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Plump Target: Basis Step-Up

To the Editor:

By Letter to the Editor (*Tax Notes*, Dec. 15, 2008, p. 1327, *Doc 2008-26091*, *2008 TNT 242-53*), "Anonymous" argued that carryover basis is an unoriginal idea, and that, when carryover basis was the law, reporting cost basis to heirs created administrative nightmares for executors. "Anonymous" argued that step up in basis is needed to prevent double taxation of appreciated property. "Anonymous" was responding to my proposal, "Elephant in the Parlor: Repeal of Step-up in Basis at Death" (*Tax Notes*, Dec. 8, 2008, p. 1181, *Doc 2008-24389*, *2008 TNT 237-31*).

The step-up in basis at death is a very, very old idea, but we need to take a look at it in the coming rounds as a source of significant and desperately needed revenue. The step-up idea is a legacy of the conceptual system that capital could never be sold but had to be preserved for the next male heir. That idea ceased to be part of a functioning military system by 1277 when King Edward I called the last medieval muster of his nobles and their knights. Before that, the castle and manor had to be preserved to feed the horses, no matter what the castle and manor were worth. Step up in basis is now unfair: it allows the wastrel heir to consume inherited interests, using a fake cost to compute tax gain. Expensed interests like oil and intangibles never get taxed. Step up blocks rational taxation of the consumption of capital even before death and distorts investment decisions. The bon-bons consumed by the heir are a plump target for fair tax, when we get around to raising some revenue.

Carryover basis was adopted in the Tax Reform Act of 1976 and then repealed retroactively in 1980. The repeal cited the undue complexity of administration, although in fairness much of the complexity arose from the "fresh start" exemptions. Section 6039A, requiring executors to tell heirs about cost basis for the property, was part of that proposal.

It is important to make life as easy as possible for executors. The solution in the proposal adopts the common sense idea that if neither executor nor heir knows the cost of a property, it is difficult to see how the cost is a burden. Zero is a very simple number to put on the section 6039A information return, and zero is a fair number when cost can not be proved. Inheritances are windfalls, appropriately taxed. We might also tax appreciated property in the hands of the executor or mandate maximum tax rates for every heir to avoid the picking of heirs who will be hurt least by low basis, although the project did not propose either provision. The problems need to be addressed head on, but not as an excuse to let high standards of living avoid tax. Moneys spent for the highest standards of living are the very best source for tax revenue.

I very much favor integration of estate tax and income tax. Appreciated property, however, would be hurt not helped, by integration because even with carry over basis, the effective tax rate on appreciated property is substantially below the average effective tax rate on capital. The appropriate yard stick under a tax that allows interest deductions is the effect of the tax on annual internal rate of return, which is the economic or effective tax rate measure. A serious systematic integration proposal would have to lift the tax on zero-basis interests like oil or intangibles, which have never borne income tax.

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Dec. 17, 2008

Static vs. Ambulatory: Treasury on Supplemental Treaty Guidance

To the Editor:

Static interpretation of treaties considers that they apply with respect to the domestic law definition of a term as it was in force when a treaty is ratified. Ambulatory interpretation considers that treaties apply with respect to the domestic law definition of a term as it is in force at the time a transaction occurs. Therefore, subsequent changes in domestic concepts of terms not defined in a treaty (as provided in Article 3(2) of the OECD Model Treaty) can result in different source taxation (including nontaxation) of items of income.

I would like to applaud the remarks of Gretchen Sierra and Patricia Brown about ambulatory interpretation of treaties (for further coverage, see *Tax Notes*, Dec. 15, 2008, p. 1258, *Doc 2008-25873*, or *2008 TNT 238-3*). In the *NatWest* cases, which involved the years 1984-1987, the government should have argued that the United States' change of position in the 1984 OECD report on "Transfer Pricing and Multinational Enterprises" (at paragraph 52) allowed it to change, under Article 3(2) of our treaty with the U.K., its interpretation of what expenses were attributable to the U.S. branch of NatWest.

As I recall, Jerome Libin's excellent brief in that case cited 1977 as well as 1963 OECD commentary, but did not go after that. I think he was concerned that the government might then bring up the 1984 change in position and the 1995 OECD amendment to its model treaty explicitly endorsing ambulatory interpretation (even for past years). Canada, whose Supreme Court adopted static interpretation, legislatively overruled that result.

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Dec. 10, 2008