Statement of Harry L. Gutman

before

The Select Revenue Measures Subcommittee of the Committee on Ways and Means

May 12, 2021

Mr. Chairman and Members of the Subcommittee,

The following is the formal statement to accompany my testimony as an invited witness at the hearing on "Funding Our Nation's Priorities: Reforming the Tax Code's Advantageous Treatment of the Wealthy".[1]

In my testimony I argued that tax-free step-up in basis should be repealed and replaced by a regime in which death and lifetime transfers are income tax realization events. That would mean that when an individual dies owning property that has appreciated in value, tax would be payable on that gain rather than forgiven as it is under current law. Conforming rules would treat lifetime transfers similarly.

Other witnesses discussed the data that shows the enormous concentration of wealth and income in the top 1% of Americans.[2] Those data also demonstrate another disturbing phenomenon—the effective rate of tax on taxable, as compared to economic, income actually declines for the taxpayers more than $5 million of adjusted gross income.[3] That differential would be even greater if taxes paid were compared to economic income. This disparity is in large measure attributable to the failure to tax capital income, which constitutes a significant portion of the economic income of this population cohort, in a manner equivalent to labor income. An obvious cure to this problem is to tax income the same whether its source is labor or capital. Those witnesses also examined the extent to which the removal of capital income preferences would likely affect economic growth and capital investment. I will not repeat their analysis and conclusions. I will simply observe—as a layman—that horizonal equity requires equivalent treatment of income regardless of its source and that until the tax rate exceeds 100% people will invest in income generating opportunities, although the tax rate applicable to labor compared to capital income may well affect the choice between consumption and investment.

The Joint Committee on Taxation lists more than 230 income tax provisions as "tax expenditures".[4] An economic or social policy objective can be cited for virtually all of them. However, try as one might, no one can create a plausible tax, social, or economic policy justification for "step-up", which creates vertical and horizontal inequity, impedes sound economic behavior and produces a significant revenue loss.

Some have suggested that repeal is unnecessary because unrealized appreciation is captured by the estate tax. Indeed, a principal tax policy justification for the estate tax was to ensure that those with capital income that has been exempted from current taxation bear their fair share of the tax burden. In other words, by subjecting the full value of included property to tax, the estate tax acted to protect the progressivity of the income tax system by capturing untaxed, unrealized appreciation in the tax base.

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[1] The following is taken in large part from Gutman, "Taxing Gains at Death", 170 Tax Notes Federal 215 (January 11, 2021). The views expressed in this testimony are the author's own.
[2] Sullivan, "The SALT Cap is a Poor Way to Tax the Rich", 171 Tax Notes Federal 851 (May 10, 2021).
[3] *Ibid*.
[4] JCT, "Estimates of Federal Tax Expenditures for Fiscal Years 2020-2024", JCX-23-20 (Nov. 5, 2020).

But that backstop role has diminished as the estate tax exemption has climbed. Even if the estate tax exemption was returned from its current level of $11.58 million per taxpayer to its 2009 level of $3.5 million per taxpayer it would not discharge this policy role in any meaningful way. In a world in which the estate tax is limited to less than .1 percent of all decedents, a provision that forgives the income tax on unrealized appreciation is particularly indefensible.

Here is an illustration of what is at stake. Twenty years ago, Ann Smith dropped out of college and started a tech company. Her ownership shares in that company are now worth $1 billion. For twenty years she paid income tax on her $1 million salary until her retirement this year. But on the bulk of her income, the $1 billion of appreciation on her shares of stock, she has been allowed the tax benefit of deferring tax until sale. Even though she would like to diversify, it is safe to assume she will not sell the bulk of her shares until death because tax-free step up in basis at death creates a significant inducement to hold her shares. That is the lock-in effect. If Ann needs cash, she can borrow using her shares as collateral. Under current law, upon her death, the benefit of tax deferral on the increase in value of her shares—in this case, many decades of deferral—is transformed into tax forgiveness.

Ann's situation is rare among the general public. Most income for low, middle, and even mildly wealthy people is generated through wages, salaries, and business income on which they pay tax without deferral at ordinary income tax rates. Her situation, however, is commonplace among the super-rich. The bulk of unrealized appreciation in property other than homes and retirement accounts is held by a small fraction of the most wealthy. And the amount of that income is hidden from view because it is unrealized. Most economic analyses of the tax burden across income classes do not include this important component of economic income purely for lack of data.

Treating death as an income tax realization event would tax Ann's unrealized gain at death. She would still enjoy the benefits of decades of deferral of tax on her unrealized gain. Twenty years of deferral, assuming a discount rate of 2 percent, cuts the effective tax rate by approximately one-third. Forty years of deferral cuts the rate by more than half.

Existing law violates the tax policy goal of **horizontal equity**. Similarly situated taxpayers should pay similar amounts of tax. The horizontal inequity that result from tax-free step up in basis at death is simply illustrated. A and B are siblings. Each bought stock X for $100,000. It is now worth $3 million and each has decided to sell. A meets B in the street outside their broker's office just after A has executed her trade and before B is going to do the same thing. A car hits them and both die. Assuming a 20-percent income tax rate and no estate tax, B's heirs receive $2,420,000. A's heirs get the stock with a new basis of $3 million and can sell the next day and pocket the entire $3 million. That's indefensible. And that is not all. If A borrowed money using the stock as collateral, A had the use of the appreciation during her life and the debt can be repaid from the tax-free proceeds of the sale of the stock after A's death. There is nothing fair about that either.

As noted in the example of Ann, step-up induces individuals to hold property until death, a phenomenon called **"lock-in".** It creates an artificial impediment to sales that would normally occur and therefore distorts capital flows.

Finally, as is obvious, the failure to tax unrealized appreciation results in a major **revenue loss.** The Joint Committee has estimated the tax expenditure revenue loss to be $218 billion for 2020-2024 plus $19 billion for carryover basis for gifts.

Recognition of a problem and solving it in a political world are two very different matters. As early as 1942 the Treasury proposed that a beneficiary carry over the decedent's basis in property transferred at death.[5] In 1963 President Kennedy proposed taxing the unrealized appreciation in property transferred at death.[6] That recommendation was reiterated in a 1969 Treasury study.[7] In 1976 Congress eliminated "step-up" by enacting a carryover basis regime that was repealed in 1980 without ever having become effective.[8] In 1977 the outgoing Republican Treasury proposed transfers at death and by gift as realization events.[9] Carryover basis was in effect for one year—2010—in connection with a phased-in estate tax repeal.[10] President Obama proposed treating transfers of appreciated property as sales in his fiscal year 2016 and 2017 budget.[11] President Biden has included a similar provision in his recent individual tax proposals.[12] Congressman Pascrell has introduced legislation to treat and lifetime transfers as income tax realization events.[13] Senator Van Hollen, with four others, has released a discussion draft of legislation to achieve the same result.[14]

It is fair to ask why, if both Democratic and Republican Treasury Departments have identified "step-up" as a problem and proposed essentially identical solutions, a permanent solution has not been enacted. I suspect the answer lies in the nature and distribution of the tax benefit. As noted above, most taxpayers do not have significant amounts of unrealized appreciation in their personal investment portfolios. To the extent they have interests in appreciated property, other than their residence, most of that property is held in tax favored retirement accounts and is subject to ordinary income tax when distributed. They are simply unaware that a problem exists and consequently they do not exert political pressure to resolve it. Moreover, I suspect most politicians are keenly aware of the issue and its potential impact. The combination of popular ignorance and political "sensitivity" produces a powerful inducement to dismiss the problem. This observation emphasizes the importance of today's hearing and the need more fully to inform the taxpaying public of this issue.

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This proposal will undoubtedly resurrect the arguments that emerged in the past when a realization regime has been suggested as well as those used to urge the repeal in 1980 of the carryover basis regime that Congress enacted as part of the Tax Reform of 1976. I will address them briefly now.

A Realization Regime Causes a Forced Sale of Assets. Funds will be needed to pay the tax due on appreciated assets. Under most proposals, deathtime recognition would be limited to marketable assets (e.g., stocks, bonds and mutual funds in which most Americans hold their wealth) which, by definition, are liquid. Funding the tax obligation may require the sale of some assets and the timing of sales may be inconvenient. However, a market exists to eliminate liquidity issues and inconvenient timing issues

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[5] Hearings on Revenue Revision 0f 1942 Before the House Committee on Ways and Means, 77th Cong. 2d Sess., vol. 1 at 89.

[6] Hearings on President's 1963 Tax Message Before the House Committee on Ways and Means at 20,49 and 122 (1963).

[7] Treasury, "Tax Reform Studies and Proposals", 91st Cong., 1st Sess., Pt.3, 331-351 (1969) (1969 Treasury Proposals).

[8]Carryover basis was enacted as section 2005 of TRA 1976. It was retroactively repealed by section 401 of the Crude Oil Windfall Profit Tax Act of 1980.

[9] Treasury, "Blueprints for Basic Tax Reform", at 204 (Jan. 17, 1977)

[10] Section 542 of the Economic Growth and Tax Relief Reconciliation Act of 2001.

[11] Treasury, "General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals", at 156 (Feb. 2015) (2016 Treasury Proposals); Treasury, "General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals", at 155 (Feb. 2016) (2017 Treasury Proposals

[12] White House, American Family Plan, April 28, 2021.

[13] H.R. 2286.

[14] Sensible Taxation and Equity Promotion (STEP) Act.

may be alleviated by borrowing against the value of the property. Bunching issues that may arise due to the impact of progressive tax rates on the deferred gain can be addressed through averaging conventions.

The proposed regime must, however, address the legitimate concerns of those who own non-marketable assets—particularly closely held family businesses and farms. Requiring the sale of some of those assets to pay the tax could materially and adversely affect the business and its owners. Consequently, special rules should be enacted to defer the tax on non-marketable assets until the assets are sold, thus eliminating a "forced" sale of those assets.

Lack of basis records. Whether one believes the claim that basis records somehow disappear at death (recall that they were necessary to establish gain or loss on a lifetime sale), any proposed system puts taxpayers on notice of the need for basis records. A properly designed system would provide relief in problematic areas—personal residences and non-collectible tangible personal property. In addition, a lookback rule by which the basis of an asset may be established by discounting its value at the relevant tax date back to its acquisition date could be provided to determine unknown basis.

Interaction with the Estate Tax. Any income tax payable with respect to recognized gain would be deductible from the decedent's gross estate for estate tax purposes. Thus, the total income and estate tax burden on property that is subject to the realization regime will be the same whether that property is sold before or after death.

Transition Relief. Transition is a particularly difficult issue. The new regime could apply to all realizations occurring after the effective date, only appreciation occurring after the effective date or assets acquired after the effective date. Each has a different effect. Ideally, transition should not create winners and losers. But sometimes the search for "equitable" transition rules produces perceived inadequate relief or political impracticality and, as a consequence, a desirable law change is not enacted. In my view, we should not let the perfect be the enemy of the good; the most important objective is the enactment of the general rule. Generous transition relief may be necessary. But transition relief is, by definition, temporally limited.

The challenge is to design a system that is comprehensive in coverage, administrable, perceived as fair and not subject to abuse. That task involves not only identifying the assets that will be subject to the regime but also the exclusions and exemptions deemed necessary to promote administrability and perceptions of fairness. The fundamental question of the taxable unit to which the new regime will apply must be resolved. The need for and design of anti-abuse protections must be examined. Provisions to assist in valuation issues and the determination of unknown basis must be devised. And finally, an effective date provision that will be viewed as acceptable by the affected community of taxpayers and advisors must be selected. The proposal to treat death and lifetime transfers that follows reflects my judgment as to the appropriate balance of conceptual purity, administrability and political reality.

General Rule

Subject to specified exclusions and exemptions, **all deathtime and lifetime transfers will be income tax realization events.** All non-spousal deathtime transfers of marketable assets[15] would be recognition events. All non-spousal lifetime transfers would be recognition events. Recognition may be elected by the taxpayer/transferor for any realized gain on an asset-by- asset basis. The tax on realized but unrecognized gain, together with a deferral charge to equate the total payment to that which would

[15] Marketable securities are defined in section 731(c). Actively traded personal property, as defined in Regs., Section 1.1092(d)-2, would also be subject to recognition.

have been due upon realization, would be payable when the subject property is later disposed of in a recognition event. The following is an explanation of the proposal in three sections: property held at death, lifetime transfers and effective date/ transition.

Property Held at Death

Death is an income tax realization event

The objective of the regime is to capture all of a decedent's accrued gains and losses at death and assure that the resulting total tax liability will be collected in present value terms.

Subject to the effective date rule and the exemptions and exclusions noted below, death will be treated as an income tax realization event for all property owned (or treated as owned for income tax purposes) by a decedent as well as any property subject to a general power of appointment in the hands of the decedent.[16] The fair market value of such property, which will become the tax basis in the hands of any recipient, will be determined at death (or at the estate tax alternate valuation date if applicable), with the same choice being required for both estate tax and income tax purposes. Property to which special estate tax valuation rules would apply will be valued in accordance with those rules without regard to whether the decedent is subject to the estate tax.[17]

Recognized Gain Limited to Marketable Assets. The extent to which realized gain is to be recognized is a critical issue as to which proposals have varied over the years. The 1969 Treasury proposal, the 1977 Blueprints for Basic Tax Reform proposal and the Obama Administration proposals treated all assets, other than those subject to exemptions or exclusions, as recognition events. Each provided some form of liquidity relief.[18]

In my judgment the prior proposals failed to recognize the practical and, arguably more important, political issues surrounding the issue of liquidity. It is one thing to fund the tax payment by a sale of marketable property. By definition, that property is liquid. It is quite another to require current tax payment associated with non-marketable assets, such as a farm or small business, especially because a "forced" sale in such circumstances may materially affect the amount that could be realized at that time. While it is conceivable to borrow against the value of the asset to pay the tax, that is not an ideal solution. Nor is a deferred payment schedule, which is economically equivalent to an installment loan from the government and would still require raising cash to pay each installment. To alleviate this problem, I propose that the immediate recognition of gain be limited to marketable assets other than those transferred to a surviving spouse (as to which recognition is not elected) or subject to one of the exclusions described below.

Net recognized gain, determined after accounting for any net realized loss from non-marketable property, will be taxed separately from all other income realized during the decedent's final taxable year at the rate then applicable to capital gain. The gain would be spread over five years so the impact of progressive rates would be moderated.[19] A net recognized loss will first be utilized, on a pro rata basis, to offset net realized gain from non-marketable property held at death. Any remaining loss may be

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[16] This realization rule does not depend upon estate tax inclusion rules.
[17] See Section 2032A.
[18] For example, the 2017 Treasury Proposals allowed the exclusion for capital gain on certain small business stock (Section 303), a postponement of the tax due until sale with respect to certain small family owned and operated businesses, and a deferred payment plan for non-liquid appreciated assets. 2017 Treasury Proposals at p.156.
[19] Gain that would be taxed as ordinary income, such as OID items, inventory or depreciation recapture, would also have an averaging convention.

utilized to offset net capital gain on the decedent's final income tax return, and to the extent necessary, carried back to the three preceding taxable years. Losses in excess of net capital gain for the preceding three years may be used to offset ordinary income commencing in the year immediately preceding death.

__Treatment of Non-marketable Property__.

Non-marketable property as to which recognition has not been elected, other than that subject to the exclusions described below, will be valued at death in accordance with the valuation principles stated above. Net realized gain in excess of any applicable net recognized loss will be calculated. Net recognized loss will be allocated pro rata with realized gain. The tax payment with respect to each non-marketable asset will be deferred until the property is sold or transferred inter-vivos in a recognition transaction that results in the transferee no longer being treated as the owner of the property for income tax purposes, at which time the gain will be taxed at the rate in effect on the date of death of the decedent together with an interest charge that will equate the present value of the deferred tax with the tax that would have been paid at death.[20] Realized losses in excess of realized gains with respect to non -marketable property ("net realized losses") may be utilized to offset net recognized gain, with any excess treated in the same manner as net losses with respect to marketable property.

The transferor of any non-marketable asset may elect recognition treatment on an asset by asset basis.

The transferee of a non-marketable asset will be liable on a non-recourse basis for the deferred tax upon a taxable disposition (as well as any tax due with respect to the disposition itself). Thus, the deferred tax liability will not exceed the value of the property at the time of the taxable event. In the case of multiple non-recognition transfers, such as if A dies and transfers to B and then transferee B dies and the property passes to C, a separate realization event will occur. The realized gain at B's death will be equal to the difference between the value of the property at B's death and the property's basis (determined by reference to the value of the property when B received it). If C disposes of the property in a taxable transaction, C will be responsible for the payment of deferred taxes on both the transfer from A to B and from B to C, as well as any tax due with respect to the recognition event. Gain with respect to all realization events will be reported on a separate information return that will also report the basis of the transferred property in the hands of the transferee. The gain reported on that return, together with the appropriate deferral charge, will be due when the property is disposed of in a taxable transaction.

The deferred tax liability will be secured by a lien on the subject property.

__Examples:__

Example 1. M dies owning marketable security A with a value of 100, basis of 10, marketable security B with a value of 200 and a basis of 100 and marketable security C with a value of 100 and a basis of 150. M recognizes gain of 140.

Example 2. N dies owning marketable security A with a value of 100, basis of 10 and a non-marketable asset B with a value of 100, basis of 50. No election is made to treat asset B as a recognition event. N

[20] The design of the deferral tax is an important component of the proposal. The present value of the tax liability is known. It is the future value that must be calculated. The variables are the time period between the realization and recognition events and the interest rate to apply. The latter will, of course, vary, perhaps considerably. The Service could publish tables to utilize to approximate the actual interest rates over the appropriate time period. See the discussion below for the treatment of successive non-recognition transfers.

will recognize gain of 90. The realized gain of 50 attributable to asset B will be taxed according to the deferred gain rules upon its disposition in a recognition event by the transferee.

Example 3. O dies owning marketable security A with a value of 100 and basis of 200. A has no unrealized gain. O recognizes a loss of 100 which may be utilized on O's final income tax return.

Example 4. P dies owning marketable security A with a value of 100 and a basis of 300. P owns non-marketable asset B with a value of 200 and basis of 100. P also owns non-marketable asset C with a value of 400 and a basis 100. The net loss of 200 attributable to marketable security A is allocated 50 to Asset B and 150 to Asset C. Thus, the net realized gain for Asset B is 50 and for Asset C it is 150.

Example 5. Q dies owning marketable security A with a value of 200 and basis of 50. Q owns non-marketable asset with a value of 50 and basis of 100. The realized loss of 50 offsets the recognized gain of 150 leaving a net recognized gain of 100.

Example 6. R dies owning no marketable assets and non-marketable asset A with a value of 100 and a basis of 200. The realized loss of 100 may be utilized on R's final income tax return.

Marital Transfers

Marital transfers present special issues. If the objective of measuring all gains and losses at the decedent's death is implemented, the "traditional" treatment of deathtime spousal transfers should be revisited.

Prior proposals have treated the marital unit as a single taxpayer for realization purposes. Thus, transfers to a surviving spouse would not be treated as realization events and the decedent's basis in the transferred property would carry-over to the recipient spouse. However, the decision to treat the marital unit as a single taxpayer is a policy choice that introduces a number of issues that have to be addressed. First, a marital exemption gives an executor the incentive to transfer low basis property to a surviving spouse and high basis property to other beneficiaries. This incentive can be mitigated by creating an average basis mechanism that allocates total basis of the decedent's assets in accordance with their relative fair market values. However, an average basis mechanism could be difficult to administer because the reallocated basis is dependent upon both the basis and the value of every other asset, each of which may be uncertain. Second, the assets used to fund a marital bequest must be identified before the income tax liability of the decedent is calculated. Thus, an executor would be required to claim tentative exemptions on the decedent's income tax return that reflect the property to be transferred after death. Amended returns would be required if the distribution differs from that originally claimed on the return.

An alternative, which is consistent with the objective of determining all gain and loss at the decedent's death, recognizes the special status of the marital unit but removes the gaming opportunities and administrative difficulties presented by treating the marital unit as a single taxpayer. Unless recognition is elected, all transfers to a surviving spouse in any form that would qualify for the estate tax marital deduction are treated as realization but non-recognition events in accordance with the rules governing outright transfers of non-marketable property. The effect would be to determine the tax due with respect to all property held by the decedent but defer the tax on appreciated property transferred to a surviving spouse until the earlier of the sale of the property, the inter-vivos transfer of the property (whether marketable or not), the death of the surviving spouse in the case of marketable property or the taxable disposition of non-marketable property in the hands of a testamentary distributee of the surviving spouse. In the case of loss property, the decedent could elect immediate recognition.

Charitable Transfers*.*

Charitable transfers of fee interests in property would not be treated as realization events. The conceptually correct result is to treat the transfer as an income tax realization event and allow a charitable contribution deduction in the amount of the value of the transferred property. Under current law a charitable transfer is not realization event. Political pragmatism would likely prevail and attempting to overturn a long-standing rule seems a bridge too far at the moment.

There are alternative possibilities involving a split system in which gain would be realized for either lifetime or deathtime transfers but not both. Non-realization would, of course, provide an incentive to make transfers during the period to which that regime applies. There is no principled basis upon which to make this determination, but it could provide a rationale for imposing the correct answer in at least some circumstances.

Transfers of partial interests in property to a charity will be excluded to the extent the value of the interest would be deductible for federal income tax purposes. In effect, therefore, remainder interests would generally be in the form of charitable remainder annuity trusts or unitrusts or pooled income funds and charitable income interests would be in the form of guaranteed annuity interests or unitrusts. This rule avoids the difficult valuation issues that would be presented by unusual types of charitable bequests.

Where a qualified charitable interest either precedes or succeeds the interest of a non-charitable beneficiary, the amount realized that is attributable to each interest is determined in accordance with the present value of the respective interests. The decedent's basis would be allocated in the same proportion. Gain or loss will be realized to the extent of the difference between the portion of the amount realized allocated to each non-charitable interest and the basis allocated to that interest. Gain or loss will be recognized to the extent the transferred interest consists of marketable property. Special rules will have to be developed to determine when gain attributable to the transfer on non-marketable assets will be recognized.

Miscellaneous Items.

Life Insurance. Proceeds of life insurance on the death of the decedent would not be subject to realization.[21]

Income in Respect of a Decedent ("IRD"). "In general, 'income in respect of a decedent' refers to those amounts to which a decedent was entitled as gross income but which were not properly includible in computing his taxable income for the taxable year ending with the date of his death…under the method of accounting employed by the decedent."[22] Examples include compensation for services, accrued dividends and interest, amounts in qualified retirement plans, and amount due on installment sales. Under current law these items do not receive a basis step-up under section 1014.[23] Rather, the item is taxable to the estate or beneficiary at the same time and in the same manner that it would have been taxed had the decedent lived.[24]

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[21] While not part of this proposal, the internal interest buildup on permanent life insurance should be taxed currently to the policyholder.

[22] Regs. Section 1.691(a)-1(b).

[23] Section 1014(c).

[24] Regs. Section 1.691(a)-3.

The issue is whether to continue the present law treatment of IRD, tax all IRD at death or adopt a hybrid approach. The 1969 Treasury proposal would have repealed section 691 and required recognition of IRD at death.[25] The rationale for the repeal was that the IRD rules "were designed to avoid bunching of ordinary income in the decedent's final return". The 1969 proposal contained special rules to alleviate perceived bunching issues and therefore Treasury concluded that section 691 was no longer necessary.

Under the proposal, items of IRD would be valued at death and the realized gain would be recognized as the deferred payments are received. Thus, inclusion in the proposal does not create a liquidity issue. As noted earlier, an averaging convention will be necessary to ameliorate the bunching issues. The rule does require valuation of the deferred amount. In this respect though it is no different than any other non-marketable asset subject to this regime. Moreover, taxation of IRD items in this manner is consistent with the underlying policy goal of determining the total tax liability of a decedent at death. IRD items are property of the decedent and if liquidity issues are adequately addressed there is no reason for the items to receive special treatment.

Property Subject to Liabilities. Rules will be needed to deal with special situations in which liabilities exceed the basis and value of the property.

<u>Exclusions</u>**.**

Basic Exclusion. Any proposed regime must take into account the practical aspects of its implementation and should not impose undue burdens on decedent's estates. On the other hand, it must be comprehensive enough to achieve the objective of subjecting unrealized appreciation to tax.

There are a number of ways to limit the applicability of the regime. One is to provide a "minimum basis" amount.[26] A second is to provide an exclusion for a defined amount of gain.[27] A third is to exempt all estates below a certain level.

A minimum basis proposal will affect only those whose aggregate asset basis is below the minimum. It is not immediately apparent why this limited form of relief is appropriate. In any event it will require a convention to allocate basis among assets.

A gain exclusion provides relief to all taxpayers with aggregate gain. It too will require a convention to allocate the exclusion among assets. The simple solution is to allocate the exclusion pro rata among the gain assets.

Under either rule, the minimum basis adjustment or gain exclusion should be applied first to capital gain property and then to property the disposition of which would result in ordinary income.[28]

The exemption of estates below a certain level is superficially attractive because it would eliminate the need to compute gain or loss for estates below the threshold and it avoids allocation problems. It would have disparate impacts depending upon the amount of unrealized appreciation in each exempt estate. But more importantly, the "cliff effect" of cutting off the application of the rule at a specified dollar amount is simply unfair.

A portable exclusion is the preferred result.

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[25] 1969 *Treasury Proposals*, p.338.
[26] 1969 *Treasury Proposals*, p.342.
[27] See, e.g. *2017 Treasury Proposals* at p.156 proposing an indexed $100,000 portable exclusion per taxpayer.
[28] E.g., Inventory or depreciation recapture.

Non-Business Tangible Personal Property. All prior proposals have recognized that attempting to tax non-business tangible personal property creates difficult issues. There are valuation and basis identification issues and, as a practical matter, most such property (other than "collectibles"[29]) has not appreciated in value. The question is how to fashion an appropriately targeted exclusion.

There are at least three issues. The first is whether the exclusion should be limited by a dollar amount. The second is whether, if so limited, the exclusion should apply on an asset by asset or aggregate basis. The third is how to allocate the exclusion among affected assets.

I believe that the complexity and administrative burden connected with any dollar limited/allocated exclusion cannot be justified. Thus, I would endorse the Treasury 2016 Budget proposal to exempt all non-business tangible person property other than collectibles as defined in Section 408(m)(2).

Principal Residence. Consistent with the treatment accorded a lifetime sale a $250,000 exclusion will apply to gain realized with respect to a principal residence that qualifies under section 121. The exclusion will be portable with respect to transfers to a surviving spouse.

Deductibility of Tax. Any currently payable tax will be deductible from the decedent's gross estate. Deferred tax presents a different issue. The deferred tax is not a liability of the decedent. It is payable by the owner of the property at the time it is disposed of in a taxable transaction. However, the actual value of the property that passes to a recipient is net of the deferred tax liability. Thus, the deferred tax should reduce the value of the asset in the decedent's estate.

Payment of Tax. The tax on recognized gain, calculated as provided above, will be payable by the estate of the decedent. Deferred tax, limited to the value of the property at that time will be payable by owner of the property at time of recognition.

Periodic Imposition of Tax. The question arises as to whether it is necessary to require periodic payment of the deferred tax attributable to non-marketable property. To the extent the deferral charge on the deferred payment is accurate, this would be an unnecessary complication.

Foreign Tax Considerations. The extent to which the death-time tax could be offset as a result of death-time recognition under the taxing system of another country must be further explored.

Lifetime Transfers

Lifetime Transfers Are Generally Income Tax Recognition Events. The guiding principle of this proposal is that, to the extent practicable and consistent with other applicable income tax rules, all transfers of property should be accounted for in the tax return of the transferor at the time of the transfer. Consequently, apart from inter-spousal, charitable and transfers of non-business tangible personal property (other than collectibles), all gratuitous lifetime transfers will be recognition events. Recognition (rather than realization) is appropriate because the lifetime transfer is a voluntary event and liquidity issues can be anticipated and resolved. An election to treat inter-spousal transfers as recognition events is provided. As further explained below, non-charitable transfers to trusts will be recognition events when and to the extent the transferor is no longer treated as the owner of the property for income tax purposes. Special rules would be provided for the creation of joint tenancies.

Outright transfers. Except as provided below, an outright transfer of property other than to a spouse or charity will be a recognition event. Gain will be recognized to the extent of the difference between the fair market value of the property and its basis. Losses will not be recognized for transfers of non-

[29] See, Section 408(m)(2).

marketable investment property and any property transferred to related parties within the meaning of section 267. The recipients of such property will receive a carryover basis.

Spousal Transfers. Consistent with the general principle of the proposal and the suggested deathtime transfer rule, outright transfers to a spouse as well as transfers that qualify for the gift tax marital deduction would be treated as realization events with recognition occurring upon the disposition of the property by the transferee spouse with the tax determined in accordance with the rules set forth above.[30] However, immediate recognition of gain property may be elected.

Charitable Transfers. Lifetime charitable transfers will be treated in the same manner as deathtime transfers. Thus, outright transfers will not be subject to the regime and split interest or transfers in trust will be treated as described above.[31]

Transfers in Trust.[32] Transfers in trust in which the transferor retains no powers or interests will be recognition events. Transfers in trust in which the transferor retains a power or interest pose a special problem of determining the taxable event. This is because under the transfer tax a transfer of property may, as illustrated below, be subject to tax twice, whereas under the income tax, there is only a single event that shifts the tax burden from the transferor. There are two options to resolve the issue. The first is to treat a transfer as a recognition event when and to the extent it is subject to transfer taxation. The second is to treat the transfer as a taxable event when and to the extent the transferor is no longer treated as the owner of the property for income tax purposes. The difference in treatment may be illustrated by the following simplified example: Assume that A transfers marketable property with a value of 100, basis of 10 in trust with income payable to A for life, remainder to unrelated party B. The actuarial value of A's retained interest is 80. Under current law a has made a completed gift to B of 20.[33] However, A is taxed on the income from the trust until A's retained interest expires[34]. If transfer tax principles govern the determination of the recognition event, A has made a taxable transfer of 20 and the gain recognized is 18 at the time of the transfer. However, the property is also included in A's estate[35] and consequently would be subject to further income taxation at that time. The subsequent inclusion of previously taxed property would require the creation of a credit mechanism to avoid double

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[30] An inter-vivos spousal transfer does not raise the same administrative issues as a deathtime transfer. See, *Marital Transfers* discussion, *supra*. Consequently, the decision could be made to exempt such transfers from the general rule and account for the property only upon disposition by the transferee spouse.

[31] See, *Charitable Transfers* discussion, *supra*.

[32] The application of the proposal to lifetime transfers in trust, as well as to deathtime transfers of property included in decedent's estate invites a re-examination of the differing rules regarding the income and transfer tax treatment of transfers to trusts, with the goal of establishing identical rules regarding the taxable event for both. This is an issue that has been examined in the past. See, e.g., American Law Institute, *Federal Income Tax Project, Subchapter J—Income Taxation of Estates, Trusts and Beneficiaries and Income in Respect of a Decedent*, Tentative Draft No.12 (March 28, 1984); U.S. Treasury Department, *Tax Reform for Fairness, Simplicity and Economic Growth*, vol.2, pp. 378-380 (Nov. 1984).

[33] The transfer tax treatment of this disposition has a number of widely recognized mismeasurement possibilities, e.g., the transferor 's life expectancy, the interest rate used to determine the value of the retained interest and the fact that the transferred corpus may be invested in a manner that differs from the interest rate assumed in the initial valuation. Adopting the income tax rule for a completed gift would eliminate these mismeasurement issues. Note that if B is a member of the transferor's family within the meaning of section 2704(c) the entire transfer would be subject to gift tax. See section 2702.

[34] Section 677.

[35] Section 2036(a)(1).

taxation. On the other hand, if income tax principles are used to determine the taxable event, recognition will occur only upon the expiration of A's interest.

The proposal adopts the rule that realization generally occurs at the time and to the extent the transferor is not treated as the owner of the trust corpus for income tax purposes, with recognition dependent upon the character of the trust assets. Thus, in some cases, the transfer itself or a subsequent lifetime transfer will constitute a realization event. However, where a transferor has until death been treated as the owner of all or a portion of a trust for income tax purposes, the death of the transferor will be a realization event with recognition depending upon the composition of the taxable interest. Realization may, therefore occur, even if the trust corpus is not included in the transferor's gross estate.

Joint Tenancies. In general, the creation of a joint tenancy or similar interest will be treated as a recognition event without regard to whether or to what extent a gift tax might be imposed. For example, assume stock is purchased by an individual in his or her name for $10,000. When the stock is worth $20,000, the individual creates a joint tenancy with another person. If the applicable state law is such that the new joint tenant can sever the property and thereby take stock worth $10,000 the first individual has made a transfer of $10,000 and will recognize gain of $5,000. The new joint tenant has a basis of $10,000 and the transferor has a basis of $5,000 in his or her remaining interest. If, as a result of applicable state law, the values of the respective interests are valued actuarially, the actuarial values are used to determine the amount of recognition by the transferor and the basis of the transferee.

A transfer to a spouse that qualifies for the gift tax marital deduction is a realization event in accordance the spousal transfer rule described above.

If the creator of the joint tenancy subsequently transfer his interest to another person by gift, gain will be recognized to the extent of the difference between his basis and the fair market value of his interest in the property at the time of the transfer. The recipient of the transferred interest will have a basis equal to the fair market value of the interest at the time of transfer. If the joint tenant donee transfers her interest by gift gain will be recognized in an amount equal to the difference between her basis and the fair market value of her interest at the time of the transfer.

Exclusions.

Non-Business Tangible Personal Property. Transfers of non-business tangible personal property other than collectibles are excluded.

Principal Residence. As in the case of deathtime transfers, a $250,000 exclusion will apply to gain realized with respect to a principal residence that qualifies under section 121. The exclusion will be portable with respect to transfer to a spouse.

No Present Interest Exclusion. The gift tax present interest exclusion will not apply.

Certain non-recognition provisions. Transfers described in sections 351, 354 and 721 will not be realization events.

Effective Date/Transition

The regime described above is very different from present law. Perhaps the most important practical decisions in its implementation are the choice of an effective date, and if necessary, the provision of transition relief. Those decisions require a careful balancing of theoretical purity with a calculated appraisal of political reality.

Scope. There are three basic choices with respect to the scope of the deathtime regime. First, the regime could apply to all realization events occurring after a specified date. Thus, all pre-effective date appreciation is captured.[36] Second, the regime could apply only to appreciation occurring after a specified date.[37] Finally, it could apply only to assets acquired after a specified date.

Application of the regime to all realization events occurring after the effective date treats all taxpayers similarly without regard to the date of acquisition of the appreciated asset. As the Joint Committee on Taxation has noted "One could argue that the absence of a transition rule raises a question of fairness for taxpayers who have made decisions based on present law to retain appreciated assets in anticipation of death."[38] It is, of course, arguable whether a taxpayer has a protected right to the tax treatment in effect when he acquires an asset. Moreover, such a rule puts pressure on basis identification and the need to provide rules to establish basis when it is unknown. More practically, apart from the 2016 and 2017 Obama Treasury proposals, there has been general agreement that at the least only appreciation occurring after the effective date should be subject to the new regime.

The 1969 Treasury proposal, the 1977 Blueprints for Basic Tax Reform and the 1976 carryover basis regime all provided that only appreciation occurring after the effective date would be subject to the regime. In practice, this solution foundered on the alleged difficulty of establishing a new basis for non-marketable property on the effective date. One solution, of course, is to get an appraisal, a potentially costly exercise that would invite controversy with the IRS. Another is to devise a "discount back" approach in which the date of death value is discounted back to the effective date at a prescribed rate of interest.[39]

The third alternative is to apply the new regime only to assets acquired after the effective date of the statute. For policy purists this is an unacceptable solution precisely because it codifies the questionable expectancy of those who bought assets before the change in the law and is very uneven in its effect over the short term. That is a powerful policy argument. However, there are at least two counterarguments. First, apart from issues specifying how the regime would apply in the case of post-effective date transfers to and acquisitions by pre-effective date entities, the rules are clear. Basis must be kept for all post-effective date acquisitions. Second, and most important in my mind, is the likelihood that this is

[36] *2016 Treasury Proposals* at p. 157;*2017 Treasury Proposals* at p. 156.

[37] *1969 Treasury* Proposals at p. 335; *Blueprints* at p.204.

[38] Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained In The President's Fiscal Year 2016 Budget Proposal*, JCS-2-15, (September 2015) p.191.

[39] This is the opposite of the mechanism to determine the tax due on a deferred sale of non-marketable property. However, it introduces a new element for consideration—the rate of appreciation in the subject property. The simplest solution is to ignore fluctuations in the rate of appreciation and simply provide a discount rate, by table. There are, as expected, more complicated ways to address the problem, each of which would have to reversed to calculate the acquisition date value (basis). Section 1291 provides an existing model with respect to deferred PFIC earnings. Others have been suggested by e.g. Altshuler and Grubert, *Shifting the Burden of Taxation from the Corporation to the Personal Level and Getting the Corporate Rate Down to 15 Percent*, 69 National Tax Journal No.3 (2016) http://ssrn.com/abstract=2802109 pp.25-39, Auerbach, *Retrospective Capital Gains Taxation*, American Economic Review, March 1991, 167– 178. See also, Wyden, *Treat Wealth Like Wages*, Senate Finance Committee Democrats, Appendix I: Lookback Taxation of Nontradable Property, (2019) pp.23-24.

the proposal that is most likely to survive the political process.[40] As noted above, to me, the goal is the codification of the right rule. Transition relief is, by definition, temporal. The resulting "revenue loss" is the price to be paid to "purchase" the right result.

Lifetime Transfers. All lifetime transfers other than to charity occurring after the effective date are realization events as described above. Lifetime transfers are voluntary events. Potential issues of basis identification is simply a factor to be taken into account by a donor in deciding whether to make a gift. However, the disparity in treatment between lifetime and deathtime transfers will act as an inducement to hold pre-effective date property until death. The alternative is limit realization to assets acquired after the effective date. In the latter case current law would apply to the transfer of any pre-effective date assets. However, pre-effective date assets acquired after the effective date by lifetime transfer would be treated as post-effective date acquisitions by the transferee. The basis of such assets would be the carryover basis of the transferor as under current law. The gain realized upon the disposition of such assets by the donee will be equal to the difference between the fair market value of the asset and its basis in the hands of the donor. The only difference from current law is that a subsequent lifetime transfer or retention at death becomes a realization event to the donee.

Effective Date. In order to reduce planning opportunities, the new regime should apply to decedents dying and transfers made after date of introduction of the implementing legislation.

Anti-Abuse Rules. If the new regime applies only to property acquired after the effective date a mechanism must be devised to capture the appreciation attributable to post effective date transfers of property transferred to pre-effective date assets, such as partnerships or corporations, in non-recognition events. The simplest rule is to have a pro-rata portion of the owner's interest subject to the realization regime. Thus, for example, assume that A is the sole owner of Corporation X with a value of 1000. A makes a post effective date transfer of 100 to the corporation. 1/11 of the value of the stock of Corporation X will be subject to the new regime.

More significant is the incentive for existing entities to make post-effective date acquisitions that would otherwise be made by their owners. While this is not likely a major problem for publicly traded entities, it is for closely held entities. For example, assume A, the owner of pre effective date closely held entity X would like to acquire corporation Z after the effective date. If acquired outright by A, Z would be subject to the new regime. If acquired by X, absent a look-through rule, it would not be subject to the new regime. This is a potentially significant problem that does not have an easily administrable solution. Conceptually, post effective date acquisitions that occur outside the normal course of the entity's business, narrowly defined, should be treated as post-effective acquisitions. However, defining the transactions that would be subject to this rule and devising a mechanism to assure adequate tracing is a daunting task.

Transition Relief. Application of the new regime only to assets acquired after the effective date alleviates the need for general transition relief. Notwithstanding the fact that taxpayers are on notice that they will be required to maintain basis records for post-effective date transfers, there still may be circumstances in which basis records will be unavailable or difficult to determine. In such cases the

[40] It is my understanding that had Treasury agreed to apply carryover basis only to assets acquired after the effective date the provision would not have been repealed. And today, forty years after its repeal, it would be virtually universally applicable.

“discount back” approach, in which the value at the date of the realization event is discounted back to the appropriate acquisition date at a prescribed rate of interest, can be utilized to determine basis.

Conclusion

The time to repeal Section 1014 is well overdue. Replacement with a regime such as I have suggested would enhance horizontal equity, economic efficiency and revenue. Most importantly, at a time when income inequality is growing to what many consider unacceptable levels, the proposal directly addresses what is perhaps the most glaring loophole in the income tax—the complete exemption of the bulk of the wealth accumulation of the super-rich from income tax.