THE MEEK SHALL INHERIT THE EARTH WITH A STEPPED-UP BASIS: ALTERNATIVES TO STEPPED-UP BASIS AT DEATH

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I. INTRODUCTION

At the 2015 State of the Union Address, President Obama announced his plans for tax reform. One of the goals of this reform was to close, what some believe is "the largest single loophole in the entire individual income tax code," the stepped-up basis provision.[1]

Stepped-up basis refers to section 1014 of the Internal Revenue Code (the Code), which states that assets acquired or passed from a decedent receive a step-up in basis to the fair market value of the property at the date of the decedent's death.[2] This means that the built-in gain of the property is never subject to income tax and the gain essentially disappears, as it is exempt from taxes forever. For example, consider a person holding $5 million worth of stock originally purchased for $1 million. If he sells the stock the day before he dies, there would be $4 million of gain subject to income tax, which at the top Federal capital gains rate of 23.8 percent would result in a tax liability of $952,000. If instead the taxpayer held on to the $5 million worth of stock until his death and his beneficiaries then sold the stock one day after he died, the stock would receive a basis step-up to the fair market value of the property at the date of the decedent's death, which in this case is $5 million. Therefore, no gain would be realized upon the disposition. The $4 million of built-in gain would escape taxation forever.

In a November 2007 Senate Hearing regarding the estate tax, Warren Buffet argued those who referred to the estate tax as the "death tax" were misrepresenting the tax. He thought, if the estate tax were to be renamed, it should more appropriately be called "the death present" because "far more people who die receive a large tax benefit…namely, a stepped-up basis on appreciated assets."[3] Others have referred to this phenomenon as the "Angel of Death Loophole."[4] This paper will evaluate this loophole and whether the current system of stepped-up basis should be replaced.

In 2014, the revenue collected from estate and gift taxes was $19.3 billion, amounting to only 0.6 percent of the total net Federal tax collections for the year.[5] Addressing the issue of stepped-up basis will be able to increase revenues without changing the overall wealth transfer system. Very few taxpayers owe Federal estate tax at death and the number has continued to decrease as the Federal estate tax exemption increases. In 2013, there were 2.6 million deaths in the United States and only 4,700 estate tax returns reporting tax liability were filed.[6] Only one-fifth of one percent of individuals dying in 2013 owed Federal estate tax.[7] While the revenue raised by the estate tax may seem like a small part of overall revenue from the tax system, it is not insignificant and the stepped-up basis provision allows an enormous amount of gain to escape taxation each year resulting in a loss of potential revenue. While less than 0.2 percent of estates are subject to the estate tax, every person who dies with assets is given the benefit of a stepped-up basis in that property. As the justification for the estate tax has shifted towards social policy reasons such as equity and fairness, stepped-up basis has been viewed as an abatement to estate taxes, but as the Federal estate tax exemption has increased, few are subject to the estate tax, while everyone, including many that have the ability to pay tax on the appreciation of gains, receives the benefit of stepped-up basis. "Exempting unrealized capital gains on assets held at death is a tax expenditure."[8] For 2016, the estimated total tax expenditure for unrealized capital gains on assets held at death is $32.9 billion.[9] This number rises to $66.67 billion if death is treated as a realization event, though.[10] That is more than triple the amount of revenue the estate tax raised in 2014!

This paper will examine the current system of stepped-up basis along with possible options for reform. In Part II, this paper will detail the history of the estate tax and stepped-up basis treatment. Part III will evaluate seven options for treatment of gains at death, including the current system of stepped-up basis. Part IV addresses some of the concerns related to switching to a system that does not use stepped-up basis. Finally, Part V concludes a variation of a system that implements a limited stepped-up basis with carryover basis for the excess is the best option for reformation because it will raise revenue by capturing gain that previously escaped taxation and it aligns with the modern purpose of the wealth transfer system to prevent concentrations of wealth and tax those with the greatest ability to pay.

II. HISTORY

The precursor to the modern estate tax dates back to 1797 as a stamp duty on legacies to finance the military support needed during a time of hostility with the French.[11] The original purpose of the estate tax was purely to raise revenue.[12] In fact, until 1916, "the estate tax was imposed only periodically to finance wars or threats of war, and was repealed at the end of the hostilities."[13] In 1916, a system similar to the modern estate tax regime was implemented to finance World War I and was not repealed after the war due to the concern of loss of revenue.[14]

It was not until the early 1900s that the estate tax evolved into a tool of social policy.[15] Despite its original purpose of raising revenue, the estate tax was used as a justification for social engineering. President Theodore Roosevelt advocated for an estate tax as a way to combat high concentrations of wealth and inequalities in wealth.[16] The estate tax is the most progressive tax in the entire federal tax regime. Its progressivity allowed the estate tax to evolve into legislation that exemplified the core values of America; these ideals being fairness and equality for all. In a 1935 message to Congress on tax revision, Franklin Delano Roosevelt said, "The transmission from generation to generation of vast fortunes by will, inheritance, or gift is not consistent with the ideals and sentiments of the American people."[17]

The basis provisions of the modern estate tax were codified in the Revenue Act of 1921.[18] Included in this were provisions related to the step-up in basis at death. “Prior to 1921, it was the administrative practice of the Bureau of Internal Revenue to fix the basis of property acquired by bequest at the fair market value on the date of death.”[19] Originally, the practice of step-up basis does not appear to have been a result of any specific policy decision, but may have been for the ease of administration and determining basis.[20] Over time, the justification for stepped-up basis treatment evolved into the avoidance of double taxation.[21] Stepping-up the basis in property to fair market value ensures that property will not be subject to both estate tax and income tax. Additionally, stepped-up basis served as a check on estates subject to the estate tax that are incentivized to minimize the value of the decedent’s assets to avoid estate taxation on as much of the estate as possible.[22]

Stepped-up basis treatment for property transferred at death remained the status quo from its codification in 1921 until 1976. In the Tax Reform Act of 1976, Congress replaced stepped-up basis with carryover basis, section 1023 of the Code, for property acquired at death.[23] “Congress added the carryover basis provision to the Act very late in the legislative process, with little opportunity for either input from interest groups or careful technical drafting.”[24] As a result of these time constraints, the carryover provision in the 1976 Tax Reform Act was not properly considered, as there were no hearings on the provision before the Senate or the Senate Finance Committee prior to the Act’s implementation.[25] Due to the lack of proper consideration of the carryover basis provision, the legislation was lacking in procedures for implementation and administrability and therefore “practical application of the provision…produced a number of serious problems.”[26] Many professional organizations even staged protests against the carryover basis provision because of its procedural difficulties.[27] Throughout the next few years, revisions were proposed to clean up the implementation of the provision, but there was so much pushback that the carryover basis rule was finally retroactively repealed in 1980.[28] This attempt to impose carryover basis on property transferred at death has been regarded as "one of the greatest legislative fiascoes in the history of the income tax"[29] and thus, it is understandable why the issue of stepped-up basis was not revisited for nearly two decades.

In the late 1990s and early 2000s, the repeal of the estate tax rather than stepped-up basis was the focus of proposed legislation. President Clinton vetoed the Taxpayer Refund and Relief Act of 1999 and the Death Tax Elimination Act of 2000, which both sought to repeal the estate tax, but the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) was passed under President Bush.[30] With the passage of the EGTRRA in 2001, exemption levels for the estate and gift taxes gradually increased and tax rates declined until 2010, when the estate tax would be repealed for the year.[31] The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 reinstated the estate tax, but executors of estates of those dying in 2010 could make an election to apply the EGTRRA rules, so the estate would not be subjected to an estate tax, but modified carryover basis would be applied to the decedent's property.[32] The election was only available for 2010 however, as the estate tax returned in 2011, but with a higher exemption amount, that would be adjusted for inflation.

Estate Tax Exclusion Amounts and Tax Rates[33]
1998-2016

Year	Estate Tax Applicable Exclusion Amount	Starting Tax Rate on Estate above Exclusion Amount
1998	625,000	37%
1999	650,000	37%
2000	675,000	37%
2001	675,000	37%
2002	1,000,000	41%
2003	1,000,000	41%
2004	1,500,000	45%
2005	1,500,000	45%

2006	2,000,000	46%
2007	2,000,000	45%
2008	2,000,000	45%
2009	3,500,000	45%
2010	5,000,000	35%
2011[34]	5,000,000	35%
2012	5,120,000	35%
2013	5,250,000	40%
2014	5,340,000	40%
2015	5,430,000	40%
2016	5,450,000	40%

As the estate tax exemption amount has sharply increased in recent years, fewer and fewer individuals are subject to the estate tax. Previously, appreciated assets not being subject to income tax was not much of a concern because many of the people holding those assets would be subject to the estate tax. Now, with such a high exemption amount, the property of most of these individuals escapes taxation altogether because very few individuals owe estate tax.

The regulations state that the purpose of section 1014 is "to provide a basis for property acquired from a decedent, which is equal to the value placed upon such property for purposes of the Federal estate tax."[35] The valuation of an estate for federal tax purposes is based on the fair market value of the decedent's property and therefore the theory is that to avoid double taxation the basis of the property should be stepped-up to fair market value, so that the assets are not subject to both estate tax and income tax. In more recent attempts to repeal the estate tax (1999, 2000, 2001), the benefit of a stepped-up basis was repealed along with it. Although stepped-up basis appeared to originally arise for administrative simplicity, the estate tax has more recently been justified for social policy reasons such as fairness and equity and the step-up in basis has been viewed as a benefit received as a tradeoff for the estate tax.[36]

Just as Warren Buffet termed the estate tax and stepped-up basis benefit "the death present," stepped-up basis is viewed as a significant benefit, which is often at the center of many estate planning schemes. Today, very few people are actually affected by the estate tax because of the sharp increase in the Federal estate tax exemption resulting from the EGTRRA and the Tax Relief Act of 2010 legislation, so the stepped-up basis provision has become a loophole for many. Stepped-up basis for these individuals is not a tradeoff for paying the estate tax, it is purely beneficial. For the majority of individuals, stepped-up basis is not needed to avoid double taxation because 99.8 percent of estates are not subject to the estate tax. Stepped-up basis is not necessary to carry out its legislative purpose of avoiding double taxation when it is applied to most people. Another system of determining basis or the taxation of gain at death may better align with the desired progressivity of the wealth transfer system.

III. PROPOSALS FOR TREATMENT OF GAINS AT DEATH

When evaluating whether a tax regime is "good" or "bad," this paper will examine the current system and reformation ideas with an eye toward the policy considerations of equity and fairness, efficiency, and administrability. Equity and fairness evaluate how the solutions effect vertical equity, i.e., how to tax those with different levels of income and wealth, specifically the progressivity of the system; and horizontal equity, i.e., treating those in similar economic situations equally. With efficiency there is an aim toward neutrality and reducing efficiency costs. Administrability considers the transparency of the law, the costs to taxpayers to comply with the law, and the ability and cost to the government to administer the law.

When evaluating the different tax regimes, this paper will utilize a hypothetical decedent's situation to show the effect of the regimes on the net totals given to beneficiaries and the total tax liabilities. The same hypothetical scenario will be revisited for each regime. In these hypothetical scenarios, Mr. Comfortable, a decedent who has $2 million of total assets, and Mr. Wealthy, who has $10 million of total assets, are compared. The paper evaluates the scenarios where each of these individuals owns $1 million of marketable securities as part of their total assets and compares the outcomes when the basis in the $1 million of marketable securities is alternatively $200,000 and $800,000 for each individual. For these scenarios, there are several assumptions that remain constant throughout the application of each tax regime. The assumptions are the following:

Assumptions

- Federal Estate Tax Exemption = $5,450,000[37]
- Federal Estate Tax Rate Excess = 40%[38]
- Federal Long Term Capital Gains Tax Rate = 23.8%[39]
- Mr. Wealthy and Mr. Comfortable live in a state with no State Estate or Inheritance Tax[40]
- Mr. Wealthy and Mr. Comfortable live in a state with a 5% State Income Tax on Capital Gains[41]
- Mr. Wealthy has $10,000,000 in assets
- Mr. Comfortable has $2,000,000 in assets
- Both Mr. Wealthy and Mr. Comfortable own $1,000,000 of marketable securities as part of their assets
- Mr. Wealthy and Mr. Comfortable are both single
- Mr. Wealthy and Mr. Comfortable both die in 2016
- Beneficiary sells the $1 million of inherited marketable securities in 2016

A. CURRENT SYSTEM

The current system employed under section 1014 of the Code states that the basis of property acquired from a decedent shall be the fair market value of the property at the date of the decedent's death.[42] This results in a step-up or step-down in basis from the basis of the property when held in the decedent's hands, but more often than not the result is a step-up in basis.

One of the negatives of the stepped-up basis system is that it provides equal treatment for assets of the same fair market value, regardless of the basis the decedent held in the property. The after-death basis for Mr. Comfortable and Mr. Wealthy is the same regardless of the basis they each hold in their $1 million of marketable securities before death. When comparing the value and the difference in basis of Mr. Comfortable and Mr. Wealthy's $1 million worth of marketable securities, it is important to keep the Haig-Simons definition of income in mind. Henry Simons wrote that income is "the result obtained by adding consumption during the period to 'wealth' at the end of the period and then subtracting 'wealth' at the beginning. The *sine qua* *non* of income is gain…and gain to someone during a specified time interval."[43] Under the current system of stepped-up basis, it is irrelevant that the asset with 20 percent basis has accumulated more built-in gain than the asset with 80 percent basis. Mr. Comfortable's and Mr. Wealthy's $1 million of marketable securities is treated exactly the same regardless of the basis they hold in the property despite the asset with 20 percent basis providing Mr. Comfortable and Mr. Wealthy with more income, under the Haig-Simons definition of income.

Current System

	Mr. Comfortable		Mr. Wealthy	
	20% Basis ($200,000 Basis)	80% Basis ($800,000 Basis)	20% Basis ($200,000 Basis)	80% Basis ($800,000 Basis)
Starting Asset	$1,000,000	$1,000,000	$1,000,000	$1,000,000
less Federal Estate Tax (40%)	0	0	($400,000)	($400,000)
less Federal Capital Gains Tax (23.8%)	0	0	0	0
less State Income Tax on capital gains (5%)	0	0	0	0
Net to beneficiary	$1,000,000	$1,000,000	$600,000	$600,000
Total Tax Liability	$0	$0	($400,000)	($400,000)

The current system of stepped-up basis generates inefficiency by creating a lock-in effect. The lock-in effect is the idea that people are disincentivized to sell their assets before death because they want to avoid realization of gain. Individuals know that if they hold on to their assets, especially highly appreciated assets, the gain will escape taxation forever.[44] This breeds market inefficiency. If there were no step-up in basis at death there would be little incentive to hold onto highly appreciated assets and therefore people would be more likely to base their portfolio decisions on maximizing profits rather than avoiding taxation. This would result in many more transactions before a person's death and the government would be able to collect additional revenue from the increase in buying and selling of assets before death.

Conversely, the stepped-up basis regime may encourage the disposition of property by beneficiaries because they are able to immediately sell property acquired from the decedent and not have to recognize any gain. This may still create market inefficiencies though because individuals are basing their decisions on taxation rather than maximizing their portfolio.

The stepped-up basis regime violates vertical equity. While the estate tax is extremely progressive, the stepped-up basis provision is actually regressive because even though stepped-up basis is available to everyone, wealthy individuals disproportionately hold highly appreciated property such as capital assets, so they are most able to take advantage of the step-up in basis. Almost 95 percent of long-term capital gains holdings are held by those in the top 20 percent of income-earners, with nearly 70 percent being held by the top one percent.[45] Those that are wealthy enough to hold onto their property until death are able to take advantage of the stepped-up basis provision. Conversely, those that do not have as much wealth and are forced to liquidate assets because they are in need of funds, during retirement for example, are forced to recognize all of their built-in gain. Only the wealthiest individuals are able to take advantage of a step-up in basis because they can afford to defer the disposition of assets and therefore realization of gain to the future and in many cases forever because they hold the property until death.

One of the benefits of the stepped-up basis provision is that it avoids double taxation, as this is the main purpose of section 1014.[46] The property of the estate is valued at fair market value for estate purposes, so to avoid being additionally subject to income tax, the property must be stepped-up to fair market value. Another benefit for beneficiaries is that all post-death appreciation is deemed to be long term capital gain, regardless of the actual holding period.[47]

There is a concern of overvaluation of hard to value property under the stepped-up basis system. The sharp increase of the Federal estate tax exemption has resulted in the potential abuse of section 1014. Those that are not subject to the estate tax have an extreme incentive to overvalue property to take advantage of the step-up in basis. For example, under the current system, Mr. Comfortable has an incentive to value his property to the highest levels within reason, but previously when the estate tax exemption was lower and he was subject to the estate tax, the higher rate of the estate tax compared to capital gains rates would keep the incentive to overvalue his property in check because even though his beneficiaries would hold the property with a lower basis, it would be subject to lower income tax rates. The government was able to compensate for property valuations on the lower end of the spectrum by collecting income tax on a larger amount of built-in gain when appreciated property was disposed of. The high estate tax exemption has created an environment where individuals with estates valued up to the Federal estate tax exemption have great incentive to value their property as high as possible within reason.[48]

The most likely reason stepped-up basis has been able to withstand reform efforts is that the ease of administration that it provides has seemed to outweigh the negatives of the system. Unless death is treated as recognition event, determining basis with the fair market value of property makes investigating the decedent's recordkeeping for pre-death basis purposes essentially unnecessary. The problems of the system have been exacerbated though by the sharp increase in the Federal estate tax exemption as many wealthy individuals that fall below the high exemption are not subject to any estate or income tax on their property.

B. PURE CARRYOVER

Under a "Pure Carryover" system of assessing basis at death, the beneficiary would hold the property acquired from the decedent with the same basis as the decedent held in the property at the decedent's date of death. In 2010, the executors of estates that were subject to the estate tax with a stepped-up basis in the decedent's property could elect to have no estate tax, but the property would be transferred with a modified carryover basis. The "Pure Carryover" regime differs in that if the decedent's assets exceeded the Federal estate tax exemption threshold, they would be subject to the estate tax *and* carryover basis would be implemented.

This regime decreases the amount of progressivity of the estate tax system, as those that were not previously subjected to the estate tax, such as Mr. Comfortable, will now be subject to capital gains taxes due to the appreciation of their assets, whereas under the stepped-up basis system they avoided all taxation. From a revenue standpoint, this is a good thing because the implementation of carryover basis will help to capture much of the appreciated gain that is lost through the step-up in basis. To preserve progressivity, it would be best that not everyone is subject to carryover basis, but it may be less of a concern because those in the lowest income brackets hold very few capital assets and thus, would be less affected by carryover basis. It is probably best to apply carryover basis after a threshold estate amount at the level where there is enough added revenue to make the increased costs of implementing the system worth it. A threshold could be used where everyone is allowed up to $1 million of basis step-up and the excess is subject to carryover basis, so anyone falling below the threshold will still use the stepped-up basis system.

Pure Carryover

	Mr. Comfortable		Mr. Wealthy	
	20% Basis ($200,000 Basis)	80% Basis ($800,000 Basis)	20% Basis ($200,000 Basis)	80% Basis ($800,000 Basis)
Starting Asset	$1,000,000	$1,000,000	$1,000,000	$1,000,000
less Federal Estate Tax (40%)	0	0	($400,000)	($400,000)
less Federal Capital Gains Tax (23.8%)	($190,400)	($47,600)	($190,400)	($47,600)
less State Income Tax on capital gains (5%)	($40,000)	($10,000)	($40,000)	($10,000)
Net to beneficiary	$769,600	$942,400	$369,600	$542,400
Total Tax Liability	($230,400)	($57,600)	($630,400)	($457,600)

The benefit of the “Pure Carryover” system is that it would be able to recapture some of the tax lost from individuals, most notably, in the $1 million to $5.449 million range who are not currently subject to the estate tax or income tax, but have the ability to pay more in tax. As evidenced by Mr. Comfortable and Mr. Wealthy, progressivity is preserved in the fact that Mr. Wealthy is subject to a much higher tax penalty resulting from the combination of the estate and income tax, whereas Mr. Comfortable is only subject to the much lower income tax rates. Pure carryover does result in a very high overall tax rate for Mr. Wealthy, ranging from 46 percent to 63 percent, depending on the basis in his $1 million of marketable securities. A tax rate this high may create inefficiencies by disincentivizing individuals to work or save and make more money if they know it will be taxed so highly.

The tax liabilities for Mr. Comfortable and Mr. Wealthy under this system are made with the assumption that the beneficiary disposes of the assets and therefore realizes the built-in gain of the assets in 2016. With a carryover basis though, beneficiaries have the benefit of being able to choose when they realize the gain and therefore they can defer the gain to the future. This benefit disproportionately helps wealthier beneficiaries though because they are the individuals who can afford to defer the gain rather than a person who must dispose of the assets because they need to use the funds now.

Because of this indefinite deferral of gain, it is difficult to estimate exactly how much additional revenue a system based on carryover basis would raise. While there is still the opportunity to defer gain, there would not be the same lock-in effect created by stepped-up basis because gain does not disappear. A person would still be able to avoid taxation if they continue to hold the property for generations, but in actuality there are probably very few assets in which individuals will continue to hold for generations and generations without some kind of disposition. Transferees would be able to indefinitely defer their gain if they are able put off the disposition of inherited property.[49] Individuals that are most likely to be able to take advantage of this are wealthy individuals who are not in need of the funds, but this would also be potentially beneficial to small business owners and farmers who would like to keep their business or farm in the family for multiple generations.

One of the benefits of a carryover system is that the basis of the property is taken into account when determining the amount of tax liability. Where the stepped-up basis system failed in terms of the Haig-Simons definition of income, this system captures the difference in gain between the 20 percent basis assets and the 80 percent basis assets, despite their equal fair market value. A carryover basis system is more in line with the Haig-Simons definition of income and its relation to gain. Although a "Pure Carryover" system still allows a deferral of the recognition of gain, whereas a true Haig-Simons approach would tax gains each year as they accrue.

The implementation of carryover basis for everyone would be administratively troublesome. Many people do not have enough assets where implementing carryover basis would make it worthwhile from an added revenue standpoint. This is another reason why it may be best to implement carryover basis only on assets above a designated threshold. There would also be an increase in filings as those that are not subject to the estate tax, but are subject to carryover basis will probably need to make some kind of filing now to document their carryover basis, whereas currently only those subject to the estate tax must make a filing.[50] Also, while most individuals that are subject to an estate tax work with professionals such as lawyers or accountants, most of those that are not subject to the estate tax will not have worked with professionals and probably will not be as prepared to deal with the implementation of carryover basis from a records standpoint. Additionally, because people have not needed to maintain records for basis purposes for those assets retained until death in the current system, many people will not have proper documentation to determine the carryover basis.

Administrative difficulties was the main reason for the retroactive repeal of carryover basis treatment in the Tax Reform Act of 1976,[51] but recordkeeping for basis purposes would be much easier today with advances in technology. The basis of many types of assets are already tracked. For example, since 2011 brokerage firms have been required to report gains and losses of stock to their customers for tax reporting purposes.[52] Hard to value property would still present basis reporting issues, but it is something that over time would become less of a problem as individuals improve their basis record-keeping practices.

The "Pure Carryover" system does a better job of capturing the built-in gain that currently escapes taxation; although it is unclear how much would be immediately recaptured upon the death of an individual because of the possibility of indefinite deferral of gain. The administration of the system presents some concerns, but the problems would not rise to the level of those in the late 1970s, when there was an attempt to implement carryover basis, because of the use of technology in tracking basis. The higher tax rate on the assets of those subject to the estate tax, like Mr. Wealthy, is troublesome, but individuals would have the benefit of choosing when to dispose of the property and recognize the gain, although this benefit seems to be disproportionately available to the wealthy.

C. CARRYOVER UNDER SECTION 1015

A "Carryover under Section 1015" regime is similar to pure carryover in that the basis of the property acquired from the decedent would be the basis the decedent held in the property, but under section 1015 of the Code there is an increase in basis for gift tax paid. The increase in basis of the property "shall be an amount (not in excess of tax so paid) which bears the same ratio to the amount of tax so paid as the net appreciation in value of the gift, bears to the amount of the gift,"[53] with net appreciation being "the amount by which the fair market value of the gift exceeds the donor's adjusted basis immediately before the gift."[54] Applying section 1015 to the estate tax, the basis of the property would be increased depending on the amount of estate tax paid and the amount of appreciation of the property. There would effectively be an amount reserved to increase (or step-up) basis, which is equal to the amount of estate tax paid by the decedent multiplied by the ratio of built-in gain. Once the amount of tax paid has been allocated, there will be no further increase in basis.

Carryover under Section 1015

	Mr. Comfortable		Mr. Wealthy	
	20% Basis (200,000 Basis)	80% Basis (800,000 Basis)	20% Basis (200,000 Basis)	80% Basis (800,000 Basis)
Starting Asset	$1,000,000	$1,000,000	$1,000,000	$1,000,000
less Federal Estate Tax (40%)	0	0	($400,000)	($400,000)
less Federal Capital Gains Tax (23.8%)	($190,400)	($47,600)	($114,240)[55]	($28,560)[56]
less State Income Tax on capital gains (5%)	($40,000)	($10,000)	($24,000)	($6,000)
Net to beneficiary	$769,600	$942,400	$461,760	$565,440
Total Tax Liability	($230,400)	($57,600)	($538,240)	($434,560)

Many of the benefits of the "Pure Carryover" system hold true for this regime, such as the ability to capture and tax the built-in gain to raise additional revenue and the different treatment of assets with different amounts of gain. For individuals, like Mr. Comfortable, who are not subject to the estate tax, their beneficiaries' tax liability would be the same as under the "Pure Carryover" system. The difference between the regimes lies in the scenario illustrated by Mr. Wealthy's estate. To lessen the effects of double taxation, someone who is subject to the estate tax, receives an increase in their basis depending on estate tax paid and their ratio of appreciated gain. Here, the highest tax rate Mr. Wealthy is subjected to is 54 percent. For those that pay an estate tax, they receive the benefit of having reduced income taxes, so this achieves some of what stepped-up basis was trying to achieve, but not to the full extent that section 1014 allows. Therefore, the system is able to retain its progressivity while lessening the burdens of double taxation.

In addition to the administrative concerns raised in the previous section regarding basis record keeping, this system also presents issues regarding transparency and complexity. Determining the ratio of gain and applying it to all of the decedent's assets could be complex and tedious increasing the costs of compliance. Individuals affected by this system, those paying the estate tax, would almost surely need to work with a professional to determine tax liabilities, although most that pay the estate tax are already working with professionals on their estate planning.

Overall, the benefits a system of carryover basis under section 1015 provides in raising additional revenue by being able to capture and tax built-in gains, while also lessening the burdens of double taxation, may be outweighed by the complexity of the system.

D. Canadian System – Death is a Deemed Recognition Event

In Canada, there is no estate tax, but at death there is a deemed disposition of property and therefore there is a recognition of the built-in gain that has appreciated in the decedent's assets.[57] In applying this idea to the United States, this paper assumes the estate tax would remain, but there would be a deemed disposition of the decedent's property. This gain would be reported on the decedent's final, Individual Income Tax Return, Form 1040.

This regime is similar to the proposal President Obama made in 2015 to address the concerns presented by the stepped-up basis provision. His proposal "would close the stepped-up basis loophole by treating bequests and gifts other than to charitable organizations as realization events, like other cases where assets change hands."[58] To lessen tax and compliance burdens on middle class families, Obama also proposed that there be a capital gains exemption of $100,000 per individual, along with other exemptions for personal residences, certain tangible personal property, and protections for small businesses and farms.[59]

One benefit this regime provides for the taxpayer is that the built-in gain is recognized at the decedent's death, so the income tax liability would be determined prior to the estate tax as a deductible debt of the estate, resulting in a smaller amount subject to the 40 percent estate tax rate, lessening the overall tax rate. This helps to limit the amount of double taxation.

Canadian System

	Mr. Comfortable		Mr. Wealthy	
	20% Basis (200,000 Basis)	80% Basis (800,000 Basis)	20% Basis (200,000 Basis)	80% Basis (800,000 Basis)
Starting Asset	$1,000,000	$1,000,000	$1,000,000	$1,000,000
less Federal Estate Tax (40%)	0	0	($307,840)[60]	($376,960)[61]
less Federal Capital Gains Tax (23.8%)	($190,400)	($47,600)	($190,400)	($47,600)
less State Income Tax on capital gains (5%)	($40,000)	($10,000)	($40,000)	($10,000)
Net to beneficiary	$769,600	$942,400	$461,760	$565,440
Total Tax Liability	($230,400)	($57,600)	($538,240)	($434,560)

Mr. Comfortable would be subject to the same tax liability as he was under both carryover systems and Mr. Wealthy would be subject to the same tax liability as the "Carryover Under Section 2015" system. The difference in these regimes lies in the timing of the recognition. Unlike the carryover systems where beneficiaries could defer the gain indefinitely, under this regime, gains are forced to be taxed as of the decedent's date of death. This benefits the government because revenue from decedents' appreciated property is a sure thing from year to year as the built-in gain has to be realized at death unlike carryover basis where the actual revenue the government can collect is dependent on when the beneficiary chooses to dispose of the property and recognize the built-in gain that has accrued. This treatment is not friendly to taxpayers because beneficiaries have no choice as to when they will realize the gain that has appreciated in assets. This would serve as an equalizer among taxpayers because there would not be an opportunity for indefinite deferral of gain from generation to generation that is usually only possible for the wealthiest individuals or families.

Another issue for taxpayers in a system where gain is realized at death is a lack of liquidity. For example, if the gain is from a small business, the estate may not be able to pay the tax owed on the gain unless the business is liquidated. This may also pose a problem for farms. Canada has counteracted the issue of liquidity with payment installments, allowing tax owed on gain to be paid over ten annual installments, and providing capital gain exemption amounts for farms and closely-held businesses.[62] President Obama proposed similar provisions in 2015.[63]

This system would still present the same issues in terms of recordkeeping as carryover basis because the basis will need to have been tracked to determine the amount of gain that must be realized at death. Also, this regime may simply present too much of a change from the current system. The overall tax liability is calculated differently because the built-in gain is assessed first resulting in the application of the estate tax after federal and state capital gains tax has been assessed.[64] Overall, this limits double taxation, which creates a lower tax liability than a "Pure Carryover" system, but it does add complexity. States would also receive a larger proportion of the tax liability than under a carryover system because the state capital gains tax rate would be applied to all of the asset's built-in gain. The forced recognition of gain is unlikely to garner much political support as the opportunity to defer gain under a carryover system is extremely beneficial to taxpayers and may ease the concerns related to liquidity that this system presents.

E. INCOME IN RESPECT OF A DECEDENT

Under a regime that mirrors section 691 of the Code and treats all assets at death like income in respect of a decedent (IRD), there would be carryover basis, but if estate tax is paid, the beneficiary will get some relief, like section 691 offers, in the form of an income tax deduction for the estate tax paid that is attributable to the built-in gain of the asset.[65] Income in respect of a decedent is generally "income that is payable after the death of the person who was entitled to it and that would have been taxable to him if the person had lived to receive it."[66] Examples of IRD items include traditional IRA distributions, remaining employee compensation, or qualified retirement plan distributions.[67] This type of income would have been included in gross income on the individual's tax return if the decedent had received the income when he was alive, but since the individual died before receiving the income he had a right to, the income is now considered payable after death and therefore it is taxable to the individual's estate or his beneficiaries based upon who receives the income.[68]

The purpose of providing special treatment to IRD items when an estate tax has been paid is to avoid double taxation. If there were not special treatment for IRD, it would be subject to both an estate tax and the income tax of the beneficiary.[69] For example, in the case of Mr. Wealthy who dies with $10 million of assets, consider his assets included an IRA worth $1 million. If the IRA was not part of the exempted amount of his estate, it would be subject to a 40 percent estate tax and then the beneficiary would owe ordinary income tax as high as 39.6 percent when she gets distributions from the account, resulting in a 79.6 percent overall tax rate. Because of section 691, the beneficiary is eligible for an income tax deduction equal to the amount of estate tax paid, here $400,000, thereby reducing the income tax paid on the distribution of the IRA to $237,600.[70]

This regime would adopt a pure carryover basis, but extend special treatment of IRD items to all assets of the estate, so there would be an income tax deduction equal to the amount of estate tax paid attributable to the built-in gain available to be used on any assets in the decedent's estate.

Income in Respect of a Decedent

	Mr. Comfortable		Mr. Wealthy[71]	
	20% Basis (200,000 Basis)	80% Basis (800,000 Basis)	20% Basis (200,000 Basis)	80% Basis (800,000 Basis)
Starting Asset	$1,000,000	$1,000,000	$1,000,000	$1,000,000
less Federal Estate Tax (40%)	0	0	($400,000)	($400,000)
less Federal Capital Gains Tax (23.8%)	($190,400)	($47,600)	($114,240)[72]	($28,560)[73]
less State Income Tax on capital gains (5%)	($40,000)	($10,000)	($24,000)[74]	($6,000)[75]
Net to beneficiary	$769,600	$942,400	$461,760	$565,440
Total Tax Liability	($230,400)	($57,600)	($538,240)	($434,560)

Those that do not pay the estate tax, like Mr. Comfortable, will receive no added benefit and their tax liability will be the same as under a pure carryover basis system. To lessen the burdens of double taxation, those that pay an estate tax, like Mr. Wealthy, receive an income tax deduction benefit, but only up to the amount of estate tax paid that is actually attributable to the unrealized gain that exists at death.

While the deduction amount would be determined when the estate tax is paid, the deduction would not be taken until the beneficiaries dispose of the property bequeathed to them by the decedent. This presents some concerns as there could effectively be a lag time of decades between when the deduction amount is determined and when it is used. One benefit of this though is that the time value of money and the deduction value would further incentivize beneficiaries to recognize gain sooner rather than later in order to take full advantage of the deduction amount.

Overall, this regime suffers from complexity and the determination of each beneficiary's allowable deduction for assets presents high costs of compliance.

F. Limited Stepped-up Basis with Carryover Basis for Excess ("Jeb Bush Plan")

Another possible regime for determining basis at death would be to have a limited stepped-up basis and a carryover basis for all property in excess of that threshold amount. An exemption amount would be designated for which property up to that amount would be given a stepped-up basis and any property exceeding the exemption amount would have a carryover basis.[76] This regime was most recently proposed by Jeb Bush in his bid to become the Republican Presidential nominee.[77] He proposed a step-up basis exemption amount equal to the Federal estate tax exemption. This amount would help with the ease of administration because there would be no additional filing requirements. No one would be affected by the change in law except for those that are already subject to the estate tax.

By having a high step-up exemption amount though, Jeb Bush's proposal fails to address the paramount issue of the current step-up basis system that most individuals pay no tax, neither estate tax nor income tax, on assets they hold until death because less than one percent of the population owes estate tax. Implementing this regime with a high step-up exemption amount would mean that many upper-middle class individuals, like Mr. Comfortable, who fall below the Federal estate tax exemption, currently $5.45 million, would still not be subject to any taxation, just as it is under the current system. Even though these individuals have the ability to pay, the built-in gain of their property would disappear with the stepped-up basis. Mr. Comfortable does not have any tax liability because of the step-up in basis exemption. Currently a married couple would need to have an estate larger than almost $11 million to be subject to any carryover basis.

Therefore there would be many people that would get the benefit of a stepped-up basis, that clearly have the ability to pay more.

A lower step-up exemption amount of $1 million, for example, may be more beneficial. This lower exemption amount would better capture the gains of the individuals who are well off, but not wealthy enough to be subject to the estate tax. An exemption level this low may be over-inclusive and at a level that somewhat diminishes the progressivity of the tax because those with $1 million of assets would have the same tax treatment as those with $5.449 million of assets, just differentiated by tax rates on their capital gains determined by the beneficiaries' income. The differentiation in tax rates may be enough to maintain progressivity though.

Limited Stepped-up Basis with Carryover Basis for Excess
Jeb Bush's Plan with a Step-Up Basis up to the Level of the Estate Tax Exemption

	Mr. Comfortable		Mr. Wealthy[78]	
	20% Basis (200,000 Basis)	80% Basis (800,000 Basis)	20% Basis (200,000 Basis)	80% Basis (800,000 Basis)
Starting Asset	$1,000,000	$1,000,000	$1,000,000	$1,000,000
less Federal Estate Tax (40%)	0	0	($400,000)	($400,000)
less Federal Capital Gains Tax (23.8%)	0	0	($190,400)	($47,600)
less State Income Tax on capital gains (5%)	0	0	($40,000)	($10,000)
Net to beneficiary	$1,000,000	$1,000,000	$369,600	$542,400
Total Tax Liability	$0	$0	($630,400)	($457,600)

Administratively, it would be easiest to have the amount allowable for stepped-up basis be equal to the Federal estate tax exemption amount. Administrative costs would increase with an exempted amount of stepped-up basis property that is different than the estate tax exemption as many more people would have to make filings than currently do in order to designate what property will receive a step-up in basis and what property will receive carryover basis. From a policy standpoint though, the amount allowable for stepped-up basis should be lower than the Federal estate tax exemption to enhance equity and fairness. Taking into account vertical equity and the ability to pay, many upper-middle class individuals that fall below the Federal estate tax exemption and therefore do not owe estate tax still have the ability to pay the tax incurred from the appreciation of their assets and therefore should be subject to income tax on the built-in gain.

G. Multiple Tiers: Carryover for estates from $1 million to Federal estate tax exemption, stepped-up basis for those subject to the estate tax

In this tax regime, estates with less than $1 million would receive step-up basis, carryover basis would be applied to estates valued between $1 million and the Federal estate tax exemption, $5.45 million for 2016, and any estate subject to the estate tax would have a stepped-up basis.

This system most directly aligns with the purpose of section 1014, which is to avoid double taxation, so assets are not subject to both an estate tax and an income tax. As the Federal estate tax exemption has sharply increased, the government has lost a significant amount of revenue from the upper-middle class individuals who do not die with enough assets to be subject to the estate tax, but have enough assets that the benefit of a stepped-up basis is significant. The government is not able to collect either estate tax or income tax from these individuals. This regime would solve that problem because for those wealthy individuals who are not subject to the estate tax, their beneficiaries would assume carryover basis in the estate's assets. This regime would be able to capture the lost tax revenue of those who are wealthy, but not wealthy enough to be subject to the estate tax.

Multiple Tiers

	Mr. Comfortable		Mr. Wealthy	
	20% Basis (200,000 Basis)	80% Basis (800,000 Basis)	20% Basis (200,000 Basis)	80% Basis (800,000 Basis)
Starting Asset	$1,000,000	$1,000,000	$1,000,000	$1,000,000
less Federal Estate Tax (40%)	0	0	($400,000)	($400,000)
less Federal Capital Gains Tax (23.8%)	($190,400)	($47,600)	0	0
less State Income Tax on capital gains (5%)	($40,000)	($10,000)	0	0
Net to beneficiary	$769,600	$942,400	$600,000	$600,000
Total Tax Liability	($230,400)	($57,600)	($400,000)	($400,000)

The drawback of this tax regime is that those who hold the highest proportion of capital assets would be the ones escaping income taxation with a stepped-up basis. These individuals are the ones with the highest ability to pay and those most able to afford better record-keeping and therefore, to promote progressivity they should not be able to get stepped-up basis treatment, even if they are subjected to the estate tax. Additionally, many estates are able to significantly decrease the overall tax rate on their estate because of planning techniques and the charitable deduction.[79] This regime also puts a heavy administrative burden on those similarly situated to Mr. Comfortable because they will have record-keeping burdens in order to comply with a carryover basis system that those in the "Wealthy" category will not be subject to. Having multiple tiers of taxation schemes may also add complexity to the system.

IV. Other Considerations

Administration in record-keeping is a paramount concern in any regime that does not rely on stepped-up basis. Using data compiled in the mid-2000s by the IRS's Statistics of Income Division, one study found that 35.8 percent of assets passing to heirs were types of property that are hard to value, which means the value of the majority of property being passed at death would be of a type that is more easily determined.[80] There are already reporting requirements in place for some types of property, so these requirements could be extended for other types of property.

For ease of administration, it may be helpful to have a separate exemption amount to be used for especially hard to value assets, such as personal property or artwork. Although this could present issues of horizontal equity as this may favor those that invest in art or other hard to value property over individuals that invest in stock. For regimes that utilize exemption amounts, a provision could be implemented that required that the exemption be applied to hard to value property first. Administratively, it would be easier to give these items a stepped-up basis.

If a new system of determining basis were implemented, there would most likely need to be a transitional period to take into account concerns about record-keeping. Obviously there would be increased pressure on recordkeeping and in cases where decedents did not consider carryover basis rules, executors would be tasked with determining the distribution of assets to beneficiaries taking into account the fair market value and basis of the assets, which could lead to an increase in probate disputes and litigation. Going forward though, individuals would increasingly take these considerations into account when developing their estate plans. The majority of individuals that would be affected by these provisions are already working with professionals on their estate planning. Record-keeping is also something that will increasingly become less of a concern going forward.

There are already regulations in place for sections 1014 and 1015 relating to stepped-up basis, and carryover basis for gifts, respectively, that advise individuals to retain records that will be used in determining proper basis for a taxpayer's property. For example, Treasury regulation section 1.1015-1(g) states that, "To ensure a fair and adequate determination of the proper basis under section 1015, persons making or receiving gifts of property should preserve and keep accessible a record of facts necessary to determine the cost of property and, if pertinent, its fair market value."[81] The burden is on the taxpayer to prove that their determination of basis is accurate.[82]

A proposal that could be utilized for a transitional period to take into account that many taxpayers would not have kept records because they thought they would never be needed, is to adopt a program similar to what William G. Gale proposed whereby there would be a "standard basis" on capital gains held until death of 20 percent of the current asset's value.[83] The taxpayer would adopt this basis in the property unless he could prove what the actual basis in the property is.[84] Obviously there would be circumstances where this system would fail to capture all of the asset's appreciation, so it should only be adopted for a limited length of time. A system of this type could be utilized for a set period of transitional time whereby taxpayers are given warning that they should keep their records because ultimately there will be a shift to a system where the taxpayer is wholly responsible for proving the accurate basis of property. With this transitional system there would be time for individuals to get their records in order and they would know that going forward it will be necessary to keep documentation.

Charitable deductions should remain in place to ensure that charities are not adversely affected by a change in legislation. Currently, charitable contributions of highly appreciated long-term capital assets are extremely advantageous for tax purposes because in addition to not having to recognize the built-in gain of the property, the taxpayer is typically able to deduct the full fair market value of the property.[85] It would be best to continue this treatment, even with a new system of determining the basis of a decedent's property. This treatment would create an even greater incentive in regimes that do not utilize a stepped-up basis because donating the property to charity would be the only way to truly escape taxation on the property's gain forever.

V. Conclusion

There are many possible options in reforming the determination of basis at death, but it is clear that stepped-up basis does not best accomplish the goals of the wealth transfer system. As the estate tax has evolved over time, the purpose of stepped-up basis has seemed to diminish in importance. The estate tax has become an important part of the federal tax system as a way to enhance progressivity. John Rawls wrote, "The purpose of the estate tax is not to raise revenue…but to gradually correct the distribution of wealth and to prevent concentrations of power detrimental to the fair value of political liberty and fair equality of opportunity."[86] The estate tax taxes those that have the greatest ability to pay, so even though the purpose of section 1014 was to avoid double taxation, stepped-up basis should be limited in circumstances where social policy reasons outweigh its benefit to the tax structure.

Keeping in line with the goals of the estate tax, some variation of the system suggested by Jeb Bush, which limits the amount of step-up basis and applies carryover basis to the excess is best. If the amount allowable for stepped-up basis is equal to the Federal estate tax exemption amount, as proposed by Jeb Bush, double taxation is avoided for those that pay the estate tax, but it still enables those that do not pay the estate tax, to escape *all* taxation, which is not the purpose of stepped-up basis.[87] While the stepped-up basis provision has the specific purpose of avoiding double taxation, the wealth transfer system as a whole strives to enhance progressivity and promote wealth equality while raising revenue, even if the revenue is modest. Whichever basis provision is used under the wealth transfer system for handling gains at death should align with the overarching goal of the wealth transfer system first and foremost rather the purpose of section 1014.

Different step-up basis exemption amounts could be assessed, but an exemption in the $2 million range would be ideal in order to increase progressivity and capture the built-in gain of capital assets that previously escaped taxation.

<u>All Proposals</u>

	Mr. Comfortable		Mr. Wealthy	
	20% Basis (200,000 Basis)	80% Basis (800,000 Basis)	20% Basis (200,000 Basis)	80% Basis (800,000 Basis)
<u>Current System</u>				
Net to Beneficiary	$1,000,000	$1,000,000	$600,000	$600,000
Total Tax Liability	0	0	($400,000)	($400,000)
<u>Pure Carryover</u>				
Net to Beneficiary	$769,600	$942,400	$369,600	$542,400
Total Tax Liability	($230,400)	($57,600)	($630,400)	($457,600)
<u>Carryover Under Section 2015</u>				
Net to Beneficiary	$769,600	$942,400	$461,760	$565,440[88]
Total Tax Liability	($230,400)	($57,600)	($538,240)	($434,560)
<u>Canadian System</u>				
Net to Beneficiary	$769,600	$942,400	$461,760	$565,440
Total Tax Liability	($230,400)	($57,600)	($538,240)	($434,560)
<u>Income in Respect of Decedent</u>				
Net to Beneficiary	$769,600	$942,400	$461,760	$565,440
Total Tax Liability	($230,400)	($57,600)	($538,240)	($434,560)
<u>Limited Stepped-Up Basis with Carryover</u>				
Net to Beneficiary	$1,000,000	$1,000,000	$369,600	$542,400
Total Tax Liability	0	0	($630,400)	($457,600)
<u>Multiple Tiers</u>				
Net to Beneficiary	$769,600	$942,400	$600,000	$600,000
Total Tax Liability	($230,400)	($57,600)	($400,000)	($400,000)

Although this system may violate some aspects of double taxation, the ultimate goals of the wealth transfer system of raising revenue, especially from those that have the highest ability to pay, and enhancing progressivity outweigh a small amount of double taxation in this instance. Individuals that do not pay any estate tax would only be subject to one level of taxation, capital gains taxes, which would be determined based on the beneficiary's income tax rate, ranging from 0 percent for those in the lowest income bracket and rising to 23.8 percent for those in the highest income bracket. This rate would be applied to any property that exceeds the threshold exemption amount of stepped-up basis. There would be double taxation for those that are subject to the estate tax as they would owe capital gains taxes on the property that exceeded the threshold amount of stepped-up basis in addition to estate tax, but for this small percent of the population, amounting to less than 0.2 percent of the population in 2013, they are the individuals with the highest ability to pay this tax. Additionally, the administration of a system using carryover basis is a concern, but not so great of a concern that it should frustrate the implementation of a system that is fairer and more progressive. These concerns would also lessen over time as record-keeping practices become more established.

[1] *Fact Sheet: A Simpler, Fairer Tax Code That Responsibly Invests in Middle Class Families*, THE WHITE HOUSE OFFICE OF THE PRESS SECRETARY (January 17, 2015), https://www.whitehouse.gov/the-press-office/2015/01/17/fact-sheet-simpler-fairer-tax-code-responsibly-invests-middle-class-fami.

[2] I.R.C. § 1014 (2015). Section 1014 can also result in a step-down in basis to fair market value if the fair market value is less than the decedent's basis at the date of death.

[3] *Federal Estate Tax: Uncertainty in Planning Under the Current Law: Hearing Before the S. Comm. On Finance* 110th Cong. 880 (2007) (statement of Warren Buffett, Chairman and Chief Executive Officer, Berkshire Hathaway).

[4] LEONARD E. BURMAN & JOEL SLEMROD, TAXES IN AMERICA: WHAT EVERYONE NEEDS TO KNOW 40-41 (2013).

[5] Joint Committee on Taxation, *History, Present Law, and Analysis of the Federal Wealth Transfer Tax System*, (JCX-52-15), March 16, 2015, 1.

[6] *Id*.

[7] *Id*.

[8] Tax Expenditure for Exclusion of Capital Gains at Death, Office of Tax Analysis U.S. Dep't of Treasury, https://www.treasury.gov/resource-center/tax-policy/Documents/Analysis-and-Research-Tax-Expenditure-Step-Up-Basis-2014.pdf, 1.

[9] Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2015-2019*, (JCX-141R-15), December 7, 2015, 33.

[10] Office of Tax Analysis U.S. Dep't of Treasury, *supra* note 8, at 5.

[11] Darien B. Jacobson, Brian G. Raub, & Barry W. Johnson, *The Estate Tax: Ninety Years* and *Counting*, INTERNAL REVENUE SERVICE, https://www.irs.gov/pub/irs-soi/ninetyestate.pdf, 119.; Nancy M. Annick, *Plugging the 'Gaping Loophole' of the Step-Up in Basis at Death: A Proposal to Apply Carryover Basis to Excess Property*, 8 Pitt. Tax Rev. 75, 80 (2011).

[12] Jacobson, Raub, & Johnson, *supra* note 11, at 118.

[13] Annick, *supra* note 11, at 80.

[14] *Id*. at 81.

[15] *Id.*

[16] Jacobson, Raub, & Johnson, *supra* note 11, at 120.

[17] Franklin Delano Roosevelt *quoted in* Annick, *supra* note 11, at 81.

[18] Annick, *supra* note 11, at 81.

[19] *Id.* at 93.

[20] *Id*.

[21] 1 C.F.R. § 1014-1 (2015).

[22] Richard Schmalbeck & Jay A. Soled, *Estate Tax Relief and the Erosion of Capital Gains Tax Revenues*, TAX ANALYSTS (November 11, 2011), http://www.taxanalysts.com/www/features.nsf/Articles/BF5B9C8288329F498525794500669C2B?OpenDocument.

[23] Tax Reform Act of 1976, Pub. L. No. 94-455.

[24] Lawrence Zelenak, *Taxing Gains at Death*, 46 Vand. L. Rev. 361, 365 (1993).

[25] Annick, *supra* note 11, at ¶141.

[26] *Id.* at 95.

[27] Frank S. Berall, Jonathan G. Blattmachr, Lauren Y. Detzel, & Ellen K. Harrison, *Carryover Basis: a "Discredited' Concept,* 37 ESTATE PLANNING 3, 3 (No. 4, April 2010) *available at*

http://www.americanbar.org/content/dam/aba/events/taxation/taxiq-11mid-019.authcheckdam.pdf.
[28] Marc. S. Bekerman & William P. LaPiana, *Carryover Basis: Have We Learned from History?,* Nov/Dec 2005 PROBATE AND PROPERTY 38, 38 (2005), http://www.americanbar.org/content/dam/aba/publishing/probate_property_magazine/rppt_mo_premium_rp_publications_magazine_2005_nd_NovDec05_Bekerman_LaPiana.authcheckdam.pdf
[29] Zelenak, *supra* note 24, at 365.
[30] Annick, *supra* note 11, at 99-100.
[31] JOEL SLEMROD & JON BAKIJA, TAXING OURSELVES: A CITIZEN'S GUIDE TO THE DEBATE OVER TAXES 27 (4th ed. 2008).
[32] Annick, *supra* note 11, at 92.
[33] Adapted from *ACTEC Pocket Tax Tables, revised through March 1, 2016*, ACTEC 14 (2016).
[34] The applicable exclusion amount is indexed for inflation after 2011.
[35] 1 C.F.R. § 1014-1.
[36] For example, in the 1976 Tax Reform Act where carryover basis replaced step-up basis, "most of those opposed to the step-up in basis would have preferred a capital gains tax imposed at death on the unrealized appreciation in the decedent's property," but this was attacked and instead the compromise solution was carryover basis. Carryover basis was seen as the middle ground because individuals were still left with control over when the recognition of gain would occur and therefore when tax on the gain would be owed. Annick, *supra* note 11, at 93;
Even in 2010 when the estate tax was completely repealed, estates could decide to make an election to have no estate tax imposed with modified carryover basis, or subject itself to the estate tax with a stepped-up basis. Office of Tax Analysis U.S. Dep't of Treasury, *supra* note 8, at 3.
[37] *What's New – Estate and Gift Tax, Internal Revenue Service* (April 11, 2016), https://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Whats-New-Estate-and-Gift-Tax.
[38] I.R.C. § 2001 (2015), but American Taxpayer Relief Act of 2012 (Pub. L. No. 112-240) raised the estate tax rate to 40%.
[39] The maximum capital gains rate is 20% and there is an additional 3.8% Medicare net investment income surtax for singles with modified adjusted gross income over $200,000. I.R.C. § 1411 (2015).
[40] The majority of states do not have an estate or inheritance tax. Only 19 states have either an estate or inheritance tax. Scott Drenkard & Richard Borean, *You're your State Have an Estate or Inheritance Tax?*, TAX FOUNDATION (May 5, 2015), http://taxfoundation.org/blog/does-your-state-have-estate-or-inheritance-tax.
[41] While state income taxes on capital gains vary, with states ranging from 0% to 13.3% (California), 5% was chosen simply to illustrate the added effect of a state income tax on capital gains. Kyle Pomerleau, *The High Burden of State and Federal Capital Gains Tax Rates in the United States*, TAX FOUNDATION (March 24, 2015), http://taxfoundation.org/article/high-burden-state-and-federal-capital-gains-tax-rates-united-states.
[42] I.R.C. § 1014.
[43] HENRY C. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY, 50 (1938), *quoted in* Alvin C. Warren, Jr., *Three Versions of Tax Reform*, 39 WM. & MARY L. REV. 157 (1997), 159.
[44] BURMAN & SLEMROD, *supra* note 4, at 40-41.

[45] Leonard E. Burman, *President Obama Targets the "Angel of Death" Capital Gains Tax Loophole*, TAX POLICY CENTER (January 18, 2015), http://www.taxpolicycenter.org/taxvox/president-obama-targets-angel-death-capital-gains-tax-loophole.
[46] 1 C.F.R. § 1014-1.
[47] I.R.C. § 1223(9) (2015).
[48] Schmalbeck & Jay A. Soled, *supra* note 22. Individuals below the estate tax exemption have an incentive to overvalue their property to take advantage of the step-up in basis as much as possible. Conversely, individuals subject to the estate tax have an incentive to undervalue their property to lessen their estate tax burden and instead their beneficiaries are subject to income tax on the built-in gain of the property.
[49] Annick, *supra* note 11, at 106.
[50] New IRS Form 8971 *available at* https://www.irs.gov/pub/irs-access/f8971_accessible.pdf.
[51] Annick, *supra* note 11, at 95.
[52] Steven Rosenthal, *Basis Reporting: Lessons Learned and Direction Forward*, TAX NOTES (April 16, 2012), 353, *available at* http://www.taxpolicycenter.org/publications/basis-reporting-lessons-learned-and-direction-forward/full.
[53] I.R.C. § 1015(d)(6)(A) (2015).
[54] I.R.C. § 1015(d)(6)(B) (2015).
[55] Reduction is based on the ratio of gain, so here there is 80% gain and therefore there is a reduction equal to 80% of the estate tax paid ($400,000)

[800,000 gain – (400,000 estate tax paid x 80% ratio of gain)] x 23.8% tax rate = 114,240

[56] Reduction is based on the ratio of gain, so here there is 20% gain and therefore there is a reduction equal to 20% of the estate tax paid ($400,000)

[200,000 gain – (400,000 estate tax paid x 20% ratio of gain)] x 23.8% tax rate = 28,560

[57] *Deemed Disposition of Property*, CANADA REVENUE AGENCY, http://www.cra-arc.gc.ca/tx/ndvdls/lf-vnts/dth/dmd/menu-eng.html.
[58] THE WHITE HOUSE OFFICE OF THE PRESS SECRETARY, *supra* note 1.
[59] *Id*.
[60] Before applying the estate tax rate, the amount of the federal gross estate is reduced by the federal and state capital gain liabilities to reach the amount taxable by the federal estate tax.

(Asset FMV – Federal capital gains – State capital gains) x 40% = estate tax liability
(1,000,000 – 190,400 – 40,000) x 40% = 307, 840

[61] Before applying the estate tax rate, the amount of the federal gross estate is reduced by the federal and state capital gain liabilities to reach the amount taxable by the federal estate tax.

(Asset FMV – Federal capital gains – State capital gains) x 40% = estate tax liability
(1,000,000 – 47,600 – 10,000) x 40% = 376,960

[62] Zelenak, *supra* note 24, at 440.
[63] THE WHITE HOUSE OFFICE OF THE PRESS SECRETARY, *supra* note 1.
[64] It is interesting to note that this regime produces the same total tax liability for Mr. Wealthy as "Carryover Under Section 1015," although in this instance there is less federal tax and more state tax owed.
[65] I.R.C. § 691 (2015).
[66] IRD: A Tax Rule Beneficiaries Need to Know, MFS HERITAGE PLANNING, 1, *available at* http://www.tuveinvestments.com/pdf/Estate%20Planning/IRD%20a%20tax%20rule%20beneficiaries%20need%20to%20know.pdf.

[67] *Id*. at 1.
[68] *Id*. at 2.
[69] Philip H. Myers, *What Constitutes "Income in Respect of a Decedent" Within Meaning of § 691(a)(1) of Internal Revenue Code of 1954 (26 U.S.C.A. § 691(a)(1))*, 13 A.L.R. FED. 613, (1972).
[70] (1,000,000 – 400,000) x 39.6% = 237,600. The deduction is equal to 100 percent of estate tax paid because the amount of tax paid attributable to built-in gain is $400,000, because the basis in the IRA is zero.
[71] These calculations are the same as the calculations under the "Carryover Under Section 1015" system.
[72] The total amount subject to federal capital gains tax is the amount of gain reduced by the total estate tax paid that is attributable to the gain. Here 80% of estate tax paid is attributable to the gain, so the deduction is 80% of $400,000, or $320,000.

($800,000 gain – $320,000 estate tax paid) x 23.8% tax rate = $114,240

[73] 20% of estate tax paid is attributable to the gain, so the deduction is 20% of $400,000, or $80,000.

($200,000 gain – $80,000 estate tax paid) x 23.8% tax rate = $28,560

[74] ($800,000 gain – $320,000 estate tax paid) x 5% tax rate = $24,000. This assumes the state system follows the federal.
[75] ($200,000 gain – $80,000 estate tax paid) x 5% tax rate = $6,000
[76] This system is analogous to the limited basis step-up of $1.3 million that would have applied under the 2001 Tax Act had the estate tax repeal been permanent, except this paper assumes the Federal estate tax will remain.
[77] Kyle Pomerleau, *Details and Analysis of Governor Jeb Bush's Tax Plan*, TAX FOUNDATION (September 10, 2015), http://taxfoundation.org/article/details-and-analysis-governor-jeb-bush-s-tax-plan.
[78] Mr. Wealthy's tax liabilities are based on the assumption that he uses his step-up exemption towards part of his $9 million of other assets and therefore the $1 million of marketable securities would be subject to carryover basis. The liabilities are also based on the assumption that the beneficiary disposes of the property immediately.
[79] In 2013, the average effective tax rate for estates that owed Federal estate tax was only 16.6 percent. Chye-Ching Huang & Brandon Debot, *Ten Facts You Should Know About the Federal Estate Tax*, CENTER ON BUDGET AND POLICIES PRIORITIES (March 23, 2015), http://www.cbpp.org/research/ten-facts-you-should-know-about-the-federal-estate-tax?fa=view&id=2655#_ftnref5.
[80] Schmalbeck & Jay A. Soled, *supra* note 22.
[81] 1 C.F.R. § 1015-1(g); *also see* 1 C.F.R. § 1.1014-4 which states, "The executor or other legal representative of the decedent, the fiduciary of a trust under a will, the life tenant and every other person to whom a uniform basis under this section is applicable, shall maintain records showing in detail all deductions, distributions, or other items for which adjustment to basis is required to be made by sections 1016 and 1017, and shall furnish to the district director such information with respect to those adjustments as he may require."
[82] The basis of gifted assets are required to be reported on the Federal Gift Tax Return, Form 709, *available at* https://www.irs.gov/pub/irs-pdf/f709.pdf.

[83] William G. Gale, *Adjusting the President's Capital Gains Proposal*, TAX POLICY CENTER (January 21, 2015), http://www.taxpolicycenter.org/taxvox/adjusting-presidents-capital-gains-proposal.
[84] *Id.*
[85] I.R.C. § 170 (2015).
[86] WILLIAM H. GATES SR. & CHUCK COLLINS, WEALTH AND OUR COMMONWEALTH: WHY AMERICA SHOULD TAX ACCUMULATED FORTUNES, 7 (2003).
[87] 1 C.F.R. § 1014.1.
[88] While "Carryover Under Section 2015," "Canadian System," and "Income in Respect of Decedent" all produce the same numerical outcomes, it is important to note that these totals are made under the assumption that the beneficiary sells the marketable securities following the bequest. Under the "Canadian System," there is a forced recognition, whereas under the "Carryover Under Section 2015" and "Income in Respect of Decedent," there is carryover basis, so the beneficiary is not forced to recognize the built-in gain; she can instead hold onto the asset and defer the recognition of gain.