



# **CARRYOVER BASIS REFORM: WHY IT FAILED IN 1976 BUT WORKS TODAY**

**By Howard Segermark**

## **Executive Summary**

Critics of estate tax repeal frequently charge that reforming carryover basis is unworkable and often cite a failed attempt to reform the law in 1976 as evidence. However, there are significant differences between the 1976 law and today's proposals that make carryover basis reform not only viable – but a significant improvement over current law:

- The most Byzantine rules in the 1976 law involved the interaction between estate taxes and capital gains taxes on those assets. Since today's bills would repeal the estate tax completely, families would no longer be subject to these complex calculations.
- A centerpiece of the 1976 law was an amnesty that forced most of the nation to recalculate the value of all of their holdings simultaneously. This one time recalculation amnesty was completely unworkable and is not included in today's carryover basis reform proposals.
- The 1976 law had a significantly lower exemption level than today – 50% of the country would have had to pay the tax. Today, only 5% would be affected and they frequently keep sophisticated accounting records that make calculating taxes from the original basis easy.

Opponents of repeal simultaneously charge that many family business owners and farmers would be worse off under carryover basis reform and no estate tax than they would be under today's system. The numbers simply do not support this conclusion – in all but a few unrealistic scenarios family business owners would benefit from permanent estate tax repeal proposals that include carryover basis reform.

## **Introduction**

In 2010, the new carryover basis goes into effect with repeal of the estate tax – offsetting hundreds of billions of dollars in revenue losses. This provision would become permanent with passage of S. 428 or S. 988 through the Senate. However, it has faced persistent charges of unworkability from opponents of estate tax repeal.

Because the Tax Reform Act of 1976 contained a provision regarding carryover basis which was repealed before it went into effect, critics of the any repeal of the death tax point to that experience as evidence that the provisions in current law and pending legislation are equally flawed. However, significant differences between the 1976 law and today's proposals make carryover basis reform not only viable, but a significant improvement over current law.

In addition, fears of the new law making certain small business owners and farmers less well-off are unfounded, and depend on unrealistic assumptions or a misreading of the law or the facts. Virtually all farmers and family business owners will be better off if the estate tax is permanently repealed and carryover basis is reformed.

## **The 1976 Act and Today's Law vs. Today's Repeal/Reform Proposals**

Several important items are different because under current law and under the Sessions bill, the change in the carryover basis rules occur simultaneously with estate tax repeal.

In 1976, the step up basis rule in Section 1014, "The Basis of Property Acquired from a Decedent," was modified by Section 1023 which introduced a carryover basis regime but the estate tax itself continued.

Under the '76 law, all personal assets were to be revalued -- a free step-up in basis ~~was~~ as of December 31, 1976. This was an accounting and legal task of massive dimension: over 50% of households would have been required to determine all their assets' value on that day, and set up records as to the value, and provide proof of that value.

Under that '76 law, estate taxes would be levied on increases in value after that date, with a very modest exemption of \$60,000, plus \$10,000 for household goods. According to our estimate, this meant that more than 50% of households would have to go through this process.

Congress heard from CPAs, attorneys, bankers and thousands of individuals who objected to this process on the basis of its inherent difficulty, impracticability and pitfalls. Congress learned its lesson and the provision was repealed. The fresh start provided by revaluing assets was unworkable.

But, the current law doesn't provide for any fresh start, since the estate tax is going away. No revaluation is needed.

## **Higher Exemption Levels Mean Only 5% Will Pay the Tax**

Second, the '76 Act, which had modest a step-up allowance of \$60,000 plus \$10,000 for personal effects, which meant that at least 50% of the population was exposed to the 1976 carryover basis rule

The 2010 rule provides for an exemption from capital gains tax on future sales of property received from a decedent of \$3 million for spouses, and another \$1.3 million for all heirs, and an exemption of \$3 million for transfers to spouses. And, it is important to note, that these exemptions are only on the gain in value, not on the value of the asset itself.

The question of liability to the spouse is only relevant when the assets transferred from the first to die to the survivor are sold and there is a very significant exemption. If there is a \$4.3 million of appreciation in the assets, there would be no cap gains tax. Only the gain from original cost above that figure is taxable.

For example, if an asset was purchased for \$500,000 by the decedent, and after death, the heirs other than the spouse sold the asset for \$1.75 million, there would be no tax. The gain on the asset was less than the \$1.3 million exemption.

The massive reduction of the burden of capital gains taxes is further reduced when, under the 2010 rule (or under Sessions or Kyl after 2010), is that with careful planning, a couple could transfer assets on which they had \$5.6 million of gain exposure to their descendants and the descendants would have no exposure to capital gains tax (\$1.3 million exemption for the heirs, plus the \$3 million per spouse transfer). For example, assume a couple has an estate worth \$10 million. Of that, \$5 million represents increase in value over original purchase price. Upon the death of one spouse, the surviving spouse and heirs have a total of \$4.3 million from any gains on sales of the appreciated assets: the \$3 million spousal exemption and the \$1.3 million for other heirs. Upon the death of the surviving spouse, there is another \$1.3 million exemption from capital gains taxes on the appreciation of assets he/she leaves to the heirs.

In fact, under the modified step up basis and this generous step-up limit (compared to the stingy 1976 limit of \$60,000) we estimate that less than 5% of the population will have to worry about the new carryover rules.

## **The '76 Version Gave Families No Time to Plan, Today's Proposals Do**

In conforming to the new regime, there a great difference between the Sessions/Kyl and current estate tax law. There is time for planning. With planning the difficulty in determining original costs goes away. We have a perfect example in the current application of the gift tax law. When a taxable gift is made gift is made the donor's basis carries over to the donee. We hear no complaints about tracking basis for gift tax purposes.

In 2010, executors that oversee estates in which there are assets with no good original basis information is available, they can use the \$4.3 million exemption.

Even if assets on which information isn't readily available, we know that the vast majority of assets are marketable securities, houses and real property. The value of securities at any given time is easily determinable, and sales/purchase prices of houses and real property is a matter of public record. Plus, it is crucial to remember that any valuation problems would be faced not at death as is now the case, but at a subsequent sale of the asset.

### **The '76 Act's Most Byzantine Rules Won't Apply**

The 1976 Act was further complicated by the fact that the estate tax paid, was included in the calculation of the basis for capital gains taxes due upon sale of an inherited asset. And it was based on the ratio of a given asset's increase of value to the increase in value of the assets of the entire estate(!). For example, let us assume that the '76 Act wasn't changed and under those provisions, a Joe Smith died on January 1, 1986. His estate was quickly settled and \$5 million estate tax was due on a \$10 million estate (the 50% rate is used for illustration purposes only). In addition, one-fifth of the estate was a parcel of land valued at \$2 million. The nephew who inherited that parcel wanted to sell it several years after his inheritance because it wasn't going up in value, and was still marketable at \$2 million. Let us also assume that the land had been reevaluated to be worth \$1.6 million on December 31, 1976, thus meaning that the increase in value at time of death was \$400,000.

Under that law, the capital gains tax due on the sale would be reduced by some percentage of the total estate tax paid, based on the increase in value of all assets in the estate. In order to determine his capital gain tax liability, the nephew would have to determine the increase in the value of all other assets in the estate between the dates of December 31, 1976 and January 1, 1986. Thus if the entire estate was worth, only \$2 million on December 31, 1976, there would have been a capital increase of \$8 million prior to death and that meant that the \$5,000,000 estate tax paid could be apportioned against capital gains tax liability on future sales, or 62.5% of the gain. The land sale capital gains tax liability would be reduced 62.5%: capital gains would only be due on \$150,000 of the \$400,000 gain. Conversely, if the estate had a value of \$20,000,000 on December 31, 1976, and the only asset in it to increase in value was the parcel of land, then all \$5,000,000 in estate tax credits could be allocated against the land parcel, and obviously, all \$400,000 of gain would be eliminated, thus eliminating any capital gains tax liability on the sale.

To further complicate this, consider the fact that most estates are not settled rapidly, thus the estate tax liability isn't determined. That means that our nephew might not know his capital gains tax liability on the sale for some time. He would have to file his income tax returns based on a guess of his liability, and refile to pay more (with penalties) or for a refund. Oh, also add in the complexities of the \$60,000 exemption.

That rats'-nest of complications led to repeal of that provision. And, that rats'-nest of complications is totally absent in the new law and the Sessions/Kyl proposals.

Plus, the whole capital gains tax liability issue is massively reduced by the greatly increased exemptions – far, far fewer persons will be liable.

### **Liability is Determined by the Marketplace, Not Lawsuits**

Finally, the beauty of this is that with repeal, the tax liability is determined by the marketplace on the sale of the asset, and not on the opinion of an appraiser – or a court which must decide between the appraisers of the IRS versus the appraisers of the inheritors. A huge amount of litigation costs would be eliminated.

### **Another Unstated Cost of the Current Law**

Another cost of the current system, which is reformed by repeal and the change in step up basis, is that it currently allows taxpayers to double depreciate, double amortize and double delete assets. Under current law, if an apartment building is fully depreciated and it generates significant income and income tax liability is passed on to a surviving spouse, the asset is revalued at market price and depreciation can begin anew. Estate scholar Harold Apolinsky estimates that this kind tax avoidance costs the federal government a minimum of \$30 billion per year.

### **Almost All Families Are Better Off Under Repeal/Carryover**

At least one of the group opposing making current law permanent on 2010 (Kyl bill) or making it effective now (Sessions bill) have made the unsupportable statement that most (!) of its members would be “worse off under the carryover basis rules.”

First, if current law is made permanent (Kyl or Sessions bills), with careful planning, \$5.6 million of gain (not the value of property, remember) is wiped out (that's \$1.3, plus \$1.3, plus \$3 million), and only gain beyond that becomes liable to capital gains taxes when heirs sell the assets. Current law provides an exemption of \$3.5 million scheduled to be effective for the year 2009, which would allow a couple, with careful planning, to pass \$7 million worth of property free of estate tax. If you assume an estate tax rate of 45% for amounts above that (as provided in current law), then only estates between \$5.6 million and \$7.7 million would find themselves "worse off" under the repeal/carryover regime.

For estates larger than \$7.7 million, the couple would be far worse off without estate tax repeal - essentially incurring a 45% tax rather than a 15% tax. For estates less than \$5.6 million, there is no difference, because either under repeal/carryover or no repeal/\$3.5 million exemption no tax would be paid. But this worst case analysis is only the beginning. Two other critical assumptions must be made to conclude that some families with estates between \$5.6 million and \$7.7 million will be worse off.

First, the above analysis assumes that the couple has no increase in the value of their assets at death – a zero basis. This is a highly improbable situation. Even the conservative Poterba study (July 2000) concluded that, on average, a decedent's basis represents about 56% of

the value of his assets at death. So to be on the very conservative side, let's assume that the couple's basis in the above example represents just 28% (or one half of the average) of the value of the assets (with the remaining 72% representing appreciation) in their estate. 28% of \$7.7 million equals \$2,156,000. If this couple died with a 45% estate tax plus a \$3.5 million exemption in place, their estate tax would be \$315,000. On the other hand, if the repeal/carryover rule applied, their heirs would pay capital gains tax of zero. So, to determine whether an estate between \$5.6 and \$7.7 million is better or worse off, one needs to know what their basis is.

Second, the timing of the payment of the tax is a key difference. Under the "no repeal" scenario, the tax is usually due 9 months after death. Under the repeal/carryover scenario, no tax is paid until the assets are sold by the heirs! This deferral benefit is conveniently unnoticed by opponents of the reform. But the fact is that deferring a tax has substantial value, making the repeal/carryover option far more attractive for business and farm owners who wish to pass their assets to their children.

Those spreading the belief that most people will be worse off under repeal/carryover are using scare tactics not founded on logic.

1. All couples with estates of less than \$5.6 million will pay no tax whether carryover exists or no repeal exists.
2. All couples whose estates are greater than \$7.7 million are better off under repeal/carryover.
3. For estates between \$5.6 million and \$7.7 million, the largest possible difference is \$210,000, but this unrealistically assumes that a couple has no basis in their assets at death.
4. If a couple has greater than \$1.4 million of basis in their assets, they are always better off with repeal/carryover.
5. The \$210,000 worst case scenario, ignores the advantage that this tax is not due until the asset is sold, diminishing its true cost.

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