). Under this rule, the adjustment amount was equal to the product of a fraction—the numerator was equal to the number of days a taxpayer owned the property prior to January 1, 1977 (i.e., the effective date of the carryover tax basis regime), and the denominator was equal to the total number of days of asset owner-a person owned stock with a $1 million tax basis and a value of $10 million, there would be a $9 million applicable adjustment (i.e., $10 million less $1 million). The theory underlying this rule was simple: in the past, those taxpayers who never carefully tracked the tax bases they had in their assets would have a clean slate; going forward, they would have a responsibility to retain and maintain their tax basis records.[62]

2. Federal Estate and State Estate Tax Adjustment. Rightly or wrongly, many members of Congress harbored the view that it is inappropriate for taxpayers (or, by extension, their heirs) to endure both estate and income

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ship—times the asset's overall appreciation. For example, suppose a taxpayer purchased a farm for $400,000 on December 31, 1970, and suppose further that when he died on December 31, 1980, it was worth $1 million. The applicable fraction would be 2190 (number of days owned before 1977) over 3650 (total number of days owned), or 6/10. The tax basis adjustment, therefore, would equal $360,000 (6/10 x $600,000 ($1 million less $400,000)), making the carryover tax basis equal to $760,000 (i.e., $400,000 plus $360,000).

In cases of depreciable property, ascertaining the adjustment was a much more complex enterprise. This is depicted in the following fact pattern and associated nine-step process found in Robert S. Hightower, *Carryover Basis Rules for Inherited Property*, 5 FLA. ST. U. L. REV. 153, 161 (1977) (footnote omitted):

> Assume the purchase of fully depreciable, carryover basis property on January 1, 1972, at a cost of $18,000. Assume straight line depreciation, a useful life of 30 years, and annual depreciation deductions of $600. On January 1, 1982, the decedent dies and at this time the property has a value of $40,000. Inasmuch as the property was held exactly five years before January 1, 1977, and exactly ten years in total, the applicable fraction is one-half.
>
> Pursuant to § 1023(h)(2)(B), the carryover basis of this property is determined as follows:
>
> (1) The total depreciation deductions taken are $6,000, so the adjusted basis at the date of death is $12,000 ($18,000–$6,000).
>
> (2) The fair market value of the property at the date of death is $40,000.
>
> (3) The excess of the fair market value at the date of death ($40,000) over the adjusted basis ($12,000) is $28,000.
>
> (4) The total amount of depreciation deductions equal $6,000, so the total appreciation in the property from acquisition to the date of death is $22,000 ($28,000–$6000).
>
> (5) The applicable fraction is one-half.
>
> (6) The appreciation allocable to the period before January 1, 1977, is $11,000 ($22,000 x 1/2).
>
> (7) The depreciation allocable to the period before January 1, 1977, is $3,000 ($6,000 x 1/2).
>
> (8) The addition to basis is $14,000 ($11,000 plus $3,000).
>
> (9) The total fresh-start basis is $26,000 ($14,000 adjustment plus $12,000 date of death adjusted basis).

62 The fresh start adjustment set the stage; it was to be made prior to the other enumerated three adjustments. *See* H.R. REP. NO. 94-1515, at 613 (1976), *reprinted in* 1976 U.S.C.C.A.N. 4117, 4252 ("Any increase in basis permitted by the 'fresh start' rule is made before any other adjustments are made to the property's basis for Federal and State death taxes and minimum basis.").

taxes with respect to appreciation on the same asset.[63] With this thought in mind, Congress fashioned a second tax basis adjustment.[64] This adjustment was computed in the following manner: the amount of federal estate and state estate tax paid relative to the particular asset in question was to be multiplied by a fraction equal to the asset's net appreciation[65] (namely, the numerator was equal to asset appreciation, and the denominator was equal to the property's fair market value on the date of death).[66] For example, in the case where a decedent had an asset with a $1 million cost basis, a $10 million fair market value, and upon which a $4 million estate tax was levied, there would be a $3.6 million ($4 million x $9 million / $10 million) upward tax basis adjustment.

3. Minimum Basis Adjustment. Once the fresh start adjustment and federal and state estate tax adjustments were made, Congress afforded taxpayers the application of yet a third adjustment; namely, the so-called minimum basis adjustment.[67] Its amount was to be computed in the following fashion: $60,000 less the aggregate adjusted bases of all carryover basis property.[68] This adjustment's purpose was to ensure that those taxpayers having assets with only moderate appreciation did not endure any additional tax burden as a result of introducing this reform.

4. State Succession Tax Adjustment. The last adjustment, similar to the federal and state estate tax adjustment, permitted distributees who paid state succession taxes to adjust upwardly (after the first three adjustments) the carryover tax basis they had in each asset by an amount equal to state succession

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63 *See* H.R. REP. NO. 94-1380, at 39 (1976), *reprinted in* 1976 U.S.C.C.A.N. 3356, 3393.

64 *See* I.R.C. § 1023(c) (1976).

65 *Id.* § 1023(f)(2).

66 For example, under the fact pattern set forth in note 61, *supra*, the preadjustment carryover basis was determined to be $760,000 (i.e., $400,000 plus $360,000). If the resulting estate tax due with respect to this property was $100,000, its tax basis would be upwardly adjusted by $24,000 ($100,000 estate tax x $240,000 ($1 million less $760,000) / $1 million). Without delving into exhaustive detail, computing this adjustment was extraordinarily complex in those situations when (i) the estate consisted of property that was not subject to estate tax, for example, due to the marital and/or charitable deductions, *Id.* § 1023(g)(4); H.R. REP. NO. 94-1380, at 42–43, *reprinted in* 1976 U.S.C.C.A.N. 3356, 3396–97, and (ii) the property in question was subject to one or more liabilities. I.R.C. § 1023(f)(2) (1976).

67 I.R.C. § 1023(d)(1) (1976).

68 *See id.* For example, suppose a decedent taxpayer died owning two assets: a share of *X* corporate stock with a $30,000 adjusted basis and a $100,000 fair market value and a share of *Y* corporate stock with a $20,000 adjusted basis and a $100,000 fair market value. Under this scenario, the estate would be entitled to a $10,000 adjustment ($60,000 – ($30,000 + $20,000)). This adjustment was then to be allocated proportionately based upon each property's appreciation. In the example just cited, the tax basis of *X* corporate share would be adjusted upward by $4667 to $34,667 (i.e., $30,000 + ($10,000 x ($70,000 / $150,000))), and the tax basis of *Y* corporate share would be adjusted upward by $5333 to $25,333 (i.e., $20,000 + ($10,000 x ($80,000 / $150,000))).

taxes paid, if any, attributable to the remaining appreciation in such property.[69]

Aside from the foregoing adjustments, Congress instituted one other ameliorative measure to soften the impact of the carryover tax basis regime. Caselaw at the time provided that if an estate executor or administrator used an appreciated asset to satisfy a pecuniary bequest, gain must be recognized.[70] In the course of a typical estate administration, because § 1014 historically dictated that an asset's adjusted tax basis was equal to the asset's fair market value at the date of death, the application of the gain recognition rule proved largely inconsequential. Under a carryover tax basis regime, however, this would no longer be the case: there was the distinct possibility that estates utilizing appreciated assets to satisfy pecuniary bequests would have to recognize significant gains. To prevent this from happening, Congress instituted § 1040. When a pecuniary bequest was to be satisfied, this new Code section precluded gain recognition, with the proviso that recipient taxpayers (often a marital trust or so-called bypass trust) would have a carryover tax basis in the assets they received.[71]

Beyond trying to make the carryover tax basis regime equitable, Congress also sought to ensure that taxpayers were compliant. To fulfill this objective, Congress proposed that all executors (not simply those filing an estate tax return) "shall furnish the Secretary such information with respect to carryover basis property to which section 1023 applies as the Secretary may by regulations prescribe."[72] Executors who fell short of fulfilling these duties risked potential fines.[73]

Notwithstanding Congress's earnest motives to infuse the 1976 carryover tax basis regime with relief measures designed to ease transition into the new rules, the complexity of the foregoing four adjustments, the introduction of § 1040, and the concomitant administrative compliance burdens significantly dampened public enthusiasm for § 1023 and generated a firestorm of political backlash.[74] For decades, insofar as taxpayers making gifts were concerned, the carryover tax basis regime worked well, and its execution was easily grasped by average taxpayers; in contrast, in the realm of testamentary transfers, the new carryover basis regime left average taxpayers and even their seasoned advisers confused, or at least so they claimed. It may well be

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69 *Id.* § 1023(e).

70 *See, e.g.*, Kenan v. Comm'r, 114 F.2d 217 (2d Cir. 1940).

71 In pertinent part, § 1040 read as follows:

> If the executor of the estate of any decedent satisfies the right of any person to receive a pecuniary bequest with appreciated carryover basis property . . . then gain on such exchange shall be recognized to the estate only 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 [the estate tax of] chapter 11.

I.R.C. § 1040(a) (1976).

72 *Id.* § 6039A(a).

73 *Id.* § 6694(a).

74 Howard J. Hoffman, *The Role of the Bar in the Tax Legislative Process*, 37 TAX L. REV. 411, 448–68 (1982).

that the efforts to ease the transition to the new rules were the very features that provided fodder for fatal criticisms which ultimately led to the carryover tax basis repeal.[75]

Whether or not the criticisms were justified, they were presented to Congress emphatically and successfully.[76] As a result, the 1976 carryover tax basis regime never came into being: Congress delayed its implementation in 1978 and retroactively repealed it in 1980. While the carryover tax basis regime passage played a pivotal role in weakening the transfer tax regime, its ultimate repeal did not spark a reversal of fortune (i.e., a return to a robust transfer tax regime); to the contrary, at almost every opportunity, Congress has continued to sap the transfer tax regime of its vitality.[77]

B. 2010 Carryover Tax Basis Regime

Soon after President George W. Bush was elected, he sought to overhaul the income tax system and lessen its burden. Furthermore, consistent with the Republican platform, he wanted to fulfill a campaign pledge to eliminate the "death tax."[78] By electing Republican majorities in both the House and the Senate, voters had dealt Bush a strong hand, placing him in a position to fulfill his entire tax-reform agenda. The only legislative impediment standing in his way was the eponymous Byrd Rule, named after Senator Robert C. Byrd. This procedural provision allows senators to block proposed legislation that is projected to increase the federal deficit in the years beyond the revenue estimation period, typically ten years after enactment.[79] Because the proposed elimination of the federal estate tax met this criterion, the support-

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75 *See, e.g.*, Howard J. Hoffman, *Drive to Repeal Carryover Basis Goes into High Gear*, 9 TAX NOTES 211 (1979); *Practitioner Community Writes Congress on Carryover*, 6 TAX NOTES 502 (1978); *see also* Stefan F. Tucker, *Thoughts on Radical Estate and Gift Tax Reform*, 91 TAX NOTES 163, 165 (2001) ("It can be extraordinarily difficult to trace the historic basis of many assets, such as personal property held for generations within families for reasons of family history or affection, rather than because the property was not marketable.").

76 *See generally* Marvin E. Blum, Note, *Carryover Basis: The Case for Repeal*, 57 TEX. L. REV. 204 (1979).

77 *See generally* Paul L. Caron, *The One-Hundredth Anniversary of the Federal Estate Tax: It's Time to Renew Our Vows*, 57 B.C. L. REV. 823 (2016).

78 *See, e.g.*, Grayson M.P. McCouch, *The Empty Promise of Estate Tax Repeal*, 28 VA. TAX REV. 369, 373 (2008) ("Estate tax repeal figured as a prominent issue in the 2000 presidential campaign, especially after candidate George W. Bush endorsed repeal as part of his tax-cutting agenda, along with income tax rate cuts, an expanded child credit, and reduction of the marriage tax penalty.").

79 2 U.S.C. § 644(b)(1)(E) (1994); *see* Manoj Viswanathan, Note, *Sunset Provisions in the Tax Code: A Critical Evaluation and Prescriptions for the Future*, 82 N.Y.U. L. REV. 656, 664–65 (2007) (describing how the Byrd rule operates). *See generally* Michael W. Evans, *The Budget Process and the "Sunset" Provision of the 2001 Tax Law*, 99 TAX NOTES 405 (2003) (explaining how the Byrd rule operates and the role it had in the passage of the Economic Growth and Tax Relief Reconciliation Act of 2001); William G. Gale & Peter R. Orszag, *Sunsets in the Tax Code*, 99 TAX NOTES 1553 (2003) (estimating cost of Internal Revenue Code sunsets); Rebecca M. Kysar, *The Sun Also Rises: The Political Economy of Sunset Provisions in the Tax Code*, 40 GA. L. REV. 335 (2006) (evaluating sunset provisions).

ers of estate tax repeal—who constituted a majority, but not a sixty-vote supermajority—were able to pass only a temporary version of such legislation without help from Democrats, whose assistance was not actively sought.[80] Beginning in 2002, the estate tax exemption amount would gradually climb until, in 2010, the estate tax would be repealed.[81] However, because of the ten-year limit on the effect of the legislation, the entire Act had a sunset provision that rendered it void at the end of 2010, causing the estate and gift tax provisions of the Code to revert to their 2001 forms.[82]

In devising the 2010 estate tax repeal—in effect, a one-year estate tax suspension—Congress, for the second time in the nation's history, chose to institute a carryover tax basis regime. While there were many reasons that Congress made this choice (e.g., additional tax revenue), the most influential was the equitable principle that, with estate tax temporarily vanquished, all income should be taxed at least once, and a carryover tax basis regime afforded this opportunity.[83]

In formulating the new carryover basis regime, the 1976 carryover basis regime had presumably taught Congress an important lesson: a viable carryover tax basis regime should be as simple as possible. Therefore, among other things, the 2010 carryover tax basis regime targeted this objective. Like its 1976 predecessor, the 2010 carryover tax basis regime began with a straightforward rule: in the recipient's hands, the income tax bases of assets owned by a decedent would be the lesser of (i) the decedent's adjusted basis in the property and (ii) the property's fair market value at the date of the decedent's death.[84] To alleviate the future income tax burden of those beneficiaries inheriting from deemed small- and medium-sized estates, though, Congress provided two tax basis adjustments: (1) a $1.3 million tax basis increase adjustment applicable to those assets owned by a decedent taxpayer and (2) an additional $3 million tax basis increase adjustment applicable to those assets passing to a surviving spouse.

Due to the importance of these tax basis adjustments and the salient role they played in the 2010 carryover tax basis regime, each requires further explication.

80 *See* Viswanathan, *supra* note 79, at 666–68.

81 Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, § 301, 124 Stat. 3296, 3300 (codified as amended in scattered sections of 26 U.S.C.).

82 Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 901, 115 Stat. 38, 150.

83 One of the big rallying cries against the estate tax is that its existence constitutes a double tax. Karen C. Burke & Grayson M.P. McCouch, *Turning Slogans into Tax Policy*, 27 VA. TAX REV. 747, 751–54 (2008). Were it eliminated, the income on appreciated assets would escape all taxation; the carryover tax basis rule fills this otherwise empty space.

84 I.R.C. § 1022(a)(2) (2006). Unlike the 1976 version, however, this section did not provide for a "fresh start" as of any particular date. Rather, the provision simply referenced the basis rule for gifts made during life.

1. $1.3 Million General Tax Basis Increase.[85] An executor was allowed to increase the tax bases the decedent had in his assets by an additional $1.3 million, but not in excess of the particular asset's fair market value as of the decedent's date of death.[86] For example, if a decedent owned a farm worth $10 million with a $5 million tax basis, the executor could allocate the full $1.3 million adjustment to the farm, making its tax basis $6.3 million; if, instead, the farm's tax basis was $9 million, the executor could only allocate $1 million of the adjustment to the farm, making its tax basis $10 million, and allocate the remaining $300,000 tax basis adjustment (i.e., $1.3 million less $1 million) to the decedent's other appreciated assets, if any. Furthermore, additional upward basis adjustments could be made in an amount equal to the aggregate of the following sum: capital loss carryovers under § 1212(b),[87] net operating losses under § 172,[88] and allowable losses under § 165 if the decedent's property had been sold at death for its fair market value.[89]

2. $3 Million Surviving Spouse Tax Basis Increase. In addition to the $1.3 million tax basis adjustment, a decedent's executor could allocate an additional $3 million of tax basis to assets passing either outright to a surviving spouse or, alternatively, into a marital trust for her benefit.[90] The generous adjustment would permit an upward tax basis adjustment of the farm in the prior example to rise from $5 million to $9.3 million (i.e., $5 million plus $4.3 million).

The $1.3 and $3 million tax basis adjustments included all property held directly in the decedent's name.[91] In addition, basis adjustment property also included indirect property ownership, including, but not limited to, one-half of property owned jointly with rights of survivorship between a decedent and his spouse,[92] property that the decedent held in a revocable trust,[93] and a spouse's one-half interest in community property.[94] Congress also specified that certain property was not eligible for basis adjustment, such as gratuitously received property acquired by the decedent within three years of death.[95]

Aside from the $1.3 and $3 million tax basis adjustments just described, there were two other salient features of the carryover tax basis regime that warrant attention. The first pertained to the holding period: the recipient's holding period would include the period during which the decedent held

85 *Id.* § 1022(b)(2)(B). For non-U.S. domiciliary aliens, the tax basis increase was limited to $60,000. *Id.* § 1022(b)(3).

86 *Id.* § 1022(d)(2).

87 *Id.* § 1022(b)(2)(C)(i).

88 *Id.*

89 *Id.* § 1022(b)(2)(C)(ii).

90 *Id.* § 1022(c).

91 *Id.* § 1022(d)(1)(A).

92 *Id.* § 1022(d)(1)(B)(i)(I).

93 *Id.* § 1022(d)(1)(B)(ii).

94 *Id.* § 1022(d)(1)(B)(iv).

95 *Id.* § 1022(d)(1)(C)(i).

the property.[96] Second, satisfaction of a pecuniary bequest would only give rise to a gain on the difference between an asset's fair market value on the date of death and its fair market value on the date of distribution;[97] the recipient's tax basis in the asset would equal the decedent's basis plus any gain recognized.[98]

In sum, the 2010 carryover basis rules, while not entirely simple, were significantly less complex than their 1976 counterparts.

In late December 2010, as part of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (2010 Act),[99] Congress retroactively repealed the repeal of the estate tax as if such legislation had never been enacted.[100] This repeal had an immediate twofold effect: it reinstated the estate tax, making it applicable to decedents dying in 2010;[101] and, as a corollary, the basis equal to fair market value rule found in § 1014 was, once again, made universally applicable.[102] The 2010 Act, however, provided an "opt-out" election to estate executors for decedents who died in 2010: if estate executors wished, in lieu of the estate tax applicability, they could elect to have the carryover tax basis regime apply instead.[103] Nowhere is the conceptual connection between estate tax repeal and carryover basis more evident than in this provision.

Executors for decedents dying in 2010 were therefore accorded the unprecedented luxury of selecting whichever tax regime—estate tax or carryover tax basis regime—produced the lesser tax burden. From the vantage point of estates that were just barely large enough to face a positive estate tax, the opportunity to elect a step-up in basis instead was attractive. For estates that would have faced a substantial estate tax, forfeiting a step-up in basis may have been a relatively small price to pay. Executors essentially needed to do the math; and when they did, the fisc, predictably, would be the loser, one way or the other.

Apart from its temporary nature, the 2010 carryover basis regime contained another feature that caused concern: the size and availability of the $1.3 million of "free" tax basis adjustments afforded to all taxpayers and $3 million of "free" tax basis adjustments afforded to surviving spouses.[104] The thrust of the criticisms was cast in four forms.

a. <u>The Tax Basis Adjustments Were Excessive</u>. First, the size of the two "free" tax basis adjustments was excessive. Bear in mind that the estate and income tax regimes are independent of each other, with two wholly different

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96 Rev. Proc. 2011-35 I.R.B. 193.

97 I.R.C. § 1040(a), (b) (2006).

98 *Id.* § 1040(c).

99 Pub. L. No. 111-312, 124 Stat. 3296 (codified as amended in scattered sections of 19, 26, 31, and 45 U.S.C.).

100 *Id.* § 301(a).

101 *Id.* § 301.

102 *Id.*

103 *Id.* § 301(c).

104 For the most comprehensive critique of the carryover tax regime, see Joseph M. Dodge, *What's Wrong with Carryover Basis Under H.R. 8*, 91 TAX NOTES 961 (2001).

objectives in mind: the estate tax is largely supposed to curtail undue wealth accumulations;[105] in contrast, the income tax is largely designed to raise revenue necessary to enable the government to function, according to the taxpayer's ability to pay.[106] But in crafting the carryover tax basis regime, Congress offered no justifiable defense for using a dollar figure approximately equal to the then-applicable estate tax exemption as the appropriate metric to increase the tax bases that decedents had in their assets received by nonspousal beneficiaries.[107] While the income tax does offer its own set of exemptions,[108] they have historically been modest, and have rarely offered major tax reductions to high-income taxpayers. Generally, they offer a break of a few thousand dollars—not millions of dollars—and are designed primarily to remove from the tax rolls those taxpayers whose income is at or below a subsistence standard of living.[109]

b. The Tax Basis Adjustments Were Regressive. A related complaint was that the carryover tax basis adjustments were regressive. Those taxpayers who could avail themselves of these adjustments were generally well-to-do taxpayers who held highly appreciated assets; in contrast, the vast majority of other taxpayers could make little or no use of these basis adjustments because when they died they owned few, if any, assets that had appreciated. Consider, too, that the benefits of these tax basis adjustments inured randomly based upon (i) the vicissitudes of whether decedent taxpayers owned assets that had not appreciated, marginally appreciated, or greatly appreciated and (ii) the nature of the decedent's assets and whether they consisted of retirement funds (to which no basis adjustment was afforded)[110] or traditional investments such as stocks and bonds.

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105 *See* James R. Repetti, *Democracy, Taxes, and Wealth*, 76 N.Y.U. L. Rev. 825, 825 (2001) ("Congress adopted an estate tax in 1916 in response to concerns about the harmful social effects of wealth concentration."); *see also* David Joulfaian, The Federal Estate Tax: History, Law, and Economics 2 (July 2017) (unpublished manuscript) ("Supporters viewed large concentrations of wealth as dangerous to a democracy, and large inheritances were considered inconsistent with democratic ideals of equal opportunity.").

106 *See, e.g.*, Sheldon D. Pollack, *Origins of the Modern Income Tax, 1894–1913*, 66 Tax Law. 295, 329 (2013) ("[Congress's] goal was to enact some tariff reduction, relying on a modest income tax to make up the lost revenue.").

107 Admittedly, the 1976 carryover tax basis regime did use the then-applicable estate tax exemption ($60,000) as a commencement point to increase tax basis. *See supra* notes 67–68 and accompanying text. Canada, which has a deemed realization rule on death (i.e., Canada treats death as a disposition event in which taxpayers sell or exchange their assets), offers no equivalent tax basis adjustment to its taxpayers. Income Tax Act, R.S.C. 1985, 5th supp., L-1 § 70(5).

108 I.R.C. § 151(c) (2012).

109 *See* Allan J. Samansky, *Nonstandard Thoughts About the Standard Deduction*, 1991 Utah L. Rev. 531, 531 ("The standard deduction simplifies computation of tax liability for those with relatively small amounts of itemized deductions and, along with personal exemptions, eliminates federal income tax liability for many low income persons.").

110 Allowing no basis adjustment for retirement assets while permitting one for appreciated investments is nonsensical. Retirement assets—traditionally known as "income in respect of decedents," or IRD—represent income that has not been taxed because a cash-

c. Revenue-Raising Objectives Readily Thwarted. Furthermore, executors had the latitude to use these basis adjustments strategically to thwart the progressivity of the income tax.[111] More specifically, executors could allocate tax basis to those assets the gains of which were subject to the highest income tax rates (e.g., recapture property) or, alternatively, to those properties passing to taxpayers whose income was subject to high income tax rates rather than to those properties passing to taxpayers whose income was subject to low income tax rates.

d. Exacerbation of the Lock-In Effect. Finally, the vastness of these basis adjustments, if they had been left in effect (rather than being subject to a sunset provision), would have further exacerbated the lock-in effect. Taxpayers who might otherwise be inclined to sell or gift their appreciated assets would instead have an incentive to hold them until death. By subscribing to this "hold strategy," taxpayers could cleanse all or a portion of the gains embedded in their assets from future tax liability. This hold strategy is emblematic of the lock-in effect,[112] creating a potential drag on the nation's economy.[113]

The 2010 carryover tax basis regime did not last long enough to draw much outcry. However, consider the fact that there were virtually no complaints akin to those that engulfed the 1976 carryover tax basis regime—that is, that the tax bases decedents held in their assets were impossible to ascertain or identify.[114] Implicit in this silence was a tacit recognition that three and a half decades after 1976, an asset's tax basis held by a decedent taxpayer was more readily accessible than in the past. Furthermore, due to the federal estate tax's absence and the elimination of the federal state death credit, which influenced many states to repeal their estate taxes, two critical tax basis adjustments found in the 1976 carryover tax basis regime—namely, the estate tax adjustment and the state succession tax adjustment[115]—were not components of the 2010 carryover tax basis regime. Finally, by making the tax basis

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method decedent taxpayer did not receive such funds during life. The same principle holds true with respect to appreciated assets; namely, due to the concept of realization, such income remained untaxed during the decedent's lifetime. Both the accounting concept and the realization principle lack economic substance; they are mere conventions. As such, for the sake of consistency, in the case of IRD and appreciated assets, if tax basis adjustment is deemed appropriate, it should be made universal.

111 Basis adjustment allocations are essentially an assignment of income stratagem that the Supreme Court has long battled against. See *Lucas v. Earl*, 281 U.S. 111 (1930), and its progeny.

112 *See, e.g.*, Gerald Auten & David Joulfaian, *Bequest Taxes and Capital Gains Realizations*, 81 J. PUB. ECON. 213, 226 (2001) (demonstrating a correlation between age and the retention of capital assets); Leonard Burman, *Comment*, *in* RETHINKING ESTATE AND GIFT TAXATION 450, 450–51 (William G. Gale et al. eds., 2001) (describing the lock-in effect).

113 *See, e.g.*, Auten & Joulfaian, *supra* note 112, at 226 (demonstrating a correlation between age and the retention of capital assets).

114 *See supra* notes 74–75 and accompanying text.

115 *See supra* notes 65, 70 and accompanying text.

dollar adjustments so large, Congress assumed that the number of taxpayers impacted by the 2010 carryover tax basis legislation would be minuscule.[116]

II. Viability/Desirability of a Carryover Tax Basis Regime

Having just explored the 1976 and 2010 carryover tax basis regimes—the first of which was an utter failure and the second of which was extraordinarily short-lived—it may seem illogical to advocate now that a carryover basis rule permanently be added to the Code. However, the foregoing observations about the 1976 and 2010 carryover tax basis regimes serve as an important guide: they can help Congress shape a viable and long-lasting carryover tax basis regime.

Over the course of the last several decades, technological advancements have occurred, the nation's tax landscape has fundamentally shifted, and unprecedented wealth inequality has plagued the nation. Together, these phenomena have opened avenues and triggered opportunities that did not previously exist. In light of these changes, this analysis makes the case, detailed in the Sections that follow, that this is the right time to institute a carryover tax rule.

A. *Technological Changes and the Enhanced Viability of a Carryover Tax Basis Regime*

In 1913, when Congress first instituted the income tax,[117] the nation was becoming industrialized; assembly line use was being refined, and for the first time, electricity was being installed in new home construction.[118] Notwithstanding the pace of these changes, taxpaying citizens still had to rely upon their elementary school arithmetic skills to make accurate computations, and all record keeping had to be reduced to paper. Furthermore, since photocopy machines were not yet invented,[119] making extra sets of records could be resource and labor intensive, and therefore, out of the question for most taxpayers,[120] and the only "cloud" that existed was white and fluffy and in the distant sky.

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116 *See* Robert Gordon, David Joulfaian & James M. Poterba, *Choosing Between an Estate Tax and a Basis Carryover Regime: Evidence from 2010*, at 24 tbl.1 (Nat'l Bureau of Econ. Research, Working Paper No. 22722, 2016), http://www.nber.org/papers/w22722 (noting that fewer than 10,000 taxpayers nationwide made a carryover tax basis election).

117 Revenue Act of 1913, Pub. L. No. 63-16, ch. 16, 38 Stat. 114, 166.

118 Paul M. Angle, Crossroads: 1913, at 7 (1963) ("A dawning [twentieth] century lifted spirits and offered the promise of unlimited progress. The rapid development of the automobile, the proliferation of telephones, the increasing use of electricity, and the invention of the airplane seemed to confirm the promise.").

119 In 1959, Xerox introduced the first photocopying machine. *See* Xerox, The Story of Xerography 1, 7 (1999).

120 Invented in 1801, carbon paper was admittedly available to make copies of important documentation, but since most taxpayers did not own typewriters in the early 1900s because of their expense, *see* Richard Polt, The Typewriter Revolution: A Typist's Companion for the 21st Century (2015), its use to make copies of income tax returns was

As the nation's Industrial Era blossomed, the mundane task of record keeping became vastly easier. In particular, the photocopy machine was invented in 1959 and quickly grew in popularity.[121] Taxpayers who once had to rely on one set of records could readily have multiples made, greatly reducing the risk of such records being lost, misplaced, or erroneously transcribed. In addition, records could be easily catalogued, stored, and retrieved due to advancements in automatization.

In recent decades, as the Information Era has eclipsed the Industrial Era, the art of record keeping has been refined and perfected. Indeed, in many instances, the advent of computers has eradicated record-keeping concerns. Tomes of information can now be stored on disks or in the cloud and, with a few keystrokes, easily retrieved.[122] If placed securely on the internet, important information and documentation can theoretically be preserved in perpetuity, accessible by whomever is granted (or otherwise obtains) access.[123]

These technological strides have transformed the tax return filing process and shaped the Code itself. The vast majority of taxpayers and their advisers now use computer software programs to prepare their tax returns and capitalize upon the e-filing process to submit their tax returns.[124] The days of pencil and paper use and U.S. Postal System reliance are long gone. In crafting the Code, Congress has been quick to grasp the implications associated with these technological changes and their virtues in terms of facilitating tax compliance (e.g., individual income tax returns prepared by "specified tax return preparers" must be submitted electronically).[125]

With respect to accurate tax basis identification, technological changes have been transformative. Consider their impact first in the realm of first-party reporting and then with respect to third-party reporting.

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probably less than robust, *see* Kevin M. Laurence, *The Exciting History of Carbon Paper!*, THIS IS JUST TO SAY, http://www.kevinlaurence.net/essays/cc.php (last visited Oct. 11, 2017) ("Whereas carbon paper produced a good original with a pen or pencil, it did not always provide a good copy (carbon paper required adequate pressure in order to provide both); and although a metal stylus could give a good black copy, it did not produce a very legible original. The typewriter, on the other hand, produced excellent originals and copies, and carbon copying on the typewriter progressively became standard practice in the office.").

121 *See supra* note 120.

122 *See, e.g.*, RICARDO BAEZA-YATES & BERTHIER RIBEIRO-NETO, MODERN INFORMATION RETRIEVAL (2010).

123 *See generally* STEFAN BÜTTCHER, CHARLES L.A. CLARKE & GORDON V. CORMACK, INFORMATION RETRIEVAL: IMPLEMENTING AND EVALUATING SEARCH ENGINES (2010).

124 *U.S. Taxpayers Efiled More Than 128 Million Returns in 2016*, EFILE, http://www.efile.com/efile-tax-return-direct-deposit-statistics/ (last visited Oct. 11, 2017) ("The IRS has reported that as of April 2017, more than 122,164,000 million [sic] tax returns were efiled for Tax Year 2016. The number of tax returns safely efiled has continued to increase each year.").

125 I.R.C. § 6011(e)(3)(A) (2012). "[T]he term 'specified tax return preparer' means, with respect to any calendar year, any tax return preparer unless such preparer reasonably expects to file 10 or fewer individual income tax returns during such calendar year." *Id.* § 6011(e)(3)(B).

Insofar as first-party reporting is concerned, those assets that taxpayers own in their own names can typically be grouped into one of two baskets; tangible personal assets (e.g., jewelry, carpets, and other collectibles, as well as home improvements) and investment or business assets (e.g., real estate, corporate stock, and equipment).[126] Insofar as the first basket of assets is concerned, tax basis identification remains lackluster; the majority of taxpayers probably do not retain pristine purchase price records of their (i) jewelry, clothing, and furniture because they do not harbor expectations of ever selling such assets and realize that, even if they did, they would probably generate a nondeductible loss; or (ii) home improvements because the Code offers a generous exclusion for gains on the sale of a personal residence.[127] In striking contrast, when it comes to investment and business assets, due to software programs such as Quickbooks, AssetCloud, and BNA Fixed Assets (all of which maintain automatic asset depreciation schedules), tax basis records are readily accessible. Furthermore, the IRS generally mandates that this tax basis information be recorded a second time on taxpayers' tax returns.[128] While these measures are not foolproof, technological advancements combined with the IRS reporting mandate have greatly facilitated the ability to compute and retain tax basis identification for those assets comprising this second asset basket.

Insofar as third-party tax basis reporting is concerned, Congress has made remarkable strides over the course of the last decade. In yesteryear, taxpayers were essentially on the honor system: when they sold investments, third-party intermediaries (typically, brokerage firms) were obligated to report the amount realized on the sale,[129] but taxpayers were on their own as to reporting the tax bases of the assets being sold.[130] Due to an inability to track the tax basis, or alternatively, in order to minimize their tax burdens, taxpayers often unwittingly or consciously misreported the tax basis they had in their investments, resulting in significant revenue losses to the government.[131] To remedy this problem and in light of technological advancements, in 2008, Congress instituted legislation that requires third-party vendors (primarily, brokerage firms) that hold nominee title to taxpayers' investments to record, track, and report the tax basis that taxpayers have in

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126 *See Personal Property Exchanges*, INVESTMENT PROPERTY EXCHANGE SERVICES, INC. (2013), https://www.ipx1031.com/wp-content/uploads/2013/09/IPXpersonal-property-exchanges.pdf.

127 *See* I.R.C. § 121(a).

128 See *IRS Form 4562: Depreciation and Amortization* (2016), https://www.irs.gov/pub/irs-pdf/f4562.pdf, and the instructions thereto.

129 INTERNAL REVENUE SERV., YOUR FEDERAL INCOME TAX FOR INDIVIDUALS 102–09 (2016), https://www.irs.gov/pub/irs-pdf/p17.pdf.

130 *See generally* Dodge & Soled, *supra* note 6.

131 *See* U.S. GOV'T ACCOUNTABILITY OFF., GAO-06-603, CAPITAL GAINS TAX GAP: REQUIRING BROKERS TO REPORT SECURITIES COST BASIS WOULD IMPROVE COMPLIANCE IF RELATED CHALLENGES ARE ADDRESSED, at abstract (2006), http://www.gao.gov/assets/260/250426.pdf ("GAO estimates that 38 percent of individual taxpayers with securities transactions misreported their capital gains or losses in tax year 2001.").

their investments,[132] eliminating the wide latitude that taxpayers once had to self-report.

Buoyed by the success of third-party tax basis reporting for marketable securities, one additional reform has been enacted and at least one other is currently being incubated. More specifically, Congress recently enacted legislation that requires taxpayers' executors to issue tax information returns to estate beneficiaries and the IRS,[133] reporting the tax basis of the assets that heirs receive.[134] Another potential reform—not enacted yet but urged by academics and others—would extend third-party tax basis reporting to investments made in pass-through entities such as partnerships and S corporations.[135] Both of these reform measures are consistent with the national trend toward increased emphasis on accurate tax basis identification.

In sum, in virtually every sphere, technological advancements are making tax basis identification viable, even after a taxpayer's death. With respect to the vast majority of valuable assets that a decedent owns (e.g., stock and bond investments and business real estate and equipment), tax basis records are readily accessible. Admittedly, some of a decedent's assets (e.g., jewelry and title to a residential home) could prove challenging with respect to making accurate tax basis identifications. Insofar as these latter assets are concerned, it is important to recognize that, in many instances, they generally do not comprise any substantial proportion of a taxpayer's net worth. Furthermore, in crafting reforms, Congress is at liberty to make appropriate simplifying assumptions (see suggestions below) that would obviate the need for exacting evidence of what the tax bases of these assets are.

B. *Transfer Tax System Changes and the Desirability of a Carryover Tax Basis Rule*

As we have explained, there has long been a conceptual connection between the transfer tax system and the step-up in basis rule. This interdependence has historically stemmed from an engrained notion that the same

132 Energy Improvement and Extension Act of 2008, Pub. L. No. 110-343, § 403, 122 Stat. 3807, 3854–58 (codified as amended in scattered sections of 26 U.S.C.) (introducing Code § 6045(g), which requires that brokers track and report taxpayers' tax basis in the covered securities in which they invest).

133 Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, Pub. L. No. 114-41, § 2004, 129 Stat. 443, 454–55 (codified as amended in scattered sections of 26 U.S.C.) (introducing legislation requiring that executors report for estate tax purposes asset values that beneficiaries must then use as the tax basis of inherited assets).

134 I.R.C. § 1014(f) (2015); I.R.C. § 6035(a) (2012).

135 *See* James Alm & Jay A. Soled, *Tax Basis Determinations, Pass-Through Entities, and Taxpayer Noncompliance*, 40 OHIO N.U. L. REV. 693 (2014); *see also* TAXPAYER ADVOCATE SERV., 2015 ANNUAL REPORT TO CONGRESS 399 (2015), http://taxpayeradvocate.irs.gov/Media/Default/Documents/2015ARC/ARC15_Volume1_LR_11_Basis-Reporting.pdf (advocating legislative changes that would institute tax basis reporting for pass-through entities).

property should not endure multiple tax burdens.[136] As a practical matter, this has meant that if property is subject to a transfer tax, it should not be exposed to a subsequent income tax; and, conversely, those taxpayers who benefit from a step-up in basis rule should have to bear a transfer tax.[137]

There is legislative evidence for this historical connection. For decades, for example, Congress has sought to minimize the risk that a taxpayer will bear both transfer and income taxes on the same property: when someone makes a taxable gift and pays gift tax, there is an upward adjustment of the transferred asset's tax basis related to the amount of gift tax paid;[138] and furthermore, the Code instructs that a similar sort of upward tax basis adjustment be made with respect to the amount of generation-skipping transfer tax that a transfer generates (again, attributable to the appreciated portion of the property being transferred).[139] In a similar vein, if an estate tax is paid with respect to what is known as "income in respect of decedents" (IRD) (commonly, retirement accounts), a corresponding income tax deduction equal to the estate tax attributable to the IRD is permitted.[140]

Admittedly, despite the historical connection between the transfer tax regime and the step-up in basis rule, the connection has little logical support. The underlying nature and purpose of the wealth-transfer and income tax systems are entirely different. The former was instituted to raise revenue, certainly,[141] but has come to be primarily about curbing the perpetuation of dynastic wealth.[142] The latter was primarily designed as a tool to raise reve-

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136 *See, e.g.*, NONNA A. NOTO, CONG. RESEARCH SERV., RL 30875, STEP-UP VS. CARRYOVER BASIS FOR CAPITAL GAINS: IMPLICATIONS FOR ESTATE TAX REPEAL 5 (2001), http://congressionalresearch.com/RL30875/document.php?study=Step-Up+vs.+Carryover+Basis+for+Capital+Gains+Implications+for+Estate+Tax+Repeal ("A common criticism of the estate tax is that many of the assets in an estate have already been taxed at least once under the income tax.").

137 Evidence of this connection runs deep. Virtually every time there has been estate tax elimination legislation, it has been accompanied by rules to institute a carryover tax basis regime. For a listing of some examples of such legislation, see *id.* at 10–13.

138 I.R.C. § 1015(d)(6).

139 *Id.* § 2654(a).

140 *Id.* § 691(c).

141 *See* JOHN R. LUCKEY, CONG. RESEARCH SERV., CRS 95-444 A, A HISTORY OF FEDERAL ESTATE, GIFT, AND GENERATION-SKIPPING TAXES 6 (2003), https://www.naepc.org/journal/issue01f.pdf ("Federal death taxes in the United States between 1797 and 1915 appear to have served as supplementary revenue sources adopted only during war times."); David M. Hudson, *Tax Policy and the Federal Taxation of the Transfer of Wealth*, 19 WILLAMETTE L. REV. 1, 1 (1983) ("Generation of revenue clearly seems to be a primary motivation for the enactment of both past and present day wealth transfer taxes.").

142 *See* RANDOLPH E. PAUL, TAXATION IN THE UNITED STATES 88 (1954) ("The President declared vehemently for . . . 'a progressive tax on all fortunes beyond a certain amount either given in life or devised or bequeathed upon death to any individual—a tax so framed as to put it out of the power of the owner of one of these enormous fortunes to hand on more than a certain amount to any one individual.'"); Louis Eisenstein, *The Rise and Decline of the Estate Tax*, 11 TAX L. REV. 223, 235 (1956) ("With the Roosevelt Administration . . . [t]he levelling of hereditary fortunes was formally approved as one of [the estate tax's] objectives."); Schmalbeck, *supra* note 43, at 752 ("The strongest defense of the

nue, according to ability-to-pay principles.[143] Furthermore, the metric upon which each tax is levied is quite distinct: the former is levied upon a decedent's entire accumulated net worth[144] (taking into account prior lifetime gratuitous transfers),[145] whereas the latter is a measure of a taxpayer's annual flow, which represents in some sense the taxpayer's immediate consumption horizon.[146]

Notwithstanding the significant differences between the transfer and income tax regimes, the notion that they are somehow interconnected persists for political purposes. And, as was famously pointed out millennia ago by Plato in *The Republic* in the allegory of the cave, since shadows sometimes dictate what is considered "reality," it would be foolhardy to dismiss the putative interconnectedness between the two taxes as complete nonsense. That being the case, at least for the sake of argument, this analysis accedes to what appears to be politically inevitable and reluctantly assumes that the transfer and income tax regimes are loosely synchronized and designed to function inversely with respect to each other in the following fashion: if one is weak, the other is made stronger; and, conversely, if one is strong, the other is made weaker.[147]

Bearing this relationship in mind, an inescapable fact is that over the course of the last two decades the transfer tax system has been reduced to a shadow of its former self. In 2001,[148] 2010,[149] and again in 2012,[150] Congress sequentially and greatly increased the lifetime exemption amount to where it stands today, at $5,450,000 (2017),[151] a dollar figure that will continue to be adjusted upward annually for inflation.[152] In addition to the bloated lifetime exclusion amount, at least three other factors have contributed to the shrinking of the nation's transfer tax regime: (i) in 1990, Congress sanctioned the use of so-called grantor retained annuity trusts (GRATs), which permit sophisticated taxpayers to transfer wealth with little or no gift

existing wealth-transfer tax system is that it restrains a tendency in a society dominated by private markets . . . toward inequalities in wealth-holding.").

143 *See, e.g.*, Pollack, *supra* note 106, at 329 ("Their goal was to enact some tariff reduction, relying on a modest income tax to make up the lost revenue.").

144 I.R.C. § 2031(a).

145 *Id.* § 2001(b)(1).

146 *Id.* § 61(a).

147 With the recent call to repeal the estate tax has been a parallel call to institute some form of a carryover tax basis regime. *See supra* note 137.

148 *See* Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38 (codified as amended in scattered sections of 26 U.S.C.).

149 *See* Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, 124 Stat. 3296 (codified as amended in scattered sections of 19, 26, 31, and 45 U.S.C.).

150 *See* American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, 126 Stat. 2313 (2013) (codified as amended in scattered sections of 2, 7, 10, 16, 26, 42, and 45 U.S.C.).

151 Rev. Proc. 2015-53, § 3.33, 2015-44 I.R.B 623.

152 *See* I.R.C. § 2010(c)(3)(B) (2012).

tax exposure;[153] (ii) due to what are known as minority and marketability discounts, taxpayers have been able to minimize their transfer tax burdens;[154] and (iii) many states, seeking to attract capital, have strategically curtailed or repealed their rules against perpetuities,[155] enabling taxpayers to capitalize on the use of their generation-skipping transfer tax exemption[156] and thereby safeguard their wealth from estate tax exposure indefinitely—potentially forever. The combination of these changes has resulted in fewer than 5000 taxable estate tax returns being filed annually,[157] reducing the percentage of decedents whose estates have estate tax exposure to less than 0.2%.[158] Revenue from estate taxes has been reduced concomitantly—while the estate tax historically raised between 1% to 2% of the nation's annual revenue,[159] it now raises approximately 0.6%.[160]

Because the transfer tax regime has shrunk, the income tax regime should arguably be made more robust. Eliminating the step-up in basis rule would be a reform measure in that direction. It is a reform measure that is

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153 *See* David L. Weinreb & Gregory D. Singer, *An Analysis of GRAT "Immunization,"* 34 ACTEC J. 200 (2008) (explaining how taxpayers can effectively use GRAT instruments to minimize their transfer tax burdens). *See generally* Mitchell M. Gans, *GRIT's, GRAT's and GRUT's: Planning and Policy*, 11 VA. TAX REV. 761 (1992).

154 For an excellent overview of how taxpayers utilize these discount techniques, see James R. Repetti, *Minority Discounts: The Alchemy in Estate and Gift Taxation*, 50 TAX L. REV. 415, 431–34 (1995).

155 *See* Note, *Dynasty Trusts and the Rule Against Perpetuities*, 116 HARV. L. REV. 2588, 2590 (2003) ("The repeal or modification of the Rule Against Perpetuities in a growing number of states is one aspect of this broader trend in trust law. It is driven by states' desire to remove the barrier to dynasty trusts, adding such trusts to the menu of options local financial institutions have to offer in competition for out-of-state trust business.").

156 *See* Edward J. McCaffery, *Through the Looking Glass: The Politics of Estate Tax Reform*, 35 ACTEC J. 121, 124 (2009) ("The history of gift and estate tax repeal is full of unintended consequences. For but one example, the introduction of a brave new generation-skipping transfer tax in 1986 'simply' led to the repeal of the rule against perpetuities and the rise of dynasty trusts—which, when combined, create a massive tax-saving device."); Max M. Schanzenbach & Robert H. Sitkoff, *Perpetuities or Taxes? Explaining the Rise of the Perpetual Trust*, 27 CARDOZO L. REV. 2465, 2465 (2006) ("By abolishing the Rule Against Perpetuities, twenty-one states have validated perpetual trusts.").

157 For example, in 2015 (the last year data is available), there were 11,917 estate tax returns filed (of which only 4,918 were taxable). *See* INTERNAL REVENUE SERV., SOI TAX STATS—ESTATE TAX STATISTICS FILING YEAR TABLE 1 (2015), https://www.irs.gov/statistics/soi-tax-stats-estate-tax-statistics-filing-year-table-1.

158 For 2014, the number of deaths reported in the United States was 2,626,418. Kenneth D. Kochanek et al., *Deaths: Final Data for 2014*, 65 NAT'L VITAL STAT. REP. 1, 3 (2016).

159 *See* JOINT COMM. ON TAXATION, JCX-52-15, HISTORY, PRESENT LAW, AND ANALYSIS OF THE FEDERAL WEALTH TRANSFER TAX SYSTEM 28 (2015), https://www.jct.gov/publications.html?func=startdown&id=4744 (reflecting the history of estate tax revenue collected).

160 In 2014, the estate tax raised $19.3 billion, according to the Office of Management and Budget, or 0.6% of total federal revenue of more than $3 trillion. OFFICE OF MGMT. & BUDGET, FISCAL YEAR 2016 HISTORICAL TABLES: BUDGET OF THE U.S. GOVERNMENT 52 tbl.2.5 (2016), https://www.gpo.gov/fdsys/pkg/BUDGET-2016-TAB/pdf/BUDGET-2016-TAB.pdf.

consistent with the popular conceptual linkage between wealth-transfer taxes and the basis rules for inherited assets. Put another way, if there is no wealth-transfer tax for most estates, there is no effective backstop for the income taxation of appreciated assets unless Congress closes the loophole that the step-up in basis rule creates.

C. Exorcising Past Ghosts and Formulating a Workable Carryover Tax Basis Rule

Utilization of a carryover tax rule at death has not gone untested. To the contrary, as previously pointed out, Congress has instituted variations of such a rule twice in our nation's history. The question thus remains that if a carryover tax basis rule holds such promise for meaningful tax reform, why on neither occasion did it gain traction and become permanent? In subsection II.C.1, we explore the problems that plagued the prior two carryover tax basis rules; in subsection II.C.2, bearing these problems in mind, we propose a variation of the existing carryover tax basis rule that has been successfully in place for close to a century in the realm of inter vivos gifts.

1. Ghosts That Haunted the Prior Carryover Tax Basis Rules

While many problems bedeviled the 1976 and 2010 carryover tax basis rules and ultimately led to their discontinuance, there are three particularly salient ones that warrant further explication.

At least in the case of the 1976 carryover tax basis rule, one of the most compelling complaints against it was its impracticality. More specifically, it was thought by many to be virtually impossible to know the tax basis of assets held by decedents due to their unavailability as witnesses.[161] At the time, this argument was not entirely unfounded. Taxpayers—human beings, really—tend to be poor record keepers, and a plethora of cases attests to this proposition.[162] In the most extreme cases, taxpayers have simply failed to retain

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161 *See* Hoffman, *supra* note 74, at 448–49.

162 *See, e.g.*, Power v. Comm'r, T.C.M. (RIA) ¶ 90,583, at 2876 (1990) (holding taxpayers negligent where tax records were lost); Crocker v. Comm'r, 92 Tax Ct. Rep. (RIA) 899, 917 (1989) (holding taxpayers negligent and liable for intentional disregard of rules and regulations requiring taxpayers to keep sufficient records); Anderson v. Comm'r, T.C.M. (RIA) ¶ 89,381, at 1868 (1989) (holding taxpayers negligent where taxpayers did not provide evidence showing good cause for lack of records); Potito v. Comm'r, T.C.M. (RIA) ¶ 75,187, at 796 (1975) (holding taxpayers negligent where records were unintelligible and failed to support income reported and expenses deducted), *aff'd*, 534 F.2d 49 (5th Cir. 1976); Estate of Teel v. Comm'r, T.C.M. (RIA) ¶ 58,101, at 444–45 (1958) (holding taxpayers negligent where invoices for sales were missing and there was no indication of use or disposition of them); Courtney v. Comm'r, 28 Tax Ct. Rep. (RIA) 658, 664 (1957) (holding taxpayer negligent where taxpayer failed to maintain complete and adequate books and records of net income), *acq.* 1957-2 C.B. 3, 4; Fihe v. Comm'r, T.C.M. (RIA) ¶ 56,139, at 567 (1956) (holding taxpayer negligent where taxpayer inadequately maintained records of deductions and losses claimed), *aff'd*, 265 F.2d 511 (9th Cir. 1958); Nellis v. Comm'r, T.C.M. (RIA) ¶ 55,050, at 143 (1955) (holding taxpayer liable for negligently keeping inadequate records), *aff'd*, 232 F.2d 890 (6th Cir. 1956); *see also* Jay A. Soled, *Exploring and (Re)Defining the Boundaries of the* Cohan *Rule*, 79 TEMP. L. REV. 939, 942 n.16 (2006).

any tax basis records at all.[163] Armed with that fact, critics of the 1976 carryover tax basis rule contended that if taxpayers routinely could not identify the tax basis they had in their investments, it would be, *a fortiori*, even less reasonable to expect their heirs to do so.[164] Instituting a carryover tax basis mandate would therefore trigger untold turmoil.[165]

A second, and perhaps better-founded, attack leveled against the 1976 and 2010 tax basis rules related to their complexity. Conceptually, both were simple: for purposes of computing gains and losses, heirs were supposed to utilize the tax bases that decedents had in their assets. But in both the 1976 and 2010 tax basis rules, this is where the simplicity ended. In its quest to ease transitions to the new rules, Congress offered so many tax basis adjustments (the computation of which was often mindboggling), that even skilled practitioners were often beset with frustration.[166]

A final problem associated with both the 1976 and 2010 carryover tax basis rules was a lack of political will and leadership. With respect to the 1976 carryover tax basis initiative, the Carter administration started off strongly supportive of this legislation,[167] but after meeting with stiff congressional opposition and embracing other priorities, its enthusiasm waned.[168] In contrast, the 2010 carryover tax basis rule was never enthusiastically embraced by the Republican leadership that had proposed it;[169] instead, the rule was considered an unwanted necessity, designed to generate revenue and quell the

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163 *See, e.g.*, Allnutt v. Comm'r, T.C.M. (RIA) ¶ 2004-239, at 1463 (2004) (upholding IRS position on basis because taxpayer could not produce any written records that contradicted the IRS's findings); Karara v. Comm'r, T.C.M. (RIA) ¶ 99,253, at 1656 (1999), *aff'd*, 214 F.3d 1358 (Table) (11th Cir. 2000) (discussing zero basis result for pro se taxpayer selling stock of one company and not filing return, not offering any documentary evidence, and proffering only vague testimony as to cost).

164 *See, e.g.*, *Technical Corrections Act of 1977: Hearings Before the Subcomm. on Taxation and Debt Management Generally of the S. Comm. on Fin.*, 95th Cong. 183, 223–29, 416 (1977) (stating that taxpayers do not maintain adequate records to permit a viable carryover tax basis rule).

165 *See, e.g.*, *Carryover Basis Provisions: Hearing Before the H. Comm. on Ways and Means*, 96th Cong. 81–95 (1979) (projecting that large swaths of the population could not comply with the carryover basis rules due to a lack of adequate record keeping).

166 *See supra* note 74 and accompanying text.

167 *See, e.g.*, Frank S. Berall et al., *Carryover Basis: A 'Discredited' Concept in Estate Planning*, 37 EST. PLAN. 3, 3 (2010) ("The Carter Administration and various liberal organizations tried to defend this significant change [i.e., a carryover tax basis regime], proposing a 1978 moratorium and a 'fix up.'").

168 *See id.* at 3–4 ("Retroactive repeal was enacted, but the President threatened a veto. However, an oil supply crisis, causing skyrocketing gasoline prices, made a crude oil windfall profits tax a very important Administration priority. Carryover basis opponents attached their retroactive repeal to this veto-proof bill.").

169 *See* Joel Friedman, *Lower-Cost Estate Tax Repeal Reflects Slow Phase-In*, CTR. ON BUDGET & POL'Y PRIORITIES 3 (2001), http://www.cbpp.org/archiveSite/4-3-01tax.pdf ("The carryover basis provisions are similar to those in the current Ways and Means bill, H.R. 8; President Bush includes no carry-over basis in his [estate tax] repeal proposal.").

anticipated fury had the estate tax been repealed and the wealthy been simultaneously able to escape income tax on all of their appreciated property.[170]

The aforementioned problems—impracticality, complexity, and absence of political will—led to the undoing of both the 1976 and 2010 carryover tax basis rules, leaving the step-up in basis rule as the default survivor. But, as previously pointed out, many years and changes have since occurred that make at least the administrative justification of the step-up in basis rule largely obsolete.

We wrote earlier of two baskets of assets held by decedents,[171] but it will now be useful to subdivide those baskets with greater particularity. Six different kinds of assets deserve separate consideration: (i) principal residences and other real estate; (ii) liquid assets (i.e., bank deposits, money market funds, and cash surrender value of life insurance); (iii) pension accounts; (iv) corporate stock, financial securities, mutual funds, and personal trusts; (v) unincorporated business equity; and (vi) miscellaneous assets (e.g., automobiles and jewelry), most of which might be considered "collectibles."[172]

In most instances, the tax bases of those assets that comprise each category can be accurately identified; or, if they can't be, they are typically either of inconsequential value or unlikely to have appreciated. Consider each asset category *seriatim*:

(i) Principal residences and other real estate: The tax basis in a home is the initial purchase price adjusted upwardly for improvements and downwardly for those capital items that are replaced.[173] These upward and downward adjustments are typically modest, which means that, in the vast majority of cases, the tax basis of a taxpayer's home actually remains fairly closely aligned with the initial purchase price; most local governments mandatorily record this initial purchase price so it can be easily identified. Real estate used in a business or investment context may be depreciable, but tax records reflecting those deductions should generally be available (in the hands of the IRS, if not the taxpayer) so appropriate adjustments can usually be made.

(ii) Liquid assets (i.e., bank deposits, money market funds, and cash surrender value of life insurance): The tax bases of liquid assets of this sort are generally equal to their cash value, and neither appreciation nor loss are possible.

(iii) Pension accounts: The vast majority of these assets are held on a pretax basis and, as such, have a tax basis of zero.

170 *See* Cong. Budget Office, Budget Options 422 (2001), https://www.cbo.gov/sites/default/files/107th-congress-2001-2002/reports/entire-report_0.pdf (estimating that having a carryover tax basis would raise $52.5 billion in the 2002–2011 period).

171 *See supra* notes 126–27 and accompanying text.

172 *See* Edward N. Wolff, *Recent Trends in Household Wealth in the United States: Rising Debt and the Middle-Class Squeeze—An Update to 2007*, at 48 (Levy Econ. Inst. of Bard Coll., Working Paper No. 589, 2010), http://www.levyinstitute.org/pubs/wp_589.pdf.

173 *See* I.R.C. § 1016(a) (2012).

(iv) Corporate stock, financial securities, and mutual funds: Since 2011, because brokerage firms have a responsibility to track and maintain tax basis records for marketable securities,[174] the tax basis of this category of assets is generally readily known.

(v) Unincorporated business equity: This is, admittedly, the most difficult case. Ascertaining the tax basis of a business or partnership interest can prove challenging, but if third-party reporting were instituted,[175] this would no longer be an insurmountable problem.

(vi) Miscellaneous assets (e.g., automobiles and jewelry): While the tax basis of tangible personal property is its initial cost,[176] this information is often not retained or is commonly lost; nevertheless, tax basis issues pertaining to tangible personal property are usually moot either because the fair market value of such property is typically de minimis or because the fair market value is less than the initial purchase price, resulting in a disallowed personal loss.

Given that instituting a carryover tax basis rule is no longer impractical and that certain simplifying assumptions can be made in those instances when tax bases cannot be identified (see below),[177] the time has thus come for Congress to institute a simplified carryover basis rule—one that overcomes the complexities that haunted past efforts. The next subsection details the nature of such a rule.

2. Formulation of a Workable Carryover Tax Basis Rule

Formulating a workable carryover tax basis rule applicable at death would not require any great inventive efforts. For close to a century, the carryover tax basis rule as it pertains to gifts has performed admirably with little political unhappiness or logistical hitches. That being the case, it should be used as the initial template, with certain adjustments and simplifying assumptions specified below.

Consider the salient features of the existing carryover tax basis rule applicable to lifetime transfers. The general rule is that the recipient holds the transferred asset with the same tax basis as the donor.[178] One exception and one adjustment apply to this rule. The exception applies if the trans-

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174 *See id.* § 6045(g).

175 *See supra* note 135 and accompanying text.

176 I.R.C. § 1012(a).

177 *See infra* text accompanying notes 187–90.

178 I.R.C. § 1015(a). In the absence of this knowledge, Congress instructs the IRS to determine an asset's tax basis:

> If the facts necessary to determine the basis in the hands of the donor or the last preceding owner are unknown to the donee, the Secretary shall, if possible, obtain such facts from such donor or last preceding owner, or any other person cognizant thereof. If the Secretary finds it impossible to obtain such facts, the basis in the hands of such donor or last preceding owner shall be the fair market value of such property as found by the Secretary as of the date or approximate

ferred asset's adjusted basis exceeds its fair market value and the asset is subsequently sold at a loss. In such cases, the asset's fair market value at the time of transfer is deemed the asset's tax basis.[179] The adjustment provides that the gifted property's tax basis is upwardly adjusted in the rare case in which a gift tax attributable to the amount of the property's appreciation has been paid.[180] Over its nearly 100-year history,[181] this carryover tax basis rule has endured with little controversy and has, since its enactment, more or less existed on autopilot.

But both the 1976 and 2010 carryover tax basis rules applicable at death veered far from the simple eloquence of the aforementioned carryover tax basis rule applicable to gifts. Consider each adjustment below and why it either was flawed or, for the reasons stated, is now obsolete.

1. <u>Fresh Start Adjustment</u> (present in the 1976 carryover tax basis rule). Taxpayers were to be allowed an upward tax basis adjustment so that on the effective date of the legislation, taxpayers would theoretically know the tax basis they had in their existing assets and, going forward, would carefully monitor the tax basis of post-enactment-acquired assets. Due to the Information Era's relative infancy at the time, this adjustment was possibly necessary, but its application created untold complexity for many taxpayers. The noticeable absence of this adjustment in the 2010 carryover tax basis legislation strongly suggests that, as the Information Era has matured, the vast majority of taxpayers have a fairly good command of the tax bases they have in their assets, rendering this adjustment unnecessary.
2. <u>Federal and State Estate Tax Adjustment</u> (present in the 1976 carryover tax basis rule). In years past, when the federal and state estate taxes were substantive (i.e., the estate tax exemption was lower, estate tax rates were higher, and most states imposed an estate tax), there was an argument, albeit contentious, that the tax bases of assets should be upwardly adjusted by the amount of transfer tax paid. In the present environment (i.e., when the lifetime exclusion amount is high, estate tax rates are low, and most states do not impose an estate tax), however, the need for this adjustment is absent. Consider, too, the fact that the estate and income taxes are wholly unrelated;[182] that being the case, there is no theoretical justification for connecting these two basis adjustments.

> date at which, according to the best information that the Secretary is able to obtain, such property was acquired by such donor or last preceding owner.

Id.

179 *Id.*

180 *Id.* § 1015(d)(6).

181 Congress enacted the gift tax in 1924 and repealed it in 1926. Revenue Act of 1924, Pub. L. No. 68-176, §§ 319–324, 43 Stat. 253, 313–16, *repealed by* Revenue Act of 1926, Pub. L. No. 69-20, § 1200, 44 Stat. 9, 125–26. It was subsequently reenacted in 1932. Revenue Act of 1932, Pub. L. No. 72-154, §§ 501–532, 47 Stat. 169, 245–59.

182 *See supra* note 44 and accompanying text.

3. Minimum Basis Adjustment (present in the 1976 and 2010 carryover tax basis rules). The genesis of the minimum tax basis adjustments stemmed from political sensitivities rather than tax theory. Congress thought that if it adopted a strict carryover tax basis rule, political opposition would be fierce: those taxpayers who, in the past, had no income tax liability when they sold or exchanged inherited assets would now endure potential income tax exposure. The generous transition rules of the 1976 and 2010 minimum tax basis adjustments were designed to quell these taxpayer concerns. Yet, the reality is that the vast majority of appreciated assets are held by wealthy taxpayers;[183] indeed, at death, most taxpayers do not own appreciated assets of any significant value,[184] which tends to make this adjustment less essential.
4. State Succession Tax Adjustment (present in the 1976 carryover tax basis rule). Similar to the estate and state estate tax adjustment, the state succession tax adjustment presumably shared the same underlying rationale for its enactment (i.e., two different taxes should not apply to the identical property). In light of the fact that only seven states currently impose a succession tax,[185] retention of this adjustment is now of questionable utility.

The shortcomings, inequities, and obsolescence associated with the foregoing adjustments suggest that Congress should eschew them. Instead, the proposed carryover tax basis rule applicable at death should mirror the existing carryover tax basis rule applicable to lifetime transfers. The guiding principle should be that, absent countervailing factors to the contrary, inherited assets should have the same tax basis the decedent had, with the goal that all income is taxed at least once.[186]

183 *See, e.g.*, Wolff, *supra* note 172, at 58 tbls.15a, 15b (illustrating concentration of stock ownership among the different socioeconomic classes and affirming that, in comparison to the nonwealthy, the wealthy are far more invested in stocks (i.e., an asset likely to appreciate in value)).

184 *See* James M. Poterba et al., *Were They Prepared for Retirement? Financial Status at Advanced Ages in the HRS and Ahead Cohorts* 1 (Nat'l Bureau of Econ. Research, Working Paper No. 17824, 2012), http://www.nber.org/papers/w17824.pdf ("We find that a substantial fraction of persons die[s] with virtually no financial assets—46.1 percent with less than $10,000—and many of these households also have no housing wealth and rely almost entirely on Social Security benefits for support.").

185 *See* Ashlea Ebeling, *Where Not to Die in 2016*, FORBES (Oct. 16, 2015), http://www.forbes.com/sites/ashleaebeling/2015/10/16/where-not-to-die-in-2016/#6017e953628c (listing seven states that still have inheritance taxes).

186 Consistent with that idea of taxing gain once is the idea of allowing loss once as well. What might be called the "alternate basis rule" relating to lifetime gifts, applicable when the fair market value at the time of the gift is lower than the donor's basis, fails to observe this balancing principle. When this rule applies, for purposes of computing losses, a recipient taxpayer must use the lesser of the asset's fair market value or adjusted basis. As such, application of this rule makes the donor's accumulated losses disappear for purposes of calculating losses on subsequent sales. This rule also suffers from a technical defect, one that Congress should have corrected at some point in the long history of this provision but

Furthermore, in light of administrative realities, a carryover tax basis rule at death should include two simplifying assumptions. These are enumerated below.

The first simplifying assumption pertains to tangible personal property, such as bric-a-brac, jewelry, and automobiles. In the hands of most taxpayers, these items are generally of negligible value. That being the case, Congress should permit the tax bases of all tangible personal property to equal fair market value at the decedent's date of death. Adoption of this simplification rule would come at virtually no expense to the fisc insofar as losses on such items are generally disallowed[187] and gains associated with the disposition of such property are fairly unusual.[188]

The second simplifying assumption pertains to taxpayers' personal residences. The tax basis of the residence should be deemed to be its original purchase price unless, once again, a taxpayer can present clear and compelling evidence to the contrary. Most taxpayers purchase their residences and then make periodic improvements. However, as was previously pointed out, removal of the "old" to make room for the "new" causes a corresponding reduction of the residence's adjusted tax basis.[189] While the costs associated with home remodeling may be asymmetrical (items of higher cost replace items of lower cost), utilizing the initial purchase price as the governing tax basis is probably a fairly accurate estimation of most homes' actual tax bases. If this carryover tax basis approach to personal residences were deemed too

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has not—the alternate basis rule fails to specify a basis in cases in which an asset is transferred when its fair market value is less than its basis and it is subsequently sold by the donee at a price between the donor's basis and the value at the time of gift. The core problem is that there is a circularity in the § 1015 alternate basis rule: it prescribes a basis for purposes of determining loss, but whether a loss even exists depends on the assignment of basis. An example illustrates the paradox of the alternate basis rule. Suppose a donor buys an asset for $100 and gives it to the donee when its value has declined to $70. Suppose further that the donee later sells the asset for $80. For purposes of determining loss, the taxpayer is instructed to assign a basis to the asset equal to its fair market value at the time of the gift, which was $70. But once that basis has been assigned, the loss disappears; there now appears to be a gain of $10. Conversely, for purposes of determining gain, the main carryover basis rule applies: use the donor's basis of $100. But when the taxpayer does that, the gain disappears. The regulations resolve this problem diplomatically by saying simply that, in such situations, there is neither gain nor loss (in fact, the regulations are so diplomatic about contradicting the statute that they don't even state this rule but merely provide an example that replicates the one presented above, concluding that, in such a case, "there is neither gain nor loss," 26 C.F.R. § 1.1015-1(a)(2) (1971), without mentioning the fact that the basis rules as written in the Code simply do not provide a basis rule covering this situation). But, in view of the fact that an approach that seeks to tax gain once and allow loss once has no need for an alternate basis rule, we would propose that the tax basis in inherited assets be simply carried over from the decedent's basis in every case, whether the asset was more or less valuable than its basis at the decedent's death.

187 *See* I.R.C. § 165(c) (2012).

188 Congress could exempt collectibles (e.g., artwork, jewelry, antique cars, and the like) whose fair market value exceeds a certain threshold, say, $10,000, from application of this rule.

189 *See supra* note 173 and accompanying text.

politically controversial, Congress should carve out an exception: for homes of modest value, say below $1 million, a tax basis equal to fair market value at decedent's death rule could apply. (This exception would exempt almost all homes from the carryover tax basis rule.)[190]

When considering this proposal's logistics and political practicality, there is a final item to bear in mind. It pertains to those instances in which a taxpayer perhaps would not know with specificity the decedent's tax basis in a particular asset (e.g., stock in a corporation or membership interest in a limited liability company). In those instances, notwithstanding a persistent myth that the IRS deems such assets' tax bases to be zero,[191] under the so-called Cohan rule (named after the *Cohan v. Commissioner* decision),[192] the taxpayer would be allowed to present circumstantial evidence to help estimate the asset's tax basis.[193] In this context, application of the Cohan rule alleviates potential hardship and minimizes the likelihood of inequitable outcomes. Indeed, even now, to determine the tax bases of inherited assets, taxpayers, executors, and personal representatives routinely employ the Cohan rule to make fair market estimations regarding inherited nonfungible assets such as interests in closely held businesses, artwork, and the like.[194] Needless to say, were a carryover tax basis proposal to become law, a similar process would transpire, but this time involving tax basis estimations of inherited assets.[195]

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190 *See Existing-Home Sales*, NAT'L ASS'N OF REALTORS (2016), http://www.realtor.org/sites/default/files/reports/2016/embargoes/ehs-10-20/ehs-09-2016-overview-2016-10-20.pdf (showing that the average sales prices for existing homes for 2013, 2014, and 2015 were $197,100, $208,300, and $222,400 respectively).

191 The IRS often asserts that a property's tax basis is equal to zero in those instances when taxpayers offer little or no proof to the contrary. Lerch v. Comm'r, 877 F.2d 624, 632 (7th Cir. 1989); O'Neill v. Comm'r, 271 F.2d 44, 49–50 (9th Cir. 1959); Allnutt v. Comm'r, T.C.M. (RIA) ¶ 2004-239, at 1463 (2004); Karara v. Comm'r, T.C.M. (RIA) ¶ 99,253, at 1656 (1999), *aff'd*, 214 F.3d 1358 (Table) (11th Cir. 2000); Coloman v. Comm'r, T.C.M. (RIA) ¶ 74,078, at 385 (1974).

192 Cohan v. Comm'r, 39 F.2d 540 (2d Cir. 1930).

193 *See e.g.*, S. Ry. Co. v. United States, 585 F.2d 466, 468 (Ct. Cl. 1978) (finding taxpayers incorporated during nineteenth century not responsible for failing to keep certain modern records); Reynolds v. Comm'r, T.C.M. (RIA) ¶ 99,062, at 364 (1999) (accepting taxpayer's claim that basis exceeded amount realized on gifted property from former cohabitant of twenty-four years, despite finding such figure could not be calculated to a "mathematical specificity"). *See generally* Soled, *supra* note 162, at 950–51.

194 *See, e.g.*, Thomas D. Hall, Comment, *Valuing Closely Held Stock: Control Premiums and Minority Discounts*, 31 EMORY L.J. 139, 157 (1982) ("The fair market value standard effectively requires that when one estimates the value of closely held stock one should hypothesize the close corporation in a market setting.").

195 While fair market value estimation exercises engender opportunities for taxpayer aggressiveness, their relative success in the I.R.C. § 1014 arena suggests that a tax basis estimation process would probably be just as successful and that neither exercise would prove inherently better or worse than the other.

D. *Virtues Associated with a Carryover Tax Basis Regime*

Passage of a permanent carryover tax basis rule at death would constitute a significant departure from past practices. The salient question, therefore, is whether reform of this magnitude is necessary and/or justified. For reasons related to our nation's need for (i) revenue, (ii) inequality reduction, and (iii) lock-in effect alleviation, there is no doubt that a carryover tax basis regime should be a legislative priority.

(i) *Revenue*. Consider first the fact that the nation's long-term fiscal picture looks bleak. For example, "14 cents of every dollar that Washington spent in 2014 was borrowed."[196] Such deficit spending has caused the national debt to grow larger and larger.[197] And due to the nation's greying population, Medicare costs are burgeoning,[198] casting an even darker financial shadow as red ink threatens to undermine many of the country's most vital programs. In most political circles, there is widespread recognition that something must be done, including the institution of measures that curtail expenditures and raise more revenue.[199]

One way of accomplishing the latter goal would be to institute the carryover tax basis rule at death. While institution of this rule would not be a fiscal panacea,[200] there are estimates that the existing step-up in basis rule costs the nation $70 billion annually and constitutes one of the Code's largest tax expenditures.[201]

(ii) *Inequality Reduction*. Another attractive feature of the carryover tax basis rule applicable at death is it would promote greater income equality. As

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196 ROMINA BOCCIA, THE HERITAGE FOUND., FEDERAL SPENDING BY THE NUMBERS, 2014: GOVERNMENT SPENDING TRENDS IN GRAPHICS, TABLES, AND KEY POINTS 2 (2014).

197 *See generally* COMM. FOR A RESPONSIBLE FED. BUDGET, FY 2015 DEFICIT FALLS TO $439 BILLION, BUT DEBT CONTINUES TO RISE (Oct. 15, 2015), http://crfb.org/papers/fy-2015-deficit-falls-439-billion-debt-continues-rise.

198 Dana P. Goldman & Neeraj Sood, *Rising Medicare Costs: Are We in Crisis?*, 25 HEALTH AFFAIRS 389 (2006).

199 *See, e.g.*, Christina D. Romer, *The Rock and the Hard Place on the Deficit*, N.Y. TIMES (July 2, 2011), http://www.nytimes.com/2011/07/03/business/economy/03view.html ("These long-term considerations, like the short-run concerns, point to a plan for reducing the deficit that combines spending cuts and tax increases.").

200 *See, e.g.*, Wilbur D. Steger & Frederick H. Rueter, *The Revenue Effects of Estate Tax Repeal and Basis Step-Up Limits*, 107 TAX NOTES 1314, 1315–16 (2005) ("Those results demonstrate that . . . [the] adoption of the specified limited step-up in basis will generate . . . tax revenues . . . over the period from 2005 through 2014. [The] net increase will consist of $202.5 billion in additional revenues from the capital gains tax and the personal income tax.").

201 *See* OFFICE OF MGMT. & BUDGET, FISCAL YEAR 2016: ANALYTICAL PERSPECTIVES OF THE U.S. GOVERNMENT 224 tbl.14-1, item 72 (2016) (estimating for 2017 a $70 billion annual cost associated with the basis equal to fair market value rule).

Tax expenditure items usually promote a perceived social goal. For example, the home interest deduction is supposed to encourage homeownership, while the exclusion for employer-provided health care insurance is supposed to encourage and promote medical insurance coverage. The basis equal to fair market value rule achieves no such social goals, being merely an item of administrative convenience.

was previously discussed,[202] those at the highest socioeconomic tiers hold title to the greatest amount of appreciated assets at death. Under the step-up in basis rule, this economic gain is sheltered from income tax, a financial benefit that inures disproportionately to the wealthy. Were Congress to repeal this rule and supplant it with a carryover tax basis rule, the embedded gains in these appreciated assets would be preserved in the hands of decedents' heirs and beneficiaries; at a later time, when these inherited assets were subsequently sold or exchanged, these gains would be recognized. To the extent that inherited assets thus pass primarily to the well-to-do heirs of the wealthy, a carryover tax basis rule would augment progressivity.

(iii) *Lock-In Effect Alleviation.* A final advantage associated with the carryover tax basis rule applicable at death is that it would help alleviate the lock-in effect, an explanation of which requires a brief review. As has been noted,[203] the U.S. income tax system[204] does not attempt to assess income based on annual asset value changes.[205] Rather, tax liability awaits the occurrence of a "realization event," typically the sale of the asset in question.[206] At the time of the sale (or other disposition) of the asset, all accumulated gains become taxable.

While this is thought to be the only practicable means of taxing gains on asset transactions, it has the significant shortcoming of discouraging taxpayers from realizing their accrued gains. More specifically, taxpayers can indefinitely postpone taxation by embracing a "hold strategy," which is ordinarily entirely within their control.[207] The step-up in basis rule exacerbates this hold strategy because lifetime accrued gains are permanently excluded from tax. Thus, indefinite tax deferral can easily become a complete income exclusion, as long as the asset is held until the asset owner's death. This hold

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202 *See supra* notes 183–84 and accompanying text.

203 *See supra* note 2.

204 While this Article is confined to a discussion of the U.S. income tax, the authors are aware of no income tax in any developed economy that attempts to tax gains as they accumulate; to the contrary, all contemporary income tax systems seem content to await a realization of gains by some transaction that closes out the taxpayer's investment in the relevant asset.

205 This exclusion is not explicit in the Code. Rather, it can be inferred from the language of I.R.C. § 61(a)(3) (2012), which advises that "[g]ains derived from dealings in property" are part of adjusted gross income. If gains were to be taxed annually, the reference to "dealings" would be inapt since gains would result from merely "holding" property. Similarly, the provisions of I.R.C §§ 1221–1223, distinguishing, among other things, long-term from short-term gains imply that multiyear gains are subject to taxation, not annual property valuation changes.

206 *See* I.R.C. § 1001(c) (noting that "the entire amount of the gain or loss . . . shall be recognized [in the year of disposition]").

207 Even when dispositions are forced upon taxpayers, such as by condemnation of the property for public use, destruction of the property, or the like, a generous deferral provision contained in I.R.C. § 1033 allows taxpayers to reinvest the proceeds of condemnation awards, insurance, or tort recoveries in similar assets without recognition of any gains that had accrued on the asset disposed of. Property transferred pursuant to a divorce is similarly protected from taxable recognition by I.R.C. § 1041.

strategy produces a "lock-in effect" on taxpayers' decisions about when (and if) they should realize their gains by entering into transactions that will be treated as taxable dispositions.[208]

Why is the lock-in effect a problem? There are two dimensions to this question. First, at the aggregate level, an economy in which asset owners are reluctant to sell is inefficient if assets are impeded from flowing from lower-value uses to higher-value uses.[209] Second, at the level of the individual owner/taxpayer, the lock-in effect reduces individual utility.[210]

The precise magnitude of the lock-in effect depends, of course, on many factors. Prominent among those factors is the tax rate imposed on long-term capital gains: when that rate is low, the disincentives are still present but matter less; when that tax rate is high, the disincentives are more salient.[211] Another factor is market performance of the asset in question: the greater

208 While gains are of course not literally "locked" in the hands of the taxpayer, the disincentives to engage in taxable transactions that can be easily avoided are powerful. The existence of a lock-in effect is thus virtually beyond dispute; the only differences of opinion relate to its magnitude. *See* Richard L. Schmalbeck, *The Uneasy Case for a Lower Capital Gains Tax: Why Not the Second Best?*, 48 TAX NOTES 195 (1990) (arguing that capital gains taxation was one of the few areas of income taxation in which it was plausible that lowering rates could actually increase revenue collected, due to relieving the lock-in effect), *reprinted in* THE CAPITAL GAINS CONTROVERSY: A TAX ANALYSTS READER 437 (J. Andrew Hoerner ed., 1992).

209 *See generally* Zhonglan Dai et al., *Capital Gains Taxes and Asset Prices: Capitalization or Lock-In?* (Nat'l Bureau of Econ. Research, Working Paper No. 12342, 2006), http://www.nber.org/papers/w12342.

210 An asset owner might prefer, all else being equal, to hold cash or a different asset rather than the asset she owns, for any number of reasons. Perhaps liquidation of the asset would simply be used to enhance the taxpayer's personal consumption horizon. Alternatively, the taxpayer might wish to diversify her portfolio of assets as part of a risk-management strategy. Finally, the asset holder may no longer be the best manager of the asset in question, which could be used more efficiently by another owner (e.g., if the asset is something that requires substantial management by the owner, such as an apartment building, it may be that the owner's advancing age makes her less able to manage optimally).

211 There is a considerable literature on the effect of rate changes on realization rates, much of which was produced in the early 1990s, when reducing the capital gains rate below the then-prevailing twenty-eight percent rate was being debated. Unsurprisingly for followers of public finance literature, that research produced mixed results. For example, the Treasury Department's Office of Tax Analysis estimated that President Bush's proposal to cut the capital gains rate would *increase* revenues by $12.5 billion dollars over the five-year revenue estimation period, because in its view, the reduced tax on each realization event would be more than offset by a (predicted) substantial increase in the *number* of realization events. DEP'T OF TREASURY, OFFICE OF TAX ANALYSIS, GENERAL EXPLANATIONS OF THE PRESIDENT'S BUDGET PROPOSALS AFFECTING RECEIPTS 10 (1990), https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY1991.pdf. In contrast, estimates of Congress's Joint Committee on Taxation suggested that reducing the capital gains rate would *reduce* revenue over the same period by $11.4 billion. STAFF OF JOINT COMM. ON TAXATION, JCS-12-90, EXPLANATION OF METHODOLOGY USED TO ESTIMATE PROPOSALS AFFECTING THE TAXATION OF INCOME FROM CAPITAL GAINS 3 (1990), https://www.jct.gov/publications.html?func=startdown&id=3157. The Joint Committee's estimates acknowledged that the rate reduction would increase the number of realization events, but

the historic appreciation in asset values, the greater the share of the sale price of the asset represents taxable gain and the less likelihood of a future sale.[212] A third factor is the taxpayer's assessment of the market outlook for *future* appreciation in the asset value.[213] A final important factor is the taxpayer's age and health.[214]

The proposed carryover basis proposal may not have a huge impact on the lock-in effect. It will still be in taxpayers' interests to defer the taxation of gain by holding assets rather than disposing of them. But the carryover basis proposal would reduce the compelling disincentive to retain assets late in life as a means of escaping capital gains taxation simply because a carryover basis rule would prevent that escape. Toward the end of life, what a taxpayer would get by retaining an asset is simply the possibility of continued deferral into the next generation as her heirs would inherit not only her assets but

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not by enough, the committee thought, to fully offset the revenue loss associated with the much lower tax rate. *Id.* at 2–3.

In his attempts to reconcile the two estimates in testimony before the Senate Finance Committee, Assistant Treasury Secretary Kenneth Gideon noted that estimates of the tax "elasticity" of realization rates (roughly, this refers to the percentage change in realized gains divided by the percentage change in the capital gains tax rates) among academic and government economists ranged from a low of 0.57 to a high of 3.80—an enormous range that left both the administration and Congress in great doubt about the true effects of tax rate changes. Jane G. Gravelle, *Can a Capital Gains Tax Cut Pay for Itself?*, 48 TAX NOTES 209, 211 (1990) (discussing statement of Kenneth W. Gideon, testimony before the Senate Finance Committee, Mar. 6, 1990). As one commentator put it, "[e]veryone agrees that lower capital gains taxes reduce the lock-in effect and result in more realizations." J. Andrew Hoerner, *News Analysis: Treasury's Capital Gains Estimates: Mr. Economist Goes to Washington*, 44 TAX NOTES 141, 142 (1989).

212 For example, if an asset has only a negligible basis—such as a founder's stock of a corporation—and will be taxed at a relatively high tax rate, the combined effect is daunting. A share of stock with a basis of $1 and a market value of $1000 will produce a tax liability of $299.70 if taxed at a 30% rate (i.e., 0.3 x ($1,000 – $1)). In contrast, a stock of the same value that has appreciated only 20% in value over the time the taxpayer has held it, if taxed at a rate of only 15%, will produce a tax of only $25 (i.e., this presumes that the stock had a basis of $833.33 (since $833.33 x 1.2 = $1000); so the resulting gain of $166.67 would, at a 15% rate, attract a tax liability of $166.67 x 0.15, or $25).

213 The taxpayer's willingness to hold the asset is obviously affected by her optimism about future gains or pessimism about future losses. This factor is, of course, idiosyncratic, since at any given moment, different taxpayers will reach different conclusions about the direction of future price movements affecting their asset portfolios. In fact, at equilibrium, the judgments should be roughly arrayed symmetrically around the current value of the asset since any significant asymmetry would lead to a resetting of the value of the asset to reflect the market's overall judgment about its future worth.

214 Auten & Joulfaian, *supra* note 112, at 226. Put differently, when the possibility of death draws near, a taxpayer becomes ever more aware that the angel of I.R.C. § 1014 (2012) is hovering over any assets in his portfolio, promising to cleanse those assets of any previously accumulated taxable gains. The promise that large gains will completely escape income taxation, if only the asset holder patiently retains the asset until his approaching death, is very difficult to resist.

also the tax basis in those assets. There would no longer be a cleansing of the capital gains tax by virtue of § 1014.[215]

While a carryover basis regime imperfectly addresses the lock-in effect, it is nevertheless the best that can be achieved. And it is clearly superior—in terms of reducing the lock-in effect, among other things—to the existing rule of unlimited deferral followed by forgiveness of gain at death. A carryover basis rule substantially diminishes the incentives to hold onto assets rather than realizing the gains on those assets at the time when that incentive is most acute—that is, as the taxpayer nears the end of her life.

E. An Added Estate Administrative Burden

Admittedly, the institution of the proposed carryover tax basis rule does have a blemish: its enactment would potentially complicate the estate administration process.

A simple example demonstrates the essence of the problem. Under current law, suppose a widow dies; she has two children, Jay and Kay, and she bequeaths her estate equally to them. Suppose further that the widow's estate consists of two buildings with the following adjusted bases and fair market values:

	Building *A*	Building *B*
Adjusted Basis	$0	$1,000,000
Fair Market Value	$1,000,000	$1,000,000

Under current law, the widow's beneficiaries would be indifferent regarding building receipt insofar as neither would have an embedded gain. In contrast, were Congress to enact the proposed carryover tax basis legislation, this would no longer be the case: Jay and Kay would both prefer Building *B* (with no embedded gain) rather than Building *A* (with a $1 million

215 If elimination or dramatic reduction of the lock-in effect is intensely desired, more radical suggestions would need to be considered. A system of taxing gain as it accumulates, through mandatory appraisal and reporting of asset values, would eliminate lock-in, albeit at a cost of enormous complexity and taxpayer dissatisfaction. An alternative proposal that avoids imposition of taxable events in the absence of transactions that generate cash is a system that would await the conventional realization event—a sale or other disposition—but one that would in effect charge the taxpayer interest to compensate the government for the loss of revenue due to the deferral of the tax obligation. If deferral plus makeup is the theoretical ideal but an impossible legislative approach (and only truly ideal if accompanied by some sort of system for indexing the basis of assets), then perhaps a second-best option would be the taxation of gains at death. *See infra* Part III. This would reduce the power of the lock-in effect, and would do so somewhat more effectively than a carryover basis regime would: it would end the period of tax deferral at the death of the first holder of the asset, while carryover basis permits continued deferral by the heir. However, in terms of administrative complexities and liquidity concerns, the taxation at death proposal suffers from similar political obstacles as does the first-best solution (i.e., deferral plus makeup).

embedded gain).[216] Due to the estate executor's duty of impartiality,[217] one solution would be that the widow's executors could place title to both buildings in the names of Jay and Kay as tenants in common. Admittedly, this could be a less-than-ideal solution if Jay and Kay were not on good terms, possibly compounded further had there been multiple estate beneficiaries (e.g., suppose the widow had ten children all sharing equally in her estate).[218]

Notwithstanding the fact that a carryover tax basis rule would complicate the estate administration process, the advantages associated with its institution far outweigh the administrative issue associated with estate distributions. The current step-up in basis rule was in the first instance a product of historical misunderstanding and administrative necessity,[219] which trumped revenue, equity, and economic concerns. As interpreted by the Supreme Court,[220] the Code now has a much better handle on the meaning of the word *income*—one that eschews prior misunderstandings incorporated into the law; furthermore, the Information Era has obviated the administrative necessity associated with the step-up in basis rule (i.e., an asset's tax basis is now much more easily identifiable).[221] Overall, the advantages of a carryover basis rule far outweigh the modest complications of estate administration that such a rule may entail.

III. Considering an Alternative: A Deemed Realization Rule

An alternative to a carryover basis regime would be a deemed realization rule upon death. Among the many virtues associated with such a rule are greater revenue generation, enhanced equity, and an income tax system more closely aligned with the Haig-Simons definition of income. Notwithstanding these virtues, there are several reasons why a deemed realization rule may not be desirable. Section III.A examines the virtues of a deemed

216 *See* Dodge, *supra* note 104, at 972 ("In the absence of pooling, fiduciaries—who are subject to a duty of impartiality—would face hard choices in effecting in-kind distributions. A particular legatee would not be pleased at receiving a low-basis asset (with a high built-in tax liability) in satisfaction of a legacy, while being told that another family member is receiving an equal-value distribution with a high basis because the latter happens to be in a higher tax bracket.").

217 *See* Restatement (Third) of Trusts §§ 183, 227(c)(1) (Am. Law Inst. 1992) (detailing a fiduciary's duty of impartiality).

218 Consider, too, that placing title to other assets (such as jewelry or artwork) in multiple names could prove even more challenging (raising rhetorical questions such as which beneficiary's wall the Monet would adorn).

Nevertheless, these estate administration problems could be overcome if the estate executor or personal representative chose to monetize the estate assets and then divide the proceeds. (This strategy, however, would engender an upfront tax cost generated by the realization of gain by the estate.)

219 *See* Zelenak, *supra* note 33 (manuscript at 1–2) (tracing I.R.C. § 1014's history and describing how, in all likelihood, this rule came into existence by administrative error).

220 Comm'r v. Glenshaw Glass Co., 348 U.S. 426, 429–30 (1955).

221 *See supra* Section II.A.

realization rule, Section III.B details the shortcomings associated with the institution of such a rule, and Section III.C weighs the desirability of a deemed realization rule compared to a carryover basis regime.

A. *Salient Attributes of a Deemed Realization Rule and Its Virtues*

A deemed realization rule would treat a taxpayer's death as a realization event for income tax purposes, meaning that all property held by the decedent would be treated as sold for its fair market value on the date of death. For example, if Taxpayer *X* purchased a farm for $1 million and later died when the farm was worth $10 million, then $9 million of gain would be subject to income tax upon the taxpayer's death. The taxpayer's heir would then take a cost basis in the inherited asset ($10 million in the preceding example), assuming the asset was not sold to fund the tax obligation.

Although a deemed realization rule has never achieved legislative traction,[222] it has been championed by academics,[223] and for good reason. From a theoretical perspective, taxing gains at death is far more in line with our current income tax system than a basis step-up at death. There is, quite simply, no theoretical justification for a rule that permanently exempts built-in gains from tax when a taxpayer dies. And while Haig-Simons purists would tax all gains as they accrue, taxing appreciation at death would be consistent with the Code's requirement that gains are taxed when a realization event occurs.[224]

Further, as compared to a carryover basis rule, some commentators have argued that a deemed realization rule taxes the "right" taxpayer at the correct marginal rate because the tax would be borne by the person who earned the taxable income (i.e., the decedent) and not his heirs, who may have a lower tax rate.[225] A realization rule would also make the tax system more equitable overall because § 1014's benefits inure primarily to the wealthy.[226]

In terms of reducing lock-in, a deemed realization rule would be a clear improvement over the current system. If taxpayers know that their accrued gains will be taxable upon death, they will have much less incentive to hold onto assets during their lifetime, as compared to the incentives created by § 1014.[227] Furthermore, as discussed above, a deemed realization rule is

222 *See, e.g.*, Kwall, *supra* note 46, at 80 n.16.

223 *See supra* note 9.

224 That is, unless a nonrecognition rule applies, such as those found in I.R.C. §§ 351, 721 & 1031 (2012).

225 *See* Zelenak, *supra* note 5, at 367.

226 *See* Lily L. Batchelder, *What Should Society Expect from Heirs? The Case for a Comprehensive Inheritance Tax*, 63 TAX L. REV. 1, 86 (2009); Dodge, *supra* note 8, at 476.

227 Dodge notes that lock-in would not be fully eliminated under a deemed realization rule because "appreciating property held by a multi-generational trust could be held without realization for a very long period of time." Dodge, *supra* note 8, at 442.

likely superior to a carryover basis rule from an efficiency perspective.[228] Although a carryover basis rule reduces the lock-in incentive for decedents during their lifetime, heirs who inherit property with large built-in gains will have an incentive to hold onto those properties to avoid taxable gain. A carryover basis rule would still ensure that the gain was taxed eventually and, thus, should reduce the lock-in effect overall, but probably not to the same degree that a deemed realization rule would.[229]

A deemed realization rule also avoids the potential estate administration issue posed by a carryover basis regime. As discussed in Section II.E, a carryover basis rule would present a challenge to estate administrators who must distribute properties with various amounts of built-in gain or loss.[230] Heirs will prefer assets with a high basis and want to be compensated for potential tax due on built-in asset gains. A deemed realization rule makes this issue moot. Because all built-in gain would be taxed prior to distribution of property to the heirs, the only relevant value would be the fair market value of the assets in the estate, making equitable distribution a much easier task for the estate administrator.[231]

Finally, and importantly, a deemed realization rule should raise more revenue in the short term as compared to a carryover basis rule. Although a carryover basis rule ensures that built-in gains on inherited property would be taxed eventually, tax on those gains could be deferred indefinitely into the future if heirs continued to hold the appreciated property. By contrast, a deemed realization rule would impose an immediate tax on decedents' property at the time of death, generating revenue before those assets are distributed to heirs. As a result of this crucial timing difference, studies have indicated that, within a narrow time frame, a deemed realization rule would generate significantly more revenue than a carryover basis rule.[232]

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228 *See supra* Section II.D; *see also* Johnson, *supra* note 9, at 1185 ("[C]arryover basis would decrease lock-in for the original owner before death and would increase lock-in for heirs, but by a lesser amount."); Zelenak, *supra* note 5, at 367 n.28.

229 *But see* Dodge, *supra* note 8, at 442 (arguing that a carryover basis rule might increase lock-in compared to I.R.C. § 1014 because I.R.C. § 1014 eliminates the lock-in incentive for heirs while a carryover basis creates the incentive for heirs).

230 *See supra* Section II.E.

231 *See* Zelenak, *supra* note 5, at 368.

232 *See* CONG. BUDGET OFFICE, REDUCING THE DEFICIT: SPENDING AND REVENUE OPTIONS: A REPORT TO THE SENATE AND HOUSE COMMITTEES ON THE BUDGET—PART II, at 368 (1990) (noting that a deemed realization rule would raise $10.1 billion from 1991 to 1995 compared to $3.4 billion from a carryover basis rule); *see also* Batchelder, *supra* note 226, at 86, 88 (noting that 25% of revenue raised by the estate tax could be raised by a deemed realization rule for gifts and bequests compared to 12% for a carryover basis rule). Dodge also notes that a carryover basis regime may continue to raise less revenue in the long run because heirs can hold assets indefinitely (passing them on to their heirs) without triggering gain, and realizations can be strategically timed. *See* Dodge, *supra* note 8, at 444.

B. *Shortcomings of a Deemed Realization Regime*

Notwithstanding the aforementioned virtues, a deemed realization rule suffers from several significant drawbacks. Most seriously, the valuation and liquidity issues posed by the rule would make it complex and difficult to administer.[233] Specifically, a realization rule would necessitate that all property in the decedent's estate be appraised at death to determine fair market value. This may prove contentious and costly, particularly for hard-to-value property like family heirlooms. Although various exemptions could be built into the rule to avoid some valuation difficulties, significant exceptions would weaken the revenue and efficiency benefits of deemed realization. On the other hand, a carryover basis regime avoids valuation concerns for the most part[234] because the appropriate fair market value of an asset can be established by the sale price when eventual disposition of the asset occurs.

Further, all of the potential difficulties with basis identification that are relevant to a carryover basis regime would also arise in the context of deemed realization because a realization rule would require assessing both basis and fair market value of each piece of property to determine gain or loss. In effect, a deemed realization rule presents two factual challenges (i.e., basis and fair market value), compared to one factual issue in a carryover basis regime (i.e., basis). And, as detailed above, determining basis should be simple in many cases due to electronic record keeping and third-party basis reporting; on the other hand, fair market value appraisals will always be necessary under a deemed realization regime even when decedents have kept diligent records.

Equally troubling from an administrative standpoint is that a deemed realization rule would create scenarios where estates do not have cash or liquid assets to cover income tax liability on the deemed sale of all of the assets. In that case, forced sales would have to be made, which may compel heirs to part with meaningful assets like heirlooms or family farms. Even for less meaningful assets, forced sales to meet tax obligations will delay distribution of inheritances and impose additional costs. While liquidity is also a potential issue under the estate tax, a deemed realization rule would make the concern far more pervasive, since many decedents die holding appreciated assets, but few estates are subject to the estate tax. Further, decedents who are subject to the estate tax are probably more likely to have sufficient liquid funds to cover tax obligations. These liquidity issues are moot under a carryover basis regime because a tax obligation won't arise until the heir sells an asset, which will generate funds to cover the obligation.

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233 *See* Dodge, *supra* note 8, at 433; Johnson, *supra* note 9, at 1185; Zelenak, *supra* note 5, at 367.

234 However, approximate fair market value determinations may need to be made if the estate administrator must determine how to equitably allocate significant built-in gains and losses in various assets. On the other hand, heirs might not care about built-in gain on property like family heirlooms that they don't intend to sell.

A deemed realization rule would also make transfers at death less favorable than transfers by gift for income tax purposes, whereas a carryover basis rule would impose parity between the two. A deemed realization rule would thus encourage taxpayers to gift their appreciated property during their lifetime to avoid tax and a potential forced sale upon death. If this effect were significant, it could offset much of the efficiency benefit lauded by advocates of a deemed realization rule. Rather than property being sold and put to more efficient uses during the decedent's lifetime, lifetime gifts of appreciated property may instead perpetuate the lock-in effect. One solution to this would be to restore parity in the treatment among transfers by gift and at death by also requiring deemed realization for gifts. But such a rule would be a monumental break from established tax law precedent[235] and would probably encounter substantial, and likely fatal, political opposition.

Further, whether a deemed realization rule applied to bequests only or to both gifts and bequests, taxpayers would seek to avoid its application by transfers of property to trusts.[236] The complexity of determining when a realization event has occurred under the various rules for trusts points further in the direction of a carryover basis rule, where this determination would not need to be made.

As commentators have noted, many of the administrative concerns surrounding a deemed realization rule are not insurmountable.[237] However, from a practical perspective, the biggest obstacles to instituting such a rule are public perception and politics. Specifically, taxing accrued gains at death under a deemed realization rule poses two public relations issues.

The first issue involves making death a realization event for income tax purposes. Such a rule would undoubtedly evoke the public's general unease with imposing *any* type of tax at death.[238] This unease underlies repeated calls by politicians to repeal the "death tax" (i.e., the estate tax)[239] and has led to carve-outs like the estate tax marital deduction, instituted to prevent the image of Uncle Sam standing graveside with widows and widowers. A deemed realization rule would also revive the familiar—though fallacious—argument that an income tax at death constitutes an unfair double tax in conjunction with an estate tax (an oft-cited justification for § 1014).[240]

The second public perception issue is that many people don't perceive events as being taxable when cash is not involved.[241] Thus, instituting a rule

235 *See* I.R.C. § 1015 (2012); Taft v. Bowers, 278 U.S. 470 (1929).

236 *See* Zelenak, *supra* note 5, at 409–10.

237 *See, e.g.*, Dodge, *supra* note 8, at 529–30.

238 *See, e.g.*, Dennis J. Ventry Jr., *Straight Talk About the 'Death' Tax: Politics, Economics, and Morality*, 89 TAX NOTES 1159, 1160 (2000) ("Average American taxpayers have been frightened into believing that the big, bad federal tax system will take all their assets at death, and leave their children destitute.").

239 *See supra* note 78 and accompanying text.

240 *See supra* note 83 and accompanying text.

241 *Cf.* Terrence R. Chorvat, *Perception and Income: The Behavioral Economics of the Realization Doctrine*, 36 CONN. L. REV. 75, 112 (2003) ("[W]hen individuals receive cash or property other than that in which they have invested, they tend to view this receipt [as a gain].

that imposes income tax upon the passing of an asset from decedent to heir will run counter to expectations and stir resentment if assets must be liquidated to fund the tax obligation. The longstanding treatment of gifts as *not* implicating income tax obligations for donees further bolsters this perception. In sum, Congress would face an uphill and, at this time, likely insurmountable battle were it to try to institute a deemed realization rule.

C. *Weighing the Two Options*

Notwithstanding the preceding discussion, the goal of this Article is not to persuade the reader that a carryover basis regime is superior to a deemed realization rule. As noted, deemed realization is likely superior in terms of equity, efficiency, and revenue. It is not superior to carryover basis, however, in terms of administrability and political feasibility.

Though carryover basis reform has not succeeded in the past two attempts, history suggests that there is political will to reform § 1014 and substitute a carryover basis rule for the existing step-up in basis rule. Legislators could learn from the mistakes of previous carryover basis provisions and enact a much simpler rule that is not burdened with exemptions and adjustments. Additionally, a vitally important external circumstance has come into play in the current environment: technological advancement. Electronic record keeping and basis reporting now make tracking basis viable when it previously was not. Thus, from a political perspective, a carryover basis regime can be viewed as updating the tax law to comport with modern realities.

In contrast, instituting deemed realization—despite its virtues—would not simply reflect advances in technology but a desire to institute a fundamental shift in the way we tax transfers at death. To go from a system in which heirs receive a full fair market value basis step-up to a system under which built-in gain is taxed would be a dramatic and wildly unpopular policy change. In particular, the fact that a deemed realization rule would require the liquidation of assets from many estates would give opponents a highly salient rallying cry that the government is going to "take their property" at death.

Carryover basis, on the other hand, is far less distasteful because it won't impose tax at the time of death. While not perfect, it's a step in the right direction.

Conclusion

For nearly a century, Congress has sanctioned the step-up in basis rule, enabling it to become one of the most significant revenue drains in the Code while being, at the same time, one of the least justified. It is not an exaggeration to say that what essentially amounts to a rule of convenience has, since

However, they do not view unrealized gains as real." (footnote omitted)). For example, investors exhibit a preference for cash dividends over an increase in the value of their shares even when that preference is not economically rational. *See id.* at 109–10.

its institution, resulted in well over a trillion dollars of lost revenue and skewed the scales of equity in a way that decidedly favors those taxpayers who are economically well-to-do.

When a rule of convenience does such tremendous damage to the fabric of the nation's tax system, it requires periodic reevaluations to determine whether its retention is still warranted. If a thorough investigation reveals that retention lacks merit, then reform is in order. In a day and age when the nation's transfer tax system is virtually nonexistent, technology greatly facilitates tax basis maintenance and retention, and economic disparities abound, the nation appears poised for meaningful change and is positioned to scrap a rule that is anachronistic, inefficient, and inequitable.

As previously pointed out, a fundamental precept in the Code is that gains and losses are computed by taxing the difference between the amount realized upon a sale or exchange and an asset's adjusted tax basis. For the time being, it makes sense to isolate one part of this equation, namely, proper asset tax basis identification, and require its subsequent use with respect to assets held in the hands of a decedent's beneficiaries.