The Elephant in the Parlor: Repeal of Step-Up in Basis at Death

By Calvin H. Johnson

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Under current law, gain arising on property held until death is never taxed. Heirs treat the property as if it were purchased for a price equal to its value at death. The heirs can consume the property even for wasteful consumption without either heir or decedent paying tax. The new basis at death also makes it impossible to maintain a viable tax on capital gains consumed during life. The proposal would require carryover for provable costs. The proposal would simplify recordkeeping by giving a zero basis for unknown costs and for inheritances outside the family. Heirlooms and household effects would have no basis. Collections would have basis of two-thirds the sale price, except for items costing more than $500.

The proposal is made as a part of the Shelf Project, a collaboration by tax professionals to develop and perfect proposals to help Congress when it needs to raise revenue. Shelf Project proposals are intended to raise revenue, defend the tax base, follow the money, and improve the rationality and efficiency of the tax system. The tax community can propose, follow, or edit proposals at http://www.taxshelf.org. A longer description of the Shelf Project can be found at “The Shelf Project: Revenue-Raising Projects That Defend the Tax Base,” Tax Notes, Dec. 10, 2007, p. 1077, Doc 2007-22632, or 2007 TNT 238-37.

Shelf Project proposals follow the format of a congressional tax committee report in explaining current law, what is wrong with it, and how to fix it.

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This proposal would end the step-up in basis for property acquired by reason of the death of another individual and increase the tax on inherited property when it is sold. The exemption for built-in gain at death is unfair because it allows consumption, even sumptuous consumption of investments by heirs, without either the heir or original owner paying tax on the consumption. The exemption is a vestige of a property system when the family manor and estate was permanent capital that could not be reached by the living, but had to be preserved in perpetuity for the male heirs. Sale of inherited property, however, means that the property is no longer permanent capital.

Under normal patterns, tax on heirs does less damage to incentives than a tax on the worker or investor whose activity caused the gain or in whose hands the gains arose. Shifting tax from the living to the dead will ordinarily reduce the impact of the tax. Revenue can be raised by increasing rates, but it does less harm to raise revenue by defending the tax base instead. Distributionally, revenue needs to be collected from those who first benefit from avoiding rate increases and from groups that have done especially well in recent years, rather than from those whose standard of living is closer to subsistence.

In general, the proposal would require the heir to step into the shoes of the decedent in determining basis. The proposal would, however, simplify carryover basis, by giving a zero basis when the cost of the original owner is not plausibly a burden on the heir. When the heir cannot ascertain the cost to the original owner, for example, it is difficult to see how the unknown cost is a burden on the heir. The proposal would, accordingly, require proof of any basis carried over from the original owner. Also, remote heirs receiving inheritances from outside the family plausibly do not share in the original costs. Basis in inherited property would not carry over from decedents more remote than qualified relatives. Heirlooms and household effects would have no basis. Collectibles would have exclusion of one-third of the sale price, except that pieces purchased for more than $500 would have their provable cost basis.

The proposal endorses integration of the estate and income tax, but argues that carryover basis property is lightly taxed and thus is not the place to accomplish a comprehensive integration.

Step-up in basis at death is the elephant in the parlor that no one wants to talk about. Yet, it is impossible to have a comprehensive tax on consumption without ending the nontaxation of luxurious consumption by heirs of amounts never previously subject to tax. It’s impossible to maintain a viable tax on capital gain consumed for

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1For this proposal, the term “heir” will be used to refer to the recipient of an inheritance whether received by will or intestate succession, whether by a specific bequest or a residual share, and whether the property is real or personal property.
luxuries during life as long as tax is forgiven on property held long enough. Without equitable treatment of the now untaxed gain, it is impossible to maintain a fair and equitable tax of any kind.

A. Current Law

In general, a taxpayer’s basis in property reflects a taxpayer’s capitalized costs that have not yet been recognized by the tax system. Basis is adjusted downward by the amount of basis that is recovered by depreciation, loss deductions, and withdrawals of cash. Basis is adjusted upward by taxable gain and by new nondeductible capital expenditures invested in the property. Adjusted basis not previously recovered is subtracted from the amount realized to calculate gain or loss on sale of the property.

A taxpayer who receives a gift of property during the life of the donor steps into the shoes of the donor and carries over the donor’s adjusted basis. Carryover basis on gifts, however, is subject to an exception that losses that arose in the donor’s hands cannot be used as losses to the recipient of the gift. Transfers between spouses or ex-spouses incident to a divorce, however, carry the transferor’s basis to the recipient without the limitation on losses.

Section 1014 gives the taxpayer a basis for property acquired from a decedent by reason of death equal to the fair market value of the property at death. If, however, the estate elects to value property at six months after death for estate tax purposes or elects special valuation discounts for farm and real property, the heir’s income-tax fair market value basis is the valuation used under the estate tax elections. If there is an income-tax loss built into the property at death, the death disappears.

Income in respect of a decedent (IRD) is taxed to the ultimate recipient of the income without benefit of the step up in basis. IRD includes sales arranged during life, when the decedent and heir have no further critical work to be done except collection. Section 691(c) gives the taxpayer who includes IRD in income a deduction for the estate tax attributed to the IRD.

For deaths occurring in 2010 only, basis in property acquired by death will be a modified carryover of the decedent’s basis. Under the 2010 rule, basis in the estate’s entire property is stepped up by the amount of $1.3 million, but not above the fair market value of the property. Also, a spouse of the deceased will step up basis, but not above fair market value, in the amount of $5 million. Unused net operating losses and unused losses built into property at the decedent’s death also increase basis. Specific bequests of property would be considered constructive sales to the estate, as if the estate satisfied a specific claim on it by transfer of appreciated property. The executor of an estate would be required to give beneficiaries information about the basis and character of the property. The 2010-modified-carryover-basis rule was a partial offset to the proposed repeal of the estate tax for 2010.

Because of budget discipline rules, repeal of the estate tax was adopted in 2001 with a then-distant 2010 effective date, and the repeal is scheduled to terminate at the end of 2010. As enacted, both the repeal of the estate tax and the modified carryover basis rules terminate at the same time, so that the section 1014 step-up in basis would return in 2011.

The tax law sometimes denies basis for costs borne by a “remote” transferor. Section 362(c) provides that when a corporation receives a contribution to its capital from a nonshareholder, or from a shareholder not acting as such, the corporation will have a zero basis in the property. Section 118 provides that a corporation may receive a contribution to capital without tax, except that contributions in aid of construction are taxable income.

The Office of Management and Budget estimates a revenue loss of $198 billion attributable to the step-up in basis at death over 2009-2013, which implies a revenue loss of almost $400 billion in revenue for a 10-year period. A $400 billion increase in revenue from inherited property would mean that rates could be lowered, or rate increases avoided by the same amount of yield.

B. Reasons for Change

The step-up in basis is unfair and distorts economic behavior. It originates from a medieval conception of permanent capital that is no longer part of a functioning system.

1. Unfair! The step-up in basis at death allows heirs to sell and consume the proceeds of inherited property without either the heir or the decedent having paid tax on the consumption. With some spin to the description, the step-up allows a wastrel heir to liquidate the original owner’s hard-earned productive investments so as to squander the money on luxurious bonbons and character destruction, without tax on the amounts so squandered. Ordinarily, in an income tax, consumption occurs only after paying tax (even if consumption is not squandering.

2Section 1016 (adjusting basis down for depreciation); section 358(a)(1) (decreasing shareholder basis for cash withdrawn and increasing basis for gain taxed); section 705(a) (same for partners); and section 1031(d) (increasing basis by gain recognized and reducing basis for cash withdrawn).

3Section 1001.

4Section 1015. A corporation takes the basis of a contributing shareholder or corporate merger target (section 362) and a partnership takes the basis of a contributing partner. Section 723.

5Section 1041(b)(2).

6Section 691.

7Section 1022.

8Stepping up basis by the amount of the loss built into the property is apparently a technical error. If the heir is entitled to use the decedent’s basis, the heir will already get tax recognition for the built-in loss without the need for an adjustment. There is no plausible rationale for why losses should be double counted.

9Section 1040, which is also effective only for 2010.

10Section 6018.

expenditures). As we move increasingly toward a consumption tax, reaching consumption of investments becomes an urgent need.

The step-up in basis disproportionately benefits the liquidation of large old capital, that is, those who are rich, and with that focus, the step-up is a tax exemption for amounts that are primarily not essential to basic subsistence and survival. By one reasonable estimate, Congress will have to raise $4 trillion over the coming decade.\textsuperscript{12} Before increasing rates on income or consumption that is currently taxed, we should go after exemptions and negative taxes. The disproportionately lavish consumption exempted by the step-up in basis at death is a reasonable source for revenue to prevent an increase in tax rates. Those who have benefited from an increase in wealth in recent years can be asked to participate in the revenue needs.

A comprehensive tax base without avoidance possibilities does the least harm to the private economy because it allows the lowest tax rate for whatever the chosen level of government revenue. The step-up in basis at death means that tax rates have to be higher generally and high tax rates do economic damage.

Section 1022, applicable only in 2010, would give a step-up in basis of $5 million for transfers to a spouse and $1.3 million to heirs other than spouses. It is proposed that true hardship exemptions are met by personal exemptions of section 152, now set at the level of $3,400 a year, and by the lower tax brackets of section 1. Assuming that the personal exemptions and low brackets adequately identify subsistence-level living standards, then there is no need for an added exemption of $1.3 million or $5 million for amounts that can be used for more lavish consumption.

2. Consumption by transferor. The step-up in basis at death allows tax-free luxury consumption not only by heirs, but also by the original owner during life. A taxpayer can borrow, using appreciated property as collateral, and consume the borrowed cash. On death, the loan is repaid by the sale of the appreciated property and neither the appreciation nor the prior consumption bears any tax. Similarly, a taxpayer may monetize the gain in other ways by issuing an option or variable prepaid forward contract covered by appreciated property the taxpayer holds.\textsuperscript{13} Borrowing or otherwise monetizing the gain in other ways might be transactions the taxpayer would not want in absence of tax, but the availability of the step-up gives an incentive to undertake the transactions.

A tax system taxing only realization during life also allows a taxpayer to pull cash out of a diversified and volatile portfolio tax free by holding gain property and selling loss or nongain property. Assume, for instance, a taxpayer has a diversified portfolio of $10 million that increases in value to $11 million in a year. Assume also that the $1 million appreciation is attributable entirely to half the stocks. The taxpayer sells $1 million of the stock that has not appreciated, and uses that $1 million to support his standard of living. The taxpayer holds the gain part of the portfolio until death. Overall the portfolio value started at $10 million and ended the year at $10 million, and the taxpayer has withdrawn and consumed $1 million in cash. But the selection of the nongain property to sell meant that neither the appreciation nor the consumption of it will ever be taxed.\textsuperscript{14}

The exemption given to capital gains at death also prevents Congress from taxing capital gains consumed during the life of the owner at rates appropriate to a better-than-average standard of living. The primary function of the system of personal exemptions and tax brackets is to identify whether income is used for subsistence amounts, modest comforts, or luxuries. Subsistence income is intended to be exempt from tax, and expenditures for the highest standard of living are taxed at 35 percent. Adjusting the tax rates to the intensity of the taxpayer’s needs reduces the harm that tax does to private utility. Capital gains are realized only by voluntary sales, however, and taxpayers increasingly avoid sales and hold the property until death whenever the tax cost of sales increases. Indeed, because of the availability of tax forgiveness at death, an increase in tax rates might decrease tax revenue, and a decrease in tax rates might increase tax revenue.\textsuperscript{15} The result is that even capital gains consumed lavishly at the highest standard of living are taxed at 15 percent, the level deemed appropriate for strictly middle-income households, rather than the rate more appropriate to highest standard of living. Ending the amnesty given to capital gains at death would allow a more appropriate level of tax on high standard of living expenditures made during the original owner’s life.

3. Origins in ‘permanent capital.’ The step-up in basis at death arose from an understanding of permanent capital and under a social system that is no longer in place and that prevented access to the capital. The British income tax, first adopted in 1799, exempted capital gain from the tax on the ground the gains were “capital” and not income.\textsuperscript{16} At the time of the adoption of the British income tax, most land was held under strict settlement trusts that, under a tradition going back to feudal tenures and knightly service, prevented sale of land and preserved the family manor and estate for the benefit of


\textsuperscript{13}Calvin Johnson, “End Tax-Free Monetization of Wealth,” Tax Notes, June 30, 2008, p. 1361, Doc 2008-13933, 2008 TNT 127-41, would tax cash received in writing options, a short sale, or a future related to underlying appreciated property that the taxpayer holds.

\textsuperscript{14}The taxpayer’s basis in the stock will go down from starting basis of $10 million to an ending basis of $9 million, but the $1 million built-in gain will be forgiven by death.

\textsuperscript{15}Jane C. Gravelle, “Limit to Capital Gains Feedback Effects,” Congressional Research Service Report for Congress at 11 (1991) (fraction of accruals that are realized is primarily a result of forgiveness at death).

\textsuperscript{16}See, e.g., Scoble v. Secretary of State for India (1903) A.C. 299, 4 Tax Cases 618, 621 (House of Lords) (refusing to tax gain from sale of India railroad on the grounds that “Parliament never intended to tax capital”).
the male heirs.17 The living had access only to the rents and harvests from the land, and had no access to the underlying entrusted property. The traditional family manor and estate remained permanent capital no matter what it was worth because it could not be reached by the living.

Early in the American income tax, it was sometimes argued that, even in America, capital gain should be considered permanent capital immune from a constitutionally permissible tax on mere income.18 Indeed, The New York Times made such an argument.19 The Supreme Court, however, rejected the British definition of capital that would have given an exemption to realized capital gain. In Merchants’ Loan & Trust Co. v. Smietanka,20 a trust sold some of the stock contributed at the outset to fund the trust, but reinvested the proceeds of the sale as continuing principal or corpus interest. Under the trust instrument, and indeed under general trust law, the capital gain had to be reinvested and could not be reached by the income beneficiaries. The Supreme Court nonetheless held that the trust was taxable on its capital gain because the sale was a sufficient severance from the income tax to reach gain, even though the gain had to be returned to capital.

Similarly, in Taft v. Bowers,22 the taxpayer argued that she was entitled to basis for gifted property equal to its value when the property was received because that value was her capital. The Court responded that in “truth the stock represented only a single investment of capital — that made by the donor”23 — and that there “is nothing in the Constitution which lends support to the theory that gain actually resulting from the increased value of capital can be treated as taxable income in the hands of the recipient only so far as the increase occurred while [s]he owned the property.”24 The rationale of the Court would uphold a carryover basis applied to gifts on death, as well as to the lifetime gift that was before the Court.

In the American income tax, the phrase “recovery of capital” has come to be replaced with the phrase “recovery of basis.” Basis generally describes the taxpayer’s capitalized cost, not yet recovered, rather than an untaxed endowment or permanent capital. A step-up in basis without tax is inconsistent with the comprehensive accounting for gain that is required under a basis conception of what must be allowed as a recovery.

More generally, America never had a robust feudal tradition where the family manor and estate is entrusted solely for the benefit of the male line, nor has it had a tradition of preventing access to inherited property to prevent its redeployment or consumption. In America, capital gain is almost always accessible by the living to support their current standard of living. At least since the adoption of the income tax in 1913 and the Supreme Court’s settlement in Smietanka that realized gains are income, owners have been on notice that their gain was income and possibly subject to a tax.25

A carryover basis rule gives respect to the “permanent capital” idea by continuing the income tax exemption as long as the property is not sold. If the inherited property really is a family dynasty asset like a family farm or business that must be kept for the next generation, the income tax, which is based on realization, will not reach it. A carryover basis rule taxes gains when they cease to be capital, defined as amounts “not consumed immediately,” but “contributing[] a quota to the national wealth.”26 When capital gains are realized by sale and used to support standard of living, the gains are no longer permanent capital and are no longer properly exempt.

In 1965 Britain repealed its exemption for capital gain on the grounds of “equity and justice.”27 As the British government explained to Parliament:

Most people in this country, whatever they spend, spend out of a fund of taxed income. There are a select few who, when they spend, spend money out of an untaxed fund. It is as simple as that, and what the Capital Gains Tax does is to ensure that those who spend money, be it realising gains on their capital, spend it out of a taxed fund. We believe that it is wholly unjust and unfair that the small man who has to pay tax on every penny which reaches his pocket before he spends it, should be in a different position from his wealthier neighbour who has not had to pay tax on his capital gains.28

American exemption of capital gain is an imitation of the British social system, and the ending of the exemption in its country of origin should be especially persuasive for ending the exemption here.

18See, e.g., Hearings on the Proposed Revenue Act of 1921 before the Senate Committee on Finance, 67th Cong., 1st Sess. 537 (May 2-27, 1921) (testimony of Frederick Kellogg, asking Congress to follow British law on the exemption of capital gains).
20255 U.S. 509 (1921).
21Id. at 518.
22278 U.S. 470 (1929).
23Id. at 282.
24Id. at 284.
25Section 1053 gives a taxpayer a basis equal to its value on March 1, 1913, and that is a sufficient notice that basis thereafter is the normal cost rule, not value.
2716 Parl. Deb., H.C. (5th Ser.) (1965), 795 (Secretary of the Treasury John Diamond). See also 716 Parl. Deb., H.C. (5th Ser.) (1965), 920 (Chancellor of the Exchequer James Callaghan saying that the “basic principle . . . is that people will now be taxed on a basis according to their means and irrespective of the origin of those means, whether it be capital appreciation or income”).
28Id. at 795.
4. Rejected alternatives.

a. Higher tax during life. The revenue collected under this proposal could be collected by greater taxes on living taxpayers. Tax on heirs, however, does less damage. Under the lifetime averaging model, a rational economic actor gets the best use for his money by spreading out consumption over his lifetime into a steady average level of consumption. Maintaining steady consumption is in general more important than bequests. Bequests appear to arise primarily because of cushions or caution to cover health costs and other shocks that are unused at death, and also to compensate beneficiaries for services given. Thus moving the tax burden from a lifetime burden to a tax on heirs will reduce the deleterious impact of the tax for any given level of revenue.

b. Realization of gain at death. Another alternative, rejected here, would be to tax inherited property as if it were sold at fair market value at death of the decedent. For property that does not have a readily ascertainable value, deferring the tax burden until sale improves administrability of the tax system by looking to the sale price to determine gain. Constructive sales at death must rely on valuations that are manipulated and contested. Waiting until sale also defers the tax until the taxpayer has access to liquidity from the sale to pay the tax. Consumption tax norms, which are becoming increasingly important, support not taxing inheritances that remain invested, but taxing inheritances that are consumed.

A carryover basis regime creates problems when different heirs entitled to a share of the estate face different tax burdens on the gain. As a normative matter, shares of an estate should be equalized on a pretax basis, ignoring tax, lest the poor heir be asked to suffer by reason of the tax intended to be imposed on the rich. Still, there is tax planning possible with a carryover basis that is not possible with step-up, a constructive sale, or an income tax on all inheritances. Under carryover basis, some property has a high potential tax (when basis is low) and some property has a low potential tax or even a tax loss. Minimization of the total tax would give the low-basis asset to the poor heir and the tax-loss and high-basis asset to the high-tax-rate heir. The poor heir should not acquiesce in taking a low-basis asset, but it would be cheaper for the high-tax heir to buy off the low-tax heir than to take the low-basis asset for himself.

Some limited steps can be taken against the manipulation: Executors should be encouraged to sell assets to distribute cash equitably, by any public policy. Substantially identical stock or other assets should be considered a common pool with an average cost basis for each share. What manipulation cannot be reined in, however, can probably be tolerated.

If the manipulation of low basis to low-tax-rate heirs cannot be tolerated, a possible alternative is to impose the highest capital gain rate on inherited property no matter what the individual circumstances of the heir are.

Both a constructive sale at death and carryover basis require records of a decedent’s basis, so constructive sale at death has no advantage regarding recordkeeping. A carryover of basis increases some kinds of lock-in, but as explained next, lock-in is not a problem that needs to be fixed.

5. Lock-in. The proposal for carryover basis would decrease lock-in for the original owner before death and would increase lock-in for heirs, but by a lesser amount.

Because capital gain taxes are now imposed only if the owner sells during his life, an owner will hold onto property to avoid tax on the gain and will sell property to make a new investment only if the new investment is worth more than the old by enough to pay the capital gain charge. Given that most capital gain that is not currently realized is never taxed, the capital gain tax is a toll charge on the moving from old to new that is equal in impact to most of the amount of the tax. With carryover basis, the toll charge is reduced because the capital gain will eventually be recognized, and the tax saved by not selling currently to reinvest is just a matter of the time value of money on the tax between now and eventual realization. Reducing the toll charge will encourage original holders to sell assets to make better investments. Reducing the toll charge would also encourage owners to act in their own self-interest to diversify their investments.

Heirs, by contrast, will have an increase in lock-in. Current law forgives the tax on capital up to the fair market value on death, erasing the toll charge on liquidation of inherited property until more gain builds up in the heir's hands. Requiring a carryover of basis would increase the toll charge by the amount of tax on the gain that arose in the decedent's hands. The toll charge would not be as great as original owners face under current law because with repeal of the step-up in basis the failure to sell would be a delay of capital gains tax but no longer a forgiveness of the tax.

Lock-in may prevent a holder from diversifying his investments to dampen risk or from taking advantage of new investment opportunities, but apart from that impact on the holder, lock-in is not a material problem for the economy as a whole. Capital subject to the toll charge is only old capital held by taxpaying investors. There is sufficient capital from sources that do not pay the toll charge, that is, from new individual or corporate earnings, from property with built-in losses, from pension funds and charitable endowments that do not pay tax on the rollover of their investments, and from foreign sources. The capital that does not pay the capital gain toll charge for moving from old investments to new is adequate enough to supply capital to the better investments. The capital without the toll charge is also adequate to bid to adjust the price of the new investment to be in line with its fundamental value, and so properly signal to the market the allocation of capital according to

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the underlying merits of the investment. The inheritor of old capital who bears an increased toll charge is hurt by the increase, but the equitable case for the status quo is not very strong. Normally, in the American income tax system, taxpayers make investments from amounts that have already borne tax, and that is not an unfair rule to impose on old capital.

6. Strict proof of costs. If the recipient of a gift or inheritance does not know the cost of property received, it is difficult to see how the unknown cost is a burden. Costs that an heir does not know about do not qualify as costs in a psychological sense and need not be taken into account in computing the heir’s ultimate gain or loss. Gifts are like manna from heaven, given without a quid pro quo if they are true gifts, and it is not unreasonable to consider the gift as having no basis when none is known. If the original owner of the property is aggrieved by loss of basis to an heir after his death, the owner has a simple self-help remedy of keeping records to be available to the executor or heir.

The executor of an estate needs to have an obligation to give accurate information about the cost to the recipient of the inherited property if that is available. Some tolerance of estimates of cost should be allowed. For publicly traded stock, if the date of purchase can be ascertained, then midvalue for the date of purchase should be sufficient evidence of cost basis. The executor may have partial records. Thus if the decedent has some dividend reinvested or paid capital gain tax on mutual funds realizations that are still in the fund, the executor might have records of the original cost, but not of subsequent additions to basis. The heir then would have basis equal to the original cost, but not for reinvested dividends and reinvested gains realized within a mutual fund.

As noted, the executor should be under an obligation to compute the basis of substantially identical properties as if they were a single pool with a cost basis in each share of the pool equal to the average cost per unit. Averaging cost prevents some manipulation when low-basis assets are given to low-tax-rate heirs and high-tax-rate heirs are given high-basis assets.

Cash from a sale is always worth counting, but sometimes it is the determination of costs that is too complex to be worth the effort. Household items and heirlooms are unlikely to be sold, and it is not worth the effort of trying to account either for the original cost of the item or its value when inherited. A tax system should not invite controversies on issues not worth disputing. Accordingly, the costs of household items and heirlooms, on the occasions when they are sold, should always be zero. The cash received would be taxed even though the decedent’s costs of the household good or heirloom is not allowed.

Collectibles, such as stamps, coins, or whiskey bottle collections sometimes have costs that are too large to achieve a sale price of $100 in 40 years. Under the standard formula for the future value of an annuity at 5 percent, A * [(1 + 5%)^40 - 1] / 5% = $100, it follows that A is 83 cents per year. Forty years of 83 cents is $33 per $100 sale price.

Collectibles, moreover, are usually not wise investments apart from the untaxed enjoyment of collecting and also do not contribute to general productivity, so they should never be perceived to be tax advantaged. The proposal recommends that a mandatory statutory basis, excluding one-third of sale price, be applied to all collectibles. The statutory exclusion is the basis expected for a 40-year collection with equal purchases each year. Actual cost, for example, for a single painting, coin, or stamp should be allowed only if the single unit has at least a $500 cost.

7. Privity of basis and remote relationships. The proposal recommends that an heir should not be entitled to basis for an inheritance from nonrelatives or from remote relatives, as defined by current law defining “dependents.” Assume, for example, that a bachelor farmer dies and leaves his farm, worth $10 million, to a remote heir. Assume he bought the farm when the land was $100 an acre, and it is now $4,000 an acre. Assume the heir has never met the decedent during his life. Regarding the remote heir, the farm is a windfall. Whether the bachelor farmer paid $10 an acre, $100 an acre, or $10,000 an acre has no impact on the well-being of the remote heir at any time. Tax on a remote heir the bachelor farmer did not meet or know will, at best, have a trivial impact on the bachelor farmer’s economic decisions.

It is proposed that decedents who are not relatives within the section 152(d)(2) definition would not give their cost basis to whomever receives the property by reason of death. Qualified relatives of the decedent, under the existing section 152(d) definition, include all children and descendents, parents and direct ancestors, siblings and step-sisters, aunts and uncles, nieces and nephews, and sons-in-law, daughters-in-law, mothers-in-law, and sisters-in-law. State-law marriage status would be a bright-line marker of who is married, but a seven-year monogamous cohabitation would seem to an accept-able substitute for the marriage license. An inheritance from a friend, a cousin, a second cousin, or greater degree of kinship would not be taxed on receipt but would also not carry any basis from the original owner to the recipient.

Records of adjusted basis are a serious problem when the decedent is remote, and there is only the most attenuated sense in which the decedent’s cost is a cost to the heir. Inheritances from outside the family, moreover, tend to have a factor of payment for services or favors, although the quid pro quo element may be difficult to prove. Tax on payments given for services is highly appropriate in an income tax even if the connection between inheritance and service is loose and difficult to

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32 See section 6018.

33Assume equal investments of amount A each year that will yield a sale price of $100 in 40 years. Under the standard formula for the future value of an annuity at 5 percent, A * [(1 + 5%)^40 - 1] / 5% = $100, it follows that A is 83 cents per year. Forty years of 83 cents is $33 per $100 sale price.

34Relationships short of clear legal marriage can get tricky, and the tax man (or woman) should not even try to peek into them. Casual relationships not amounting to marriage should not qualify.
prove. Giving the recipient both an exemption and zero basis is a reasonable compromise for inheritances from nonrelatives.

The proposal would also tax cash inheritances from nonrelatives. One might presume that the decedent paid tax to get cash, but a privity or relatedness requirement implies that the heir should not get credit for the tax the decedent has paid. If the heir gets no carryover of basis, it seems proper that the heir should not be able to establish basis in property by purchase with cash from the decedent, unless the heir has first paid tax on the cash.

A remote relationship between a recipient and transferor affects basis in other contexts. Section 362(a), for example, gives corporation basis from shareholders who transfer appreciated property to the corporation. Section 362(c), however, gives the corporation a zero basis for a contribution to capital from nonshareholders or shareholders not acting as such.

The relationship between transferee and recipient has been considered in other proposals on taxation of donative transfers. The Canadian 1966 Royal Commission on Taxation proposed that gifts from outside the household would be taxable income, but that transfers between spouses and dependents within a household would be tax free. Inheritances are part of the standard of living of the recipient, and so are a part of the Haig-Simons definition of income. Indeed, Henry Simons himself proposed taxing gifts as part of income, without regard to the transferor’s cost basis. Giving the heir a zero basis is a lesser burden than taxing the heir on the value of the inheritance on receipt.

No attempt is made in the proposal to narrow the definition of gifts during life or to make them taxable. If the donor is alive at the time of the gift, the donative transfer is treated, under current law, as a variety of consumption by the donor himself. Cash gifts during life are made tax exempt, under section 102, because by presumption the donor has already paid tax on the cash. The recipient gets basis even from a nonrelative for gifts during life. Gifts during life are not windfalls or surprises in the same sense as inheritances by remote heirs. The tax advantage of gifts, however, is limited by donors’ strong reluctance to give up their wealth during life. Wealth is a protection, a cushion, and a source of control as long as the owner lives, so owners tend to hold on to their wealth during life.

8. No integration with estate tax here. In general, the estate tax is imposed on wealth transferred whether or not the decedent has paid prior tax on the wealth. Thus if the decedent received stock compensation, paid ordinary income tax on it, and died shortly thereafter before there was any subsequent appreciation of the stock, the value of the stock has just borne a 35 percent tax and is nonetheless included in the taxable estate. However, some inherited interests have never been subject to income tax, for example, zero-basis assets that arose from expenses investments.

The estate tax is often said to be especially objectionable because it imposes a tax on wealth that has been fully taxed by the income tax, and also especially necessary because of inherited assets that have never borne any income tax. Accordingly, there is considerable sentiment in favor of integrating the estate and income tax into a single overall burden. In 2001 Congress enacted a modified carryover basis provision, section 1022, for the year for which estate tax was repealed (2010), and also terminated the modified carryover basis for the year when estate tax repeal lapsed (2011) and the tax was scheduled to return with a 55 percent tax rate. The 2001 act allowed either an estate tax or carryover basis, but not both.

The traditional argument for the estate tax is that it is a tax on transfer of substantial wealth from one generation to the next, whether the wealth arose from taxed or untaxed sources. Because the rationale for the tax has nothing to do with an income tax, the traditional response to calls for ending double taxation is that there is no need to integrate income and estate tax. It would not be unreasonable, however, to integrate the income and estate tax so that, for example, stock compensation that has borne full 35 percent income tax would bear a lower estate tax.

This proposal is not the place to integrate the estate tax and income tax. Carryover basis property would be a relatively low-taxed asset — the capital gain paid on sale sometime in the future is a modest tax — and thus if there is to be an integration of income and estate tax to reach a certain aggregate level, the carryover basis property would have to pay relatively more estate tax, not less. It would be possible to add estate tax attributed to the property to the basis of the property, but it would be bad policy because the carryover basis property has to have a higher estate tax to reach parity with high-income-tax assets, not a tax relief. A proposal on carryover basis property, in any event, does not seem to be the best forum for integrating estate tax and income tax if it is to be done.

C. Explanation of the Provision

The proposal would end the step-up in basis at death for property received from a decedent dying after a notice of intent to offer a bill is given by Treasury or an

Footnote continued in next column.)
elected representative. The $1.3 million and $5 million step-up to fair market value allowed by section 1022 in 2010 only would also not be allowed.

Qualified relatives of the decedent would step into the shoes of the decedent and take his adjusted basis, even in the computation of loss. Qualified relatives, as defined by current section 152(d)(2) to include, for example, uncles, step-brother, and sister-in-law, would give their provable basis to the heir. No basis would be carried over from decedents who are not related or from relatives more remote than section 152(d)(2) qualified relatives. A marriage license would be a clear definition of marital status, but long-term monogamous relationships akin to marriage could be treated similarly to relatives. Cash inheritances from section 152(d)(2) relatives would be excluded, but cash inherited from decedents more remote than section 152(d)(2) relatives would be taxable.

Household goods and heirlooms would have no basis even if inherited within the household. Collectibles would get an automatic one-third exclusion, except that pieces costing more than $500 could have their provable basis.

When basis carries over, the executor of the estate would be required to treat substantially identical property as a pool, with each share in the pool having the same average cost basis. The executor of the estate would be required to give heirs information about the decedent’s basis. Estimates of costs up to the level of more likely than not to be true under the evidence would be included in basis. Decedent’s cost that could not be proved to the level of more likely than not would not be allowed.