Death Without Taxes?

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I. INTRODUCTION

The past thirty years have witnessed a dramatic shift in the debate over the taxation of gifts and bequests. In 1976, when Congress unified the estate and gift taxes and added a new tax on generation-skipping transfers, debate focused primarily on the structure and operation of the transfer taxes, but their role as an integral part of the federal tax system was scarcely questioned. During the 1980s and 1990s, however, the transfer taxes repeatedly came under attack, culminating in recent attempts to eliminate the taxes altogether. In 1999, and again in 2000, Congress approved legislation that would eliminate the taxes over a ten-year phase-out period. Although neither bill survived a presidential veto, controversy over the taxes clearly has not subsided.

Opposition to the transfer taxes is remarkable both for its growing political momentum and its extravagant rhetoric. Some critics claim that the transfer taxes discourage work effort, impede saving, and stifle capital formation. Others blame the taxes for an alarming catalogue of social ills, including unemployment, lack of equal opportunity for minorities, and the demise of small businesses and family farms. These charges, while empirically unsubstantiated,
certainly reflect profound resentment of the taxes. To some extent, frustration with the transfer taxes in their existing form is understandable. Undoubtedly, they could be made simpler, fairer, and less intrusive — the same could be said of the income tax. But opponents of the transfer taxes clearly contemplate repeal, not reform.

Several factors may account for growing opposition to the transfer taxes. Inflation and real economic growth have pushed an increasing number of estates above the taxable threshold (currently $675,000).\(^4\) Widespread use of the unlimited marital deduction since 1981 has also increased the number and size of taxable estates in the hands of surviving spouses. Recent run-ups in stock market prices have swollen the expectations of baby boomers who stand to receive a massive intergenerational wealth transfer over the next twenty years. Finally, projected budget surpluses — which may or may not materialize — provide a rare window of opportunity for cutting taxes on a grand scale. Nevertheless, the level of popular enthusiasm for repeal, rather than reform, of the transfer taxes remains something of a puzzle. After all, these taxes produce relatively little revenue;\(^5\) they are paid by a select group of wealthy taxpayers;\(^6\) and the average effective transfer tax rate is less

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\(^4\) The exemption level is scheduled to rise to $1,000,000 in 2006. See I.R.C. § 2010(c). As a percentage of all decedents, the number of taxable estates is expected to remain just below two percent. See infra note 27 and accompanying text.

\(^5\) In 1999, the transfer taxes raised around $28 billion, representing 1.5 percent of total federal tax revenues. See Selected Historical and Other Data, 19 S.O.I. Bull. 117, 141 tbl.17 (Winter 1999-2000).

\(^6\) In 1997, the number of taxable estate tax returns filed was around 42,900, and the total number of deaths was around 2,314,700. Thus, only around 1.85 percent of all decedents incurred an estate tax liability. See Present Law and Background on Federal Tax Provisions Relating to Retirement Savings Incentives, Health and Long-Term Care, and Estate and Gift Taxes: Hearing Before House Comm. on Ways and Means, 106th Cong. 110 tbl.17 (1999) (Present Law and Background).
than half of the stated top marginal rate of fifty-five percent.\(^7\) Perhaps, as Michael Graetz has suggested, the explanation lies in an irrational optimism that leads a majority of Americans to believe that they will rank among the wealthiest one or two percent when they die.\(^8\)

The purpose of this article is not to evaluate the merits of the transfer taxes or to argue the case for repeal or reform. That debate has been ably presented elsewhere.\(^9\) Instead, we look at transfer tax repeal in terms of its repercussions on the rest of the tax system. We assume, for the sake of argument, that a decision has been taken to repeal the transfer taxes, and we then explore the implications of that decision for the income tax treatment of property transferred by gift or bequest. Part II contends that transfer tax repeal would reduce progressivity, exacerbate existing inequities with respect to transfers of appreciated property, and sharpen the need for income tax reform. Part III considers two possible responses — a deathtime gains tax and a carryover basis regime — and discusses issues of structure and implementation bearing on the choice between them. Part IV extends the analysis to address the effect of taxing gifts and bequests as income to the recipient. In conclusion, we suggest

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\(^7\) See William G. Gale & Joel B. Slemrod, Rethinking the Estate and Gift Tax: Overview 35 & tbl.7 (July 2000) (unpublished manuscript, on file with Va. Tax Rev.) (in 1997, average effective transfer tax rate for all returns was 13 percent; average effective transfer tax rate for taxable returns was 22 percent); Barry W. Johnson & Jacob M. Mikow, Federal Estate Tax Returns, 1995-1997, 19 S.O.I. BULL. 69, 83 (Summer 1999) (in 1997, for taxable returns, average estate tax rate, as percentage of net worth less estate expenses and marital and charitable bequests, was 23.2 percent).

\(^8\) See Michael J. Graetz, To Praise the Estate Tax, Not to Bury It, 93 YALE L.J. 259, 285 (1983).

that the transfer taxes cannot simply be eliminated without risking potentially serious problems for the larger tax system.

II. TRANSFER TAXES IN PERSPECTIVE

Formally, the transfer taxes operate separately from and quite independently of the income tax. Functionally, however, the transfer taxes interact with the income tax in ways that may have significant implications both for the distribution of tax burdens and for the timing and structure of gifts and bequests.

A. Progressivity

The transfer taxes are often credited with making a significant contribution to the progressivity of the federal tax system. Traditionally, the income tax has favored income from capital by permitting deferral of unrealized gains and taxing realized gains at relatively low effective rates. This preferential income tax treatment benefits the wealthy disproportionately, given the concentration of capital assets in their hands coupled with the tendency of the realized rate

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10 See, e.g., U.S. DEP’T OF THE TREASURY, 91st Cong., TAX REFORM STUDIES AND PROPOSALS 106 (Comm. Print 1969) (1969 TREASURY PROPOSALS) (estimating, based on 1965 data, that estate and gift taxes were “probably responsible for about one-third of the net progressivity” of the federal tax system); Graetz, supra note 8, at 272 (estimating, based on 1972 data, that “the estate and gift taxes contributed nearly one-third as much to the progressivity of our tax structure as did progressive individual income tax rates”). See also Harry L. Gutman, Reforming Federal Wealth Transfer Taxes After ERTA, 69 VA. L. REV. 1183, 1194 (1983).

11 In 1992, the top one percent of families held 36 percent of total household marketable wealth and 46 percent of total household financial wealth; for the top 20 percent, the corresponding figures were 84 percent and 92 percent. See Edward N. Wolff, Who Are the Rich? A Demographic Profile of High-Income and High-Wealth Americans, in DOES ATLAS SHRUG? THE ECONOMIC CONSEQUENCES OF TAXING THE RICH 74, 77 (Joel B. Slemrod ed., 2000). See also LEONARD E. BURMAN, THE Labyrinth OF CAPITAL GAINS TAX POLICY 90 tbl.6-2 (1999) (showing distribution of asset holdings by income).
of return on capital to decline as wealth increases. Thus, the estate tax backstops the income tax by reaching wealth accumulated from tax-preferred sources. While in theory it might be possible to achieve any desired degree of progressivity by increasing income tax rates, high marginal rates may have unacceptable efficiency costs. Deathtime taxes are often considered to have lesser disincentive effects than income taxes of equal yield because individuals are likely to discount deathtime taxes in making decisions concerning work, savings, and investment.

There is a strong prima facie case for the progressivity of these taxes, for they fall primarily on taxpayers in the top tier of the wealth and income distributions. Under current law, households in the top one percent of the income distribution bear sixty-four percent of the federal estate tax burden, and those in the top five percent bear ninety-one percent of the burden. The transfer tax burden is also highly

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12 See Eugene Steuerle, Wealth, Realized Income, and the Measure of Well-Being, in Horizontal Equity, Uncertainty, and Economic Well-Being 97-100 (Martin David & Timothy Smeeding eds., 1985) (measuring gross capital income subject to tax as percentage of wealth, based on 1976 data); David Joulfaian, The Federal Estate and Gift Tax: Description, Profile of Taxpayers, and Economic Consequences 30-31 & tbl.24 (U.S. Dep't of the Treasury, OTA Paper No. 80, 1998) (measuring non-wage adjusted gross income as percentage of gross estate, based on 1981 and 1982 data, and noting that “the realized rate of income for those with estates under $500,000 is about twice as large as that of the wealthiest group”).


14 See William G. Gale & Joel B. Slemrod, A Matter of Life and Death: Reassessing the Estate and Gift Tax, 88 Tax Notes 927, 930 (2000) (“Most estimates suggest that the estate tax is the single most progressive federal tax.”).

15 See Julie-Anne Cronin, U.S. Treasury Distributional Analysis Methodology 24 tbl.12 (U.S. Dep't of the Treasury, OTA Paper No. 85, 1999). The following table summarizes the proportionate shares of the federal estate and individual income tax burdens borne by households in the top one percent, five percent, ten percent, and twenty percent of the income distribution:
skewed toward decedents at the top end of the wealth distribution.\textsuperscript{16} One recent study compares the estate tax liability of wealthy decedents with their income tax liability for the year before death, and concludes that “[t]he estate tax significantly contributes to the overall tax burden on the wealthy.”\textsuperscript{17} Alternatively, the transfer taxes can be recast as an equivalent investor-level tax on capital income, with the effective rate varying according to the taxpayer’s age and mortality risk.\textsuperscript{18}

The degree of progressivity in the federal tax structure has fluctuated over the last two decades. After dramatically

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<th>Estate Tax</th>
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<td>Top 1 percent</td>
<td>64 percent</td>
<td>30 percent</td>
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<tr>
<td>Top 5 percent</td>
<td>91 percent</td>
<td>49 percent</td>
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<tr>
<td>Top 10 percent</td>
<td>96 percent</td>
<td>61 percent</td>
</tr>
<tr>
<td>Top 20 percent</td>
<td>99 percent</td>
<td>77 percent</td>
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See id. For households in the top one percent of the income distribution, the transfer tax burden is more than six percent of the individual income tax burden. See id. (for top one percent, transfer taxes represent 1.3 percent of household income, and the individual income tax represents 20.2 percent of household income). The Treasury’s method assumes that the decedent bears the burden of transfer taxes. See id. at 32. As a practical matter, however, the implications for progressivity would not be significantly different under an assumption that the burden falls on the recipient, since “recipients of estates tend to have very high income and wealth themselves.” Gale & Slemrod, \textit{supra} note 14, at 930.

\textsuperscript{16} See Gale & Slemrod, \textit{supra} note 7, at 35 & tbl.6. In 1997, estates of less than $5 million accounted for 94.5 percent of all taxable estate returns and 49 percent of total transfer taxes paid, while estates of $5 million or more accounted for 5.5 percent of all taxable estate returns and 51 percent of total transfer taxes paid. See id.

\textsuperscript{17} Joulfiaian, \textit{supra} note 12, at 31. This study, based on data from income and estate tax returns from the early 1980s, notes that the ratio of estate to income tax liability was more than seven to one for the wealthiest group of decedents but only around three to one for the least wealthy group of decedents subject to the estate tax. See id. at 31 & tbl.25.

\textsuperscript{18} See James M. Poterba, \textit{The Estate Tax and After-Tax Investment Returns}, in DO\textit{ES ATLAS SHRUG? THE ECONOMIC CONSEQUENCES OF TAXING THE RICH} 329, 330 (Joel B. Slemrod ed., 2000); id. at 335 (“Estate taxes are taxes on capital.”).
cutting the top income tax rates in 1981, Congress moved in 1986 to compress the rate structure and broaden the income tax base.\textsuperscript{19} Although the progressivity of the income tax declined during the early 1980s, subsequent developments may have largely reversed this trend. Increases in the top income tax rates in 1993 were followed in 1997 by the reinstatement of a significant capital gains preference.\textsuperscript{20}

Taking 1980 as a baseline, income tax changes during the ensuing two decades may have produced little or no net change in progressivity.\textsuperscript{21} Furthermore, in assessing the direction and magnitude of changes in progressivity, it is important to take account of the growing importance of flat-rate payroll taxes.\textsuperscript{22} A plausible argument can be made that the combined system of income and payroll taxes was no less progressive at the end of the 1990s than at the beginning of

\textsuperscript{19} For an overview of recent income tax changes, see Martin J. McMahon, Jr. & Alice G. Abreu, \textit{Winner-Take-All Markets: Easing the Case for Progressive Taxation}, 4 FLA. TAX REV. 1, 13-14, 26-30 (1998).

\textsuperscript{20} High-income taxpayers benefit disproportionately from reduced capital gains rates. In 1993, taxpayers with incomes over $200,000 realized 61.9 percent of capital gains and paid 62.4 percent of the capital gains tax, while taxpayers with incomes of $50,000 or less realized 15.6 percent of the capital gains and paid 10.5 percent of the tax. See \textit{Congressional Budget Office, Perspectives on the Ownership of Capital Assets and the Realization of Capital Gains} 31 (1997) (\textit{Perspectives on Ownership}); Burman, \textit{supra} note 11, at 117-18 (discussing methodological problems in measuring distribution of tax benefits from 1997 reduction in capital gains rates).


the 1980s, and it is far from clear that there has been a dramatic decline in the overall level of progressivity.

The transfer taxes have undergone similar fluctuations. In 1981, just five years after the unification of the estate and gift taxes and the introduction of the original generation-skipping transfer tax, Congress slashed transfer tax rates and raised exemptions, prompting one prominent commentator to describe Congress' attitude as "schizophrenic." The 1986 revision of the generation-skipping transfer tax broadened the transfer tax base, and subsequent years have brought further changes in rates and exemptions as well as an eclectic array of special allowances and anti-abuse provisions. The latest round of increases in the unified credit, enacted in 1997, will gradually raise the exemption equivalent from $600,000 in 1997 to $1,000,000 in 2006, leaving just under two percent of all decedents' estates subject to estate tax.

While the progressivity of the federal tax system may have changed only slightly since 1980, the distribution of

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23 There is considerable controversy surrounding the allocation of social security taxes and benefits within and across generations. See, e.g., William G. Gale, Comments, in TAX PROGRESSIVITY AND INCOME INEQUALITY 51, 57 (Joel B. Slemrod ed., 1994) (noting Eugene Steuerle's observation that when social security taxes and benefits are considered together, "the system looks as if it has become more progressive").

24 Graetz, supra note 8, at 263. For discussions of the impact of the 1981 legislation on the progressivity-enhancing role of the transfer taxes, see id. at 262-63; Gutman, supra note 10, at 1195-97.


27 Recent projections show the number of taxable estates, as a percentage of all decedents, fluctuating around two percent as the exemption rises over the next several years. See Present Law and Background, supra note 6, at 115 tbl.19. The number of taxable estates fell from 2.19 percent of all decedents in 1982 to less than one percent in the late 1980s, then rose to 1.96 percent in 1999. See id. at 110 tbl.17, 111-112, 114, 115 tbl.19 (attributing recent rise to several factors, including fixed nominal exemption, inflationary increases in asset values, real economic growth, and demographic trends).
income and wealth appears to have become markedly more skewed. On balance, it might appear that the tax system has had surprisingly little impact on disparities in income and wealth. Indeed, both the effectiveness and the appropriateness of using the tax system as an instrument of redistribution remain controversial. Evaluating the desired degree of progressivity inevitably requires difficult value judgments and tradeoffs. Nevertheless, in assessing the fairness of tax burdens, it is impossible to ignore evidence of inequality in the pre-tax distribution of income and wealth.

In the face of growing inequality, a strong case can be made for reinforcing rather than weakening the progressivity of the tax system.

The contribution of the transfer taxes to progressivity is necessarily constrained by the narrowness of the transfer tax base. Furthermore, these taxes may be perceived as unfair or counterproductive because they are aimed at a small group of wealthy taxpayers. The narrow focus of the transfer taxes may nonetheless be justified on two grounds. A high concentration of wealth suggests that the distributional

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28 See Kasten et al., supra note 22, at 9, 47-49; Joel B. Slemrod, *The Economics of Taxing the Rich*, in DOES ATLAS SHRUG? THE ECONOMIC CONSEQUENCES OF TAXING THE RICH 3, 20-21 (Joel B. Slemrod ed., 2000); id. at 21 ("Clearly, the rich are getting richer, not only in absolute terms but also compared to everyone else."); Wolff, supra note 11, at 75-79 (discussing rising inequality of wealth and income between 1983 and 1992). See also Lynn A. Karoly, *Trends in Income Inequality: The Impact of, and Implications for, Tax Policy*, in TAX PROGRESSIVITY AND INCOME INEQUALITY 95, 97 (Joel B. Slemrod ed., 1994) (concluding that "the rise in pre-tax income inequality dominates any increase in post-tax inequality").


30 See Slemrod & Bakija, supra note 21, at 2 (discussing optimal tax implications of distributional inequality); McMahon & Abreu, supra note 19, at 10 ("In a winner-take-all market, progressive taxation may be not only efficient, it may be nearly optimal . . . .").

31 See Gale & Slemrod, supra note 7, at 20 ("Small programs typically have small effects."); Donaldson, supra note 9, at 544; Cf. Jane G. Gravelle & Steven Maguire, *Estate and Gift Taxes: Economic Issues*, 88 TAX NOTES 551, 552 (2000) (noting that criticism of transfer taxes on the ground that they are easily avoided by the wealthy "could support reform of the tax as well as repeal").
impact of cutting transfer taxes is quite different from that of an across-the-board reduction in income or payroll tax rates. Additionally, the top tier of extremely wealthy taxpayers may have distinctive characteristics that are relevant in determining how they should be taxed. This raises delicate issues of line-drawing and may require adjustments in the current taxable threshold and rate schedule. By comparison with the prevailing income tax trend, the structure of transfer tax rates may appear unduly rigid. Over the last two decades, a burgeoning unified credit has eclipsed the progression at the lower end of the unified rate schedule, even as income tax rates have become markedly compressed. If greater harmonization in rates is desirable, one approach might be to index the unified credit and restore a more gradual progression in the unified rate schedule.

Wherever the lines are drawn, neither the limited reach of the existing transfer taxes nor their modest contribution to progressivity furnishes grounds for their repeal. Indeed, the evolution of tax policy over the last two decades suggests no clear consensus on the optimal level of progressivity within the overall tax system. The current income tax rate structure is open to criticism for failing to address growing inequalities of income and wealth. Even if a dramatic increase in the progressivity of the income tax seems unlikely, it does not follow that abolishing the transfer taxes represents an appropriate response to growing inequality. Furthermore, repeal of these taxes would have serious implications for the income tax.

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33 For example, issues of obvious interest are how responsive wealthy taxpayers are to tax law changes generally and how readily they can arrange their affairs to minimize or avoid taxes. See Karoly, supra note 28, at 126 (noting evidence suggesting that wealthy taxpayers may be less responsive than formerly assumed); Martha Eller et al., The Magnitude and Determinants of Federal Estate Tax Noncompliance (2000) (unpublished manuscript, on file with Va. Tax Rev.).

34 See McMahon & Abreu, supra note 19, at 73-80.
The role of the transfer taxes as a backstop for the income tax has been challenged on the ground that direct reform of the income tax would be preferable. For example, the income tax base could be broadened by taxing capital gains at death and perhaps including gifts and bequests in the recipient's gross income. These income tax reforms would reduce the significance of the transfer taxes as a backstop for the income tax. The existing transfer taxes might then be restructured to serve the more limited traditional goals of curbing excessive concentrations of inherited wealth and providing a modest source of additional revenue. While proposals to tax gains at death or include gifts and bequests in gross income may be conceptually satisfying, Congress has shown no inclination to move in this direction. Nevertheless, repeal of the transfer taxes might highlight glaring inconsistencies in the current income tax and thereby strengthen arguments for such reforms.

B. Deathtime Basis Step-Up

Under current law, property passing from a decedent generally takes a basis in the recipient's hands equal to its fair market value at the date of death (or alternate valuation date, if applicable). Since death is not treated as a realization event, any built-in gain or loss simply disappears. The failure to tax unrealized appreciation at death has been described as the "most serious defect" in the federal tax

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35 See, e.g., Alicia H. Munnell & C. Nicole Ernsberger, Wealth Transfer Taxation: The Relative Role for Estate and Income Taxes, NEW ENG. ECON. REV. 3, 4-5 (Nov./Dec. 1988). Proposals for a deathtime gains tax and for including gifts and bequests in income are discussed infra in Parts III and IV, respectively.

36 Even if such reforms were adopted to "perfect" the income tax, however, some form of tax on wealth transfers might nevertheless be defended "on both efficiency and redistributive grounds." Gutman, supra note 10, at 1191 n.24.

37 See I.R.C. § 1014(a).
structure. While precise figures are not available, economists estimate that up to fifty percent of all capital gains permanently escape income tax as a result of the deathtime basis step-up. Accordingly, the deathtime basis step-up contributes significantly to reducing the effective tax rate on capital gains.

The deathtime basis step-up creates considerable revenue loss and is widely regarded as both inequitable and inefficient. In 1969, the Treasury proposed an extensive program for tax reform, including a proposal to tax unrealized gains at death. The primary justification offered for this proposal was that it would eliminate unwarranted discrimination in favor of individuals who hold appreciated assets at death compared to those who realize gains during life and would thereby reduce the lock-in effect attributable to the deathtime basis step-up. Under the proposed deathtime gains tax, property held at death would be treated as if it were sold for fair market value, thereby triggering gain or loss on the decedent's final income tax return. To

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38 Jerome Kurtz & Stanley S. Surrey, Reform of Death and Gift Taxes: The 1969 Treasury Proposals, the Criticisms, and a Rebuttal, 70 COLUM. L. REV. 1365, 1381 (1970). See also Burman, supra note 11, at 19 (referring to failure to tax capital gains at death as the "angel of death loophole").

39 See THE TAXATION OF INCOME FROM CAPITAL 221 (Mervyn A. King & Don Fullerton eds., 1984) (noting that "about half of gains are never realized because of the increase of basis at death"); Burman, supra note 11, at 51.

40 The revenue loss attributable to the deathtime basis step-up is projected to rise from around $28 billion in 2001 to around $33 billion in 2005; the total projected revenue loss for the period 2001-2005 is around $153 billion. OFFICE OF MANAGEMENT & BUDGET, ANALYTICAL PERSPECTIVES: BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2001, 109 tbl.5-1 (2000) (ANALYTICAL PERSPECTIVES).

41 See 1969 TREASURY PROPOSALS, supra note 10, at 331-51. These proposals, prepared by the Treasury Department at the close of the Johnson administration, appeared in February 1969 as a joint publication of the House Ways and Means Committee and the Senate Finance Committee. For an earlier proposal along similar lines, see President's 1963 Tax Message: Hearings Before the Comm. on Ways and Means, House of Representatives, 88th Cong. 128-40 (1963) (President's 1963 Tax Message).

avoid double taxation, any resulting capital gains tax would be allowed as a deduction for estate tax purposes.\textsuperscript{43} Since the proposed tax would generally reach all built-in gain in appreciated assets held at death, such assets would receive a stepped-up basis in the hands of the recipient.\textsuperscript{44} The Treasury proposal also provided parallel treatment for lifetime gifts by taxing unrealized appreciation in property transferred by gift.\textsuperscript{45}

In addition to a death-time gains tax, the 1969 Treasury proposals also included unification of the estate and gift taxes and the introduction of a new tax on generation-skipping transfers.\textsuperscript{46} None of these proposals was enacted immediately, though all of them remained under active consideration. In 1976, Congress followed through with a sweeping reform of the transfer tax system, but failed to enact a death-time gains tax.\textsuperscript{47} Instead, as part of a compromise to achieve revenue neutrality and garner support for the transfer tax reforms, the 1976 legislation provided that property passing from a decedent would generally take a carryover basis in the hands of the recipient.\textsuperscript{48} Unfortunately, the carryover basis provisions were added late in the legislative process, without the usual opportunities for deliberation and technical

\textsuperscript{43} Cf. I.R.C. § 2053(a)(3) (allowing estate tax deduction for claims against the estate, including tax liabilities accrued during life).

\textsuperscript{44} See 1969 TREASURY PROPOSALS, supra note 10, at 339 (proposing exceptions for certain tangible personal property, charitable gifts and marital transfers).

\textsuperscript{45} See id. (explaining goal that tax on unrealized appreciation would "neither encourage nor discourage lifetime transfers as opposed to death transfers"). The Treasury proposal also provided for realization of losses on property transferred by gift, but such losses would be nondeductible in the typical case of a transfer between related parties. See id.

\textsuperscript{46} See id. at 351-401.


\textsuperscript{48} See id., § 2005(a), 90 Stat. at 1872 (adding former section 1023). See Graetz, supra note 8, at 261 (noting that "the enactment of the carryover basis was an explicit trade-off for the support of the estate tax revisions," and that revenue losses from reduced transfer tax rates, increased exemption, and certain other changes were to be offset by revenue gains from carryover basis and tax on generation-skipping transfers).
refinement, and they provoked widespread opposition from organized interest groups. After extensive hearings, Congress postponed the effective date of the carryover basis provisions in 1978 and ultimately repealed them retroactively in 1980.

Under current law, the benefit of the death-time basis step-up comes at a price. Although unrealized appreciation in property passing from a decedent escapes the income tax net, the full value of the property is includible in the decedent's gross estate and potentially subject to estate tax. By holding appreciated assets until death, it is possible to eliminate the income tax on unrealized gains accrued during life; alternatively, a lifetime sale of assets triggers a capital gains tax but removes the amount of that tax from the estate tax base at death. Thus, the death-time basis step-up has an undesirable "lock-in" effect since it encourages individuals to hold appreciated assets until death and thereby artificially distorts the choice between selling and retaining such assets.

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49 The carryover basis provisions were added in the conference report, based on a bill that had previously been approved by the House Ways and Means Committee but not by the full House or the Senate. See Graetz, supra note 8, at 261; Stanley S. Surrey, Reflections on the Tax Reform Act of 1976, 25 CLEV. ST. L. REV. 303, 319-22 (1976).


52 In general, property must be includible in the gross estate to be eligible for the basis step-up. See I.R.C. § 1014(b) (defining property acquired from (or passing from) the decedent).
during life. By reducing the incentive to hold assets until death, the estate tax partially offsets this lock-in effect. Once the potential estate tax liability is taken into account, the rate differential facing a wealthy taxpayer in deciding whether to sell or retain appreciated assets is closer to nine percent than twenty percent.\(^5\) Simple repeal of the estate tax would indirectly increase the tax price of realizing gains during life and would thereby amplify the lock-in effect.\(^5\)

The interplay between the income and estate taxes is reflected in proposals linking repeal of the transfer taxes with introduction of a death-time gains tax or a carryover basis regime. One reason for such linkage may be to offset at least part of the projected revenue loss from eliminating the transfer taxes. It is not clear, however, that the lost revenue would be fully replaced by taxing capital gains at death.\(^5\) The transfer tax rates are significantly higher than current capital gains rates, and unrealized appreciation inherent in assets held at death represents only a fraction of total wealth.

\(^{53}\) If capital gains are taxed at 20 percent, the benefit of retaining an appreciated asset until death is 20 percent of the death-time basis step-up, but the amount of capital gains tax saved may be subject to an estate tax of up to 55 percent. The rate difference can be expressed as \(0.20 \times (1 - 0.55)\), or nine percent. See Joulfaian, supra note 12, at 27. Thus, for example, suppose a taxpayer holds appreciated property with a fair market value of $100 and a basis of zero. If the taxpayer sells the property for $100, pays a capital gains tax of $20, and then incurs a 55 percent estate tax on the remaining proceeds, the total tax burden amounts to $64 ($20 + ($80 \times 0.55)). If the taxpayer holds the appreciated property until death, thereby avoiding the capital gains tax, the total tax burden amounts to $55 ($100 \times 0.55).


\(^{55}\) For example, current projections for 2005 show a tax expenditure of around $33 billion due to the death-time basis step-up, compared to total transfer tax revenues of nearly $37 billion. See Analytical Perspectives, supra note 40, at 47 tbl.3-1; id. at 109 tbl.5-1. A death-time gains tax might indirectly increase revenue by inducing lifetime realizations. See Burman, supra note 11, at 138. As a practical matter, a death-time gains tax is unlikely to reach an amount approaching the total unrealized appreciation in assets acquired from a decedent. See infra notes 119-120, 136-141 and accompanying text.
transmitted at death. Depending on exemption levels, a
death-time gains tax might raise revenue from a class of
decedents who are not subject to transfer taxes under current
law.

Revenue estimates prepared by the Congressional Budget
Office (CBO) indicate that a death-time gains tax would raise
$10.5 billion in 2002. These estimates reflect an exemption
for gains on appreciated assets passing to a surviving spouse
(which would take a carryover basis in the spouse's hands),
as well as exemptions for gains on appreciated assets passing
to charity, $250,000 of gain on a personal residence, and
small gains on personal property. As a result of these
exemptions, around ten percent of decedents would be subject
to the death-time gains tax. Additional exemptions might be
adopted to limit the reach of the tax and allay political
opposition, with potentially dramatic revenue effects. A
large general exemption would concentrate the tax burden
among the wealthiest decedents, while a more modest

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56 See James M. Poterba & Scott Weisbenner, The Distributional Burden of Taxing
Estates and Unrealized Capital Gains at the Time of Death 19 & 36 tbl.8 (June 2000)
(unpublished manuscript, on file with Va. Tax Rev.) (estimating that, based on 1998 Survey
of Consumer Finances, unrealized capital gains at death represented 36 percent of the total
expected value of all estates and 56 percent of the total expected value of estates of $10
million or more).

It is estimated that the death-time capital gains tax would raise total revenue of $78.5 billion
for the period 2001-2010. See id.

58 See id. Other estimates indicate that the revenue from a death-time gains tax with
realistic exemptions might be considerably lower. See Poterba & Weisbenner, supra note
56, at 22 (estimating revenue of $4.5 billion in 1998, based on data from the 1998 Survey
of Consumer Finances). Revenue estimates may be quite sensitive to mortality
assumptions. See id. (noting that use of annuitant mortality table rather than population
mortality table reduced estimated flow of taxable gains by more than one-third).

59 See Budget Options, supra note 57, at 311.

60 See Poterba & Weisbenner, supra note 56, at 22 (assuming exemptions for gain on
appreciated assets passing to a surviving spouse and for $250,000 of gain on principal
residence, and noting that a $500,000 gain exemption would reduce estimated revenue yield
by nearly one-half, from $4.5 billion to $2.5 billion).
exemption would shift the tax burden to middle-income taxpayers who are currently exempt from the transfer taxes.\footnote{With a $500,000 gain exemption (in addition to exemptions for marital bequests and $250,000 of gain on a personal residence), decedents with a net worth of $10 million or more would owe 51 percent of the death time gains tax; with a $100,000 exemption, those decedents would owe only 35 percent of the tax. \textit{See id. at} 22-23. Cf. Zelenak, \textit{supra} note 51, at 374-75 (criticizing "regressivity" of death time gains tax with low exemption as replacement for transfer taxes).}

In assessing distributional effects, it is important to consider whether a death time gains tax is perceived as a substitute for the existing transfer taxes or simply as a step in the direction of a comprehensive income tax base.\footnote{The distributional consequences of a proposed change may differ depending on whether households are classified according to net worth or annual income. \textit{See} Poterba & Weisbenner, \textit{supra} note 56, at 23-24 (using uniform imputed income measure to avoid problem of different income-to-value ratios for various types of capital assets).} If the death time gains tax is proposed as a replacement for the transfer taxes, the inquiry can be framed in terms of whether particular categories of decedents would experience a net increase or decrease in their tax liability. From this perspective, the death time gains tax may offer a substantial windfall to wealthy decedents.\footnote{According to one estimate, a death time gains tax (with exemptions for marital bequests and $250,000 of gain on a personal residence) would produce a lower tax liability than the existing estate tax for 95 percent of decedents with net worth of more than $1 million. \textit{See id. at} 25-26 (estimating average tax saving of $672,700 for decedents in this category). Among decedents with net worth of $1 million or less who incur estate tax, the burden of a death time gains tax would be roughly similar to that of the existing estate tax. \textit{See id. at} 25.} If the death time gains tax is instead perceived as "perfecting" the income tax, any substantial exemption that would remove decedents of low or moderate wealth from the reach of the tax would seriously erode the tax base. In terms of a comprehensive income tax, it is difficult to justify any exemption from a death time gains tax.\footnote{\textit{See} Joseph M. Dodge, \textit{Further Thoughts on Realizing Gains and Losses at Death}, 47 \textit{VAND. L. REV.} 1827, 1855-56 (1994) (arguing that exemption for small estates "makes a mockery of the income tax" and "treats the deemed-realization proposal as if it were merely an incremental estate tax").}
A carryover basis regime would raise far less revenue than a deathtime gains tax because it would permit indefinite deferral for beneficiaries who could afford to postpone selling inherited assets. By one estimate, assuming a "deemed" basis for assets acquired from a decedent equal to fifty percent of their deathtime value, a carryover basis regime would raise revenue of $1.1 billion in 2002, increasing gradually to $4.3 billion in 2005. The revenue estimates for any carryover basis regime are quite sensitive to the time horizon for realization of gains, which in turn is extremely difficult to predict.

The benefit of deferral under a carryover basis regime may be viewed as equivalent to a reduction in the effective rate of the capital gains tax. An effective capital gains tax rate that varies according to the holding period might be considered to have perverse distributional consequences, especially since realization of gains may be postponed indefinitely with respect to dynastic wealth. For distributional purposes, it is important to bear in mind that the composition of capital gain assets and the sources of unrealized appreciation vary significantly within and across

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65 See Burman, supra note 11, at 139 (noting that deemed basis would avoid difficulties in proving basis). Despite its apparent simplicity, the deemed basis approach would provide a strong incentive to overstate deathtime value, especially in the absence of an estate tax, and might invite other abuses as well.

66 See BUDGET OPTIONS, supra note 57, at 312. It is estimated that a carryover basis regime would raise a total of $47.8 billion during the period 2001-2010, or approximately one-half of the revenue raised under a deathtime gains tax. See id.; supra note 57.

67 See Poterba & Weisbenner, supra note 56, at 26 (reserving for future research the issue of potential behavioral responses).

68 See PERSPECTIVES ON OWNERSHIP, supra note 20, at 10-11 (noting that "the effective tax rate on an asset that appreciates in value at 7 percent per year would be about one-half the statutory rate of 28 percent if the asset was held for 30 years"). In a carryover basis regime, taxpayers would have a strong incentive to engage in elaborate schemes to extract cash from appreciated property without triggering a capital gains tax. See, e.g., Burman, supra note 11, at 22 (describing "short-against-the-box" scheme).
different income and wealth categories.\textsuperscript{69} To the extent that the ratio of unrealized appreciation to value increases with net worth, a deemed basis equal to fifty percent of deathtime value would tend to confer disproportionate benefits on wealthier decedents.\textsuperscript{70}

C. Lifetime Gifts

Under current law, lifetime gifts do not obtain the benefit of a stepped-up basis but instead receive a carryover basis in the recipient's hands.\textsuperscript{71} For transfer tax purposes, lifetime gifts are taxed at lower effective rates than bequests. The rate differential arises because a donor's taxable gifts do not include amounts used to pay the resulting gift tax; in contrast, amounts used to pay the estate tax are included in a decedent's taxable estate.\textsuperscript{72} Some commentators attempt to justify the lower gift tax rates as rough compensation for the fact that lifetime gifts, unlike bequests, do not receive a tax-free basis step-up in the recipient's hands.\textsuperscript{73} The income tax

\textsuperscript{69} By one estimate, primary residences account for over 90 percent of unrealized capital gains of households with net worth below $500,000, while active business assets account for over 70 percent of the unrealized capital gains of households with net worth of $10 million or more. See Poterba & Weisbenner, supra note 56, at 20 & 36 tbl.8. Furthermore, ownership of corporate stock, bonds, and business assets is concentrated among high-income households. See Burman, supra note 11, at 87-90.

\textsuperscript{70} See supra note 56 (noting that appreciation-to-value ratio rises with expected value of estate); see also infra note 127.

\textsuperscript{71} See I.R.C. § 1015(a).

\textsuperscript{72} This longstanding disparity between the "tax-exclusive" gift tax base and the "tax-inclusive" estate tax base persists despite the "unification" of the two taxes in 1976. The lower effective rate for lifetime gifts cannot be justified on the ground that the tax is paid earlier. See Harry L. Gutman, A Comment on the ABA Tax Section Task Force Report on Transfer Tax Restructuring, 41 TAXLAW. 653, 657 (1988); Alvin C. Warren, Jr., The Timing of Taxes, 39 NAT'L TAXJ. 499, 503 (1986) ("The present value to a taxpayer of a consistently defined tax will be the same whether the tax is deferred or accelerated, as long as the tax rate remains constant and the base of a deferred tax increases over time by the rate of return generally applicable to investment of proceeds available after payment of an accelerated tax.").

\textsuperscript{73} See Paul B. Stephan III, A Comment on Transfer Tax Reform, 72 VA. L. REV. 1471, 1472 (1986) ("Preserving a rate differential between gifts and deathtime transfers is one way of offsetting the income tax's discrimination between gifts and bequests.").
disparity, however, does not furnish a persuasive reason for a countervailing inconsistency in the transfer tax base.\(^\text{74}\) As a proxy for a death-time gains tax, the existing transfer taxes are both "under-inclusive" due to the large exemption in the form of the unified credit and "over-inclusive" because the transfer tax base includes the full value of transferred property regardless of appreciation.\(^\text{75}\)

A preference for lifetime gifts is sometimes defended on social, economic, or other policy grounds. For example, it has been argued that a relatively low gift tax rate "causes business and investment capital to be moved into the hands of younger, more vigorous owners" and thereby encourages risk-taking and innovation.\(^\text{76}\) The purported social or economic benefits, however, are essentially speculative, inadequately specified, and unsupported by empirical evidence.\(^\text{77}\) Even if a policy of encouraging lifetime gifts were considered desirable, there is no reason to believe that the existing system provides an efficient or effective subsidy for such transfers.\(^\text{78}\) Given the rudimentary state of knowledge concerning the motives for both gifts and bequests, the most sensible approach may be one of tax neutrality between lifetime and death-time transfers.\(^\text{79}\)

\(^{74}\) See Gutman, supra note 72, at 657 (noting that "the solution is a consistent income tax rule rather than a compensating, base-eroding transfer tax preference").

\(^{75}\) See Stephan, supra note 73, at 1484-85.

\(^{76}\) See American Bar Ass'n, Section of Tax'n, Report on Transfer Tax Restructuring, 41 TAX LAW. 393, 403 (1988); Stephan, supra note 73, at 1487-88; Ronald D. Aucutt, Further Observations on Transfer Tax Restructuring: A Practitioner's Perspective, 42 TAX LAW. 343, 345-46 (1988) (noting "practical considerations" and "psychological factors").


\(^{78}\) See Jantscher, supra note 77, at 129-30 (noting that if wealthy individuals are likely to make gifts regardless of tax savings, an efficient subsidy for lifetime gifts might be structured to provide larger savings to less wealthy donors).

\(^{79}\) A progressive rate structure would continue to provide an incentive for transferring property sooner rather than later, since the subsequent appreciation in the property would be removed from the tax base. See Gutman, supra note 72, at 655 n.13.
The existing preference for lifetime gifts might be expected to have a significant effect on the timing of intergenerational transfers, especially if such transfers also offer opportunities for income tax savings. Indeed, one study concludes that the indirect effect of the transfer taxes on the income tax may be quite large, partly as a result of incentives that encourage lifetime giving to avoid the higher estate tax rates. Wealthy individuals are assumed to make substantial lifetime gifts to lower-bracket children and tax-exempt charities, thereby reducing or eliminating the income tax on income from the donated assets. As a result of such tax-avoidance behavior, the study concludes that historically the revenue collected by the estate tax “may well have been near zero, or even negative.” This conclusion, while admittedly speculative, seems inherently implausible. Under the relatively compressed rate schedule of the existing income tax, adult children of wealthy donors are unlikely to face significantly lower marginal rates than their parents. Moreover, since much capital income escapes taxation

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81 Rather than backstop the income tax, the transfer tax system may actually “generate a rise in income tax avoidance activities sufficient to offset revenue collected through estate levies.” Id. at 115. Bernheim estimates that gifts may represent roughly one-third of total transfers during life and at death. See id. at 126, 133. See also William G. Gale & John Karl Scholz, Intergenerational Transfers and the Accumulation of Wealth, 8 J. ECON. PERSP. 145, 147 (1994) (concluding that inter vivos transfers are about half as large as deathtime transfers). Cf. Joulfaian, supra note 12, at 21 (based on cumulative taxable gifts reported by decedents in 1992, the share of wealth transferred during life was approximately 13 percent for the wealthiest decedents, equivalent to two percent of terminal wealth); see also James Poterba, Estate and Gift Taxes and Incentives for Inter Vivos Giving in the United States, 79 J. PUB. ECON. 237, 247 (2001) (in 1995, taxable gifts comprised 5.5 percent of taxable estates).

82 Bernheim, supra note 80, at 115.

83 See Gale & Slemrod, supra note 7, at 25 (noting Bernheim’s claim is “based on speculative calculations and has not been corroborated by rigorous investigation”); see also Joulfaian, supra note 12, at 29 (noting that “there is little evidence that estate and gift taxes lead to an increase in gifts from parents with high income tax rates to children with low income tax rates”). On the other hand, the surge in gift tax revenues following the Tax Reform Act of 1976 suggests that wealthy taxpayers may be quite sensitive to expected tax rate changes. See id. at 30.
entirely or is taxed at rates significantly below the maximum statutory rate, any revenue loss attributable to income-shifting behavior is likely to be attenuated. Indeed, simple repeal of the transfer taxes might well reduce overall revenue by more than the forgone receipts from those taxes.  

By lowering the price of gifts and bequests relative to the transferor's own consumption, repeal of the transfer taxes might be expected to stimulate both lifetime and death-time transfers. Indeed, a death-time gains tax would provide an incentive for lifetime transfers of appreciated property if gifts continued to receive carryover basis treatment and accordingly offered opportunities for continued deferral. By contrast, a gains tax applicable to gifts as well as bequests would enhance tax neutrality between lifetime and death-time transfers.

D. Marital and Charitable Transfers

Repeal of the transfer taxes would also call into question the treatment of transfers between spouses during life and at death. Under current law, a transfer from one spouse to the other is generally not subject to estate or gift tax due to the unlimited marital deduction. This treatment is grounded in the view that a married couple comprises a single taxable unit and that a shift of ownership within the unit does not constitute a taxable event. In accordance with this view, lifetime transfers between spouses are also disregarded for income tax purposes: the donor recognizes no gain or loss,

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84 See C. Lowell Harriss, Gift Taxation in the United States 1 (1940) (noting "protective" function of gift tax and suggesting that "[b]y checking avoidance of death and income taxes, it may indirectly increase the revenues by a far greater amount than its own direct yield"). Repeal of the estate tax with no change in the death-time basis step-up would reinforce existing incentives to hold appreciated property until death.

85 See I.R.C. §§ 2056 (estate tax), 2523 (gift tax).

86 See S. Rep. No. 97-144 at 127 (1981), reprinted in 1981-2 C.B. 412, 461 (noting that unlimited marital deduction treats spouses as "one economic unit for purposes of estate and gift taxes, as they generally are for income tax purposes").
and the recipient receives a carryover basis in the donated property, thereby deferring any built-in gain. In the case of a deathtime transfer of appreciated property to a surviving spouse, however, the spouse receives a tax-free basis step-up, and the unrealized gain accrued at the decedent's death escapes income tax altogether.

Conceptually, allowing a stepped-up basis for marital bequests is "fundamentally inconsistent" with the prevailing view of spouses as a single taxable unit. That view implies that transfers between spouses at death should be disregarded for income tax purposes and that a bequest to a surviving spouse should receive carryover basis treatment, just as in the case of a lifetime gift. As a political matter, it would be virtually inconceivable to impose carryover basis treatment on marital bequests as long as other bequests generally qualified for a tax-free basis step-up. However, repeal of the transfer taxes might pave the way for reconsideration of the existing income tax treatment of property acquired from a decedent. Under a deathtime gains tax or a carryover basis regime, the question would arise

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87 See I.R.C. § 1041.

88 In the case of community property, the deathtime basis step-up applies not only to the one-half interest passing from the decedent but also to the one-half interest already owned by the surviving spouse. See I.R.C. § 1014(b)(6). This treatment is a relic from the period between 1942 and 1948, when the full value of community property was generally subject to estate tax at the death of the first spouse. The full basis step-up for community property persisted even after the 1948 marital deduction put married couples in community property states and common law states on a more even footing for tax purposes. See Stanley S. Surrey, Federal Taxation of the Family — The Revenue Act of 1948, 61 HARV. L. REV. 1097, 1117-21, 1138-40 (1948).

89 See Gutman, supra note 10, at 1239; see also Dodge, supra note 64, at 1853 (noting that "spousal unity argument would seem to compel a carryover basis exception even under the current stepped-up basis regime").

90 See Joseph M. Dodge, Beyond Estate and Gift Tax Reform: Including Gifts and Bequests in Income, 91 HARV. L. REV. 1177, 1203 (1978) (arguing, in context of proposal to include gifts and bequests in recipient's income, that "interspousal bequests would be entirely tax-free, since the surviving spouse is the continuation of the original tax unit" and that "all such tax-free gifts and bequests would entail a carryover basis to the transferee"). But cf Dodge, supra note 64, at 1853-54 ("husband and wife can be treated plausibly as a single taxable unit only so long as both are alive").
whether marital bequests, which account for a large portion of deathtime transfers, should receive more favorable treatment than bequests to other beneficiaries.

The treatment of charitable transfers raises issues analogous to those concerning marital transfers. Under current law, lifetime charitable transfers are "doubly advantaged." The donor receives an income tax deduction for the fair market value of the donated property — even though the unrealized appreciation is not taxed — and the property is removed from the donor's transfer tax base at no cost due to the gift tax charitable deduction. By contrast, charitable bequests receive somewhat less favorable treatment, since they are eligible for an estate tax deduction but not for the general income tax deduction. Despite the tax incentives for lifetime gifts, wealthy taxpayers manifest a strong preference for charitable bequests. Given the relatively minor economic significance of the transfer taxes, scholarship in this area has focused primarily on the relationship between income taxes and charitable giving.

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91 See Joulfaian, supra note 12, at 17 (reporting that surviving spouses received around one-half of the "distributable estate" after payment of estate expenses, taxes and charitable bequests, based on 1982 data).
92 Eric Rakowski, Estate Tax Reform and Charitable Giving, 77 Tax Notes 463, 466 n.9 (1997). If \( t \) and \( e \) are the marginal rates of income tax and estate tax, respectively, the price of a lifetime charitable gift relative to a non-charitable bequest can be expressed as \( (1 - t) \times (1 - e) \). See David Joulfaian, Charitable Giving in Life and Death 4-5 (July 2000) (unpublished manuscript, on file with Va. Tax Rev.).
93 See I.R.C. §§ 170 (income tax), 2522 (gift tax).
94 See I.R.C. § 2055; see also I.R.C. § 642(c) (income tax deduction for amount of gross income paid to charity pursuant to the terms of a will or trust instrument, in lieu of section 170 deduction). It is estimated that, in 1995, the estate tax charitable deduction cost the federal government around $8.7 billion in forgone revenues. See Poterba, supra note 81, at 11.
96 The literature on income tax incentives is quite large. See, e.g., CHARLES T. CLOTFELTER, FEDERAL TAX POLICY AND CHARITABLE GIVING 32-34, 49-63 (1985) (CLOTFELTER, CHARITABLE GIVING); Charles T. Clotfelter, The Economics of Giving, in GIVING BETTER, GIVING SMARTER: WORKING PAPERS OF THE NAT'L COMM'N ON
seems clear, however, that the estate tax plays a significant role in influencing the overall level of charitable bequests.\(^{97}\)

While repeal of the transfer taxes would dampen incentives for charitable giving both during life and at death, the magnitude of the potential response is quite uncertain.\(^{98}\) The reduction in transfer taxes would raise the price of charitable giving relative to alternative uses of the transferor's accumulated wealth, including transfers to non-charitable beneficiaries.\(^{99}\) It is impossible to predict a priori the extent to which this "price effect" would be offset by the countervailing "wealth effect" due to the transferor's increased wealth.\(^{100}\) The net effect may be not only to depress charitable giving overall but also to alter the allocation of

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\(^{97}\) While stimulating charitable giving by reducing the price of such transfers (the "price effect"), the estate tax also reduces the transferor's terminal wealth (the "wealth effect"), thereby depressing the incentive to give. See David Joulfaian, *Estate Taxes and Charitable Bequests by the Wealthy*, 53 Nat'L Tax J. 743, 761 (2000) (concluding that the estate tax has a "modest effect" on charitable giving); see also Rakowski, *supra* note 92, at 470-72 (discussing econometric studies of charitable bequests). A larger issue is whether the estate tax charitable deduction "stimulates charitable giving by more than the revenue loss to the government." Joulfaian, *supra*, at 761 (concluding that deduction for charitable bequests "seems to be 'budget' efficient").

\(^{98}\) See Joulfaian, *supra* note 97, at 761 (estimating that, in the absence of estate tax, charitable bequests may decline by about 12 percent); Clotfelter, *Economics of Giving*, *supra* note 96, at 46 (estimating decline of 24 to 44 percent); Rakowski, *supra* note 92, at 471 (giving range of estimates based on different assumptions concerning wealth and price elasticity).

\(^{99}\) Under current law, a decedent in a 60 percent transfer tax bracket must accumulate an estate of $2.50 for each $1.00 left to a child (after paying $1.50 in tax), while an equivalent charitable bequest costs only $1.00. See Rakowski, *supra* note 92, at 471.

\(^{100}\) See *supra* note 97; Rakowski, *supra* note 92, at 471-72 (summarizing findings that wealth elasticity is likely to be relatively small compared to price elasticity, but cautioning that "[t]he econometrically predicted declines in charitable bequests ... might be excessive"). See also ROGER S. SMITH, PERSONAL WEALTH TAXATION: CANADIAN TAX POLICY IN A HISTORICAL AND AN INTERNATIONAL SETTING 82 (1993) (noting lack of "empirical evidence on the net effect of these offsetting forces").
charitable transfers among various categories of organizations and purposes. If, as seems likely, the brunt of the predicted decline in charitable giving is borne by organizations whose benefactors tend to be most sensitive to tax rate changes, higher education, medical research, arts, and culture may be hit hardest.\textsuperscript{101} While the impact on charitable organizations furnishes grounds for concern, the debate over repeal of the transfer taxes is likely to turn mainly on other issues.\textsuperscript{102}

\textsuperscript{101} See Gerald E. Auten et al., \textit{Taxes and Philanthropy Among the Wealthy}, in \textit{DOES ATLAS SHRUG? THE ECONOMIC CONSEQUENCES OF TAXING THE RICH} 392, 405 (Joel B. Slemrod ed., 2000); Rakowski, \textit{supra} note 92, at 472; \textit{see also} Joulfaian, \textit{supra} note 96, at 173-74 (evidence that gifts to some charities are more price sensitive than gifts to others). By contrast, religious organizations are likely to be hurt least. \textit{See} Clotfelter, \textit{Economics of Giving}, \textit{supra} note 96, at 37-38.

\textsuperscript{102} See Rakowski, \textit{supra} note 92, at 472-73.
III. ANOTHER LOOK AT A DEATHTIME GAINS TAX AND CARRYOVER BASIS

Repeal of the transfer taxes would create substantial pressure to reform the income tax treatment of property passing from a decedent. Leading reform proposals present two basic approaches for consideration. One approach imposes a gains tax on net appreciation in property owned at death and allows a corresponding basis step-up to the recipient. The other approach provides for carryover basis in the recipient's hands, thereby preserving built-in gains and losses until the property is eventually sold or exchanged. As a matter of policy, perhaps the strongest arguments in favor of a deathtime gains tax are that it imposes meaningful limits on deferral and ameliorates the problem of lock-in. Realistically, the choice between a deathtime gains tax and carryover basis is likely to turn on political and practical considerations.

Repeal of the transfer taxes would remove one longstanding obstacle to taxing gains at death, namely, the popular perception that overlapping income and estate taxes

103 The character and amount of gains and losses realized at death, as well as the applicable rates, could generally be determined in the same manner as those realized during life. See 1969 TREASURY PROPOSALS, supra note 10, at 340-41. Relief from the regular loss limitations, and perhaps special averaging provisions, might be desirable, though they would add complexity. For the sake of simplicity, deathtime gains and losses might instead be taxed at a single flat rate. See Graetz, supra note 42, at 852-53. A further issue under a deathtime gains tax is whether "income in respect of a decedent" (IRD) should be taxed on the decedent's final income tax return or (as under current law) in the hands of the recipient. Compare Graetz, supra note 42, at 853 (recommending retention of existing treatment) with 1969 TREASURY PROPOSALS, supra note 10, at 347-48 (recommending tax at death); cf. President's 1963 Tax Message, supra note 41, at 137-38 (recommending existing treatment for ordinary income items, tax at death for other items).

104 Proponents also argue that a deathtime gains tax "enforces the principle that income should be taxed to the person who earned it" and operates "at an ideal time in terms of ability to pay (because the decedent has no use for the amount due as taxes, and whatever the heirs or beneficiaries receive is a windfall)." Zelenak, supra note 51, at 367. See also Dodge, supra note 64, at 1838-44. But cf. Robert B. Smith, Burying the Estate Tax Without Resurrecting Its Problems, 55 TAX NOTES 1799, 1800 (1992) (recommending carryover basis rather than deathtime gains tax).
imposed at death constitute inappropriate "double taxation." Although this slogan reflects a fundamental misapprehension of the goals of the respective taxes and their relationship to each other, it has considerable rhetorical force and may explain why in 1976, against the backdrop of the newly unified transfer taxes, Congress opted for carryover basis rather than a death-time gains tax to deal with the problem of unrealized appreciation.

Interestingly, however, recent proposals have advanced carryover basis not as a complement to the transfer taxes but as a replacement for them. These proposals contain a bare sketch of a carryover basis regime to be implemented prospectively following a ten-year phase-out of the transfer taxes. It is difficult to imagine that the latter-day proponents of carryover basis have forgotten the experience with the 1976 legislation. Indeed, the studied casualness with which they leave implementation to future Treasury regulations suggests that their primary goal may be to abolish the transfer taxes, not to provide a workable carryover basis regime. Moreover, the potential problems with carryover basis have attracted remarkably little comment from the organized interest groups that complained

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105 See ROBERT E. HALL & ALVIN RABUSHKA, THE FLAT TAX 127 (2d ed. 1995) ("Gifts represent a transfer of income that has already been taxed, and there is no reason to tax it again."). Cf. Richard M. Bird, Canada's Vanishing Death Taxes, 16 OSGOODE HALL L.J. 133, 137-38 (1978) (discussing the political tradeoff between enactment of a death-time gains tax and repeal of transfer taxes in Canada).

106 See Zelenak, supra note 51, at 364.


108 See H.R. 8, supra note 1, § 103 (proposed section 1022).

109 See Gale & Slemrod, supra note 7, at 27 ("It seems likely that what the House really passed was an abolition of the estate tax."). The relatively small revenue impact of carryover basis proposals may raise further doubts about their long-term viability. See BUDGET OPTIONS, supra note 57, at 312 (estimating $10.5 billion revenue for first five years of carryover basis and $47.8 billion revenue for first ten years).
so strenuously about the 1976 legislation. If the carryover basis proposals are to be taken seriously, these problems deserve closer examination.\textsuperscript{110}

\section*{A. Exemptions}

A focal point of opposition to the 1976 carryover basis legislation was the problem of determining the basis of property owned at death. Organizations representing lawyers, bankers, accountants and other interest groups argued that establishing the decedent's basis in particular assets imposed unreasonable burdens, especially in the case of small estates that were exempt from other tax reporting requirements.\textsuperscript{111} In their eagerness to portray carryover basis as unworkable, however, the critics may have overstated the scope of the problem.\textsuperscript{112} Taxpayers can reasonably be expected to maintain adequate basis records, either because they may decide to sell the assets during life or because they will be

\textsuperscript{110} An important lesson from the 1976 legislation is that successful implementation of carryover basis will depend on active cooperation from the tax bar and other interest groups. See Howard J. Hoffman, \textit{The Role of the Bar in the Tax Legislative Process}, 37 TAX L. REV. 411, 438-92 (1982) (discussing role of the American Bar Association and other interest groups in the demise of carryover basis).

\textsuperscript{111} Difficulties in proving basis were attributed to several causes, including the failure of many taxpayers to keep meticulous records during life; the difficulty of reconstructing basis after death; and the inherent complexity of basis calculations for farms, closely held stock, and improved real estate. See \textit{Carryover Basis Provisions, supra} note 50, at 43, 47-48, 79-101 (statement of American Bankers Association); \textit{id.} at 111, 113-14 (statement of American College of Probate Counsel); \textit{id.} at 162, 168-69, 173 (statement of American Bar Association). For a general discussion, see Zelenak, \textit{supra} note 51, at 388-94.

aware of the need to prove basis in assets held at death.\textsuperscript{113} Even without such records, it is often possible to reconstruct basis from other sources.\textsuperscript{114} Proof of basis should not pose a significant problem in the case of publicly traded stock, which represents the single largest asset category in large estates.\textsuperscript{115} As a practical matter, it may not be worth the trouble to keep basis records for some assets;\textsuperscript{116} in other cases, the actual basis may be so low that a presumption of zero basis is warranted.\textsuperscript{117}

In some cases, proof of basis undoubtedly presents real problems. The obvious response, under a deathtime gains tax as well as a carryover basis regime, is to provide some sort of exemption. Any exemption, of course, is conceptually at odds with the notion of a comprehensive income tax base, and a purist might insist on identical treatment for gains realized during life as for those realized at or after death.\textsuperscript{118} Furthermore, any exemption tends to perpetuate the problem of lock-in. Nevertheless, as a matter of political expediency and administrative convenience, a general exemption may be necessary to ameliorate the problems of proving basis. In the past, most proposals have recommended a general exemption for small and moderate estates, typically at a level

\textsuperscript{113} Transitional relief in the form of a “fresh start” basis for assets acquired before the enactment date is discussed \textit{infra} at notes 184-186 and accompanying text.

\textsuperscript{114} Relevant sources include land records and mortgage lenders, in the case of real property; tax returns and corporate books, in the case of closely held businesses; brokers and other intermediaries, in the case of financial assets; and insurance records, in the case of jewelry and collectibles. \textit{See Carryover Basis Provisions, supra} note 50, at 178, 181-82 (statement of Paul R. McDaniel, discussing specific types of assets and taxpayers); \textit{id.} at 9, 12-14 (statement of Donald C. Lubick).

\textsuperscript{115} \textit{See Johnson & Mikow, supra} note 7, at 103 tbl.1c (publicly traded stock represented 39 percent of the value of estates of $5 million or more shown on returns filed in 1997).

\textsuperscript{116} For example, basis is irrelevant for personal or household effects that have no appreciation and generate no deductible losses.

\textsuperscript{117} \textit{See Zelenak, supra} note 51, at 393 (noting “trivial” tax consequences of inability to prove $50 basis in a “highly appreciated painting”).

\textsuperscript{118} The issue of whether an exemption for deathtime transfers should be extended on the same terms to lifetime transfers is discussed \textit{infra} at notes 166-172 and accompanying text.
corresponding to the existing transfer tax exemption.\textsuperscript{119} Even after repeal of the transfer taxes, it seems likely that the taxable threshold under a deathtime gains tax or a carryover basis regime would be set sufficiently high to ensure that estates that escaped transfer taxes under prior law would be exempt under the new regime as well.\textsuperscript{120}

A general exemption for property passing at death could be measured in terms of basis, net appreciation, or fair market value.\textsuperscript{121} The most promising approach appears to be a "minimum basis" allowance for the decedent's property: If the decedent's actual basis is less than a specified amount, the difference is allowed as a tax-free basis step-up, bringing the aggregate basis up to the specified amount (but not exceeding fair market value).\textsuperscript{122} The adjustment is then allocated to appreciated assets, reducing the amount of gain ultimately subject to tax.\textsuperscript{123} A minimum basis allowance is self-adjusting in the sense that its benefit vanishes if the decedent's actual basis equals or exceeds the specified amount. Moreover, the fair-market-value limitation ensures that the exemption cannot be used to generate artificial losses.

Compared to a minimum basis allowance, an exemption based on net appreciation or fair market value has significant

\textsuperscript{119} The deathtime gains tax proposed by the Treasury in 1969 provided a $60,000 exemption (corresponding to the then existing estate tax exemption), which would have exempted 90-95 percent of decedents. See Graetz, \textit{supra} note 42, at 842. A proposed amendment to the 1976 carryover basis legislation would have raised the exemption from $60,000 to $175,625 (matching the scheduled increase in the estate tax exemption), leaving only 1.7 percent of estates subject to carryover basis. See Surrey, \textit{supra} note 49, at 322. See also Zelenak, \textit{supra} note 51, at 414-16 (proposing deathtime gains tax with $600,000 exemption, explicitly linked to then existing estate tax exemption).

\textsuperscript{120} See H.R. 8, \textit{supra} note 1, § 103 (proposed section 1022(b)(2)(B), allowing $1,300,000 general exemption).

\textsuperscript{121} See Zelenak, \textit{supra} note 51, at 416-20 (discussing alternative forms of exemption).

\textsuperscript{122} This is the basic approach adopted in the 1976 carryover basis legislation. See former I.R.C. § 1023(d)(1).

\textsuperscript{123} No basis adjustment is allowed for assets with built-in losses, even if the aggregate basis of the decedent's assets is below the specified amount. Cf. former I.R.C. § 1023(d)(1).
shortcomings. Simply excluding a fixed amount of gain\textsuperscript{124} would confer an unwarranted benefit on large estates.\textsuperscript{125} Similarly, an exemption for property up to a specified gross fair market value, without regard to the decedent’s actual basis or the size of the estate,\textsuperscript{126} would effectively screen out “small” estates (i.e., those below the threshold amount) while conferring substantial benefits on large estates.\textsuperscript{127} The exemption could be limited to estates with a total fair market value below the threshold amount, but this would create an undesirable “cliff effect”: All appreciated property in an estate just below the threshold would receive a full basis step-up, while all appreciation in an estate just above the threshold would be exposed to an immediate or deferred gains tax.\textsuperscript{128}

Allocating a general exemption to particular assets poses fewer problems under a death time gains tax than in a carryover basis regime. To the extent that appreciation is realized at death and taxed immediately, it makes little difference how the exemption is allocated among capital

\textsuperscript{124} Cf. President’s 1963 Tax Message, supra note 41, at 132 (proposing exemption for up to $15,000 of gain on gift or bequest of appreciated property).

\textsuperscript{125} See Graetz, supra note 42, at 842-43; Zelenak, supra note 51, at 416-20. Even if reformulated as a vanishing exemption (i.e., one that disappears if total gain exceeds a specified amount), a gain exclusion lacks the versatility of a minimum basis allowance which functions equally well whether gain is realized immediately (as under a death time gains tax) or deferred (as in a carryover basis regime).

\textsuperscript{126} To avoid allowing an unlimited basis-step-up for debt-financed assets, such an exclusion should be based on the gross value of the decedent’s assets (i.e., including debt). See Zelenak, supra note 51, at 420. H.R. 8, however, provided an exemption for property with an “adjusted fair market value” (i.e., net of secured indebtedness) of $1,300,000. See H.R. 8, supra note 1, § 103 (proposed section 1022(b)(2)(B)). This would apparently permit a taxpayer to finance lifetime consumption with secured indebtedness and then obtain a basis step-up at death. See Zelenak, supra note 51, at 416-20.

\textsuperscript{127} The ratio of appreciation to value in property other than personal residences appears to be highest for the wealthiest category of decedents, i.e., estates worth $10 million or more. See supra notes 56 & 69. If personal residences are eligible for a separate exemption, see infra note 139 and accompanying text, this suggests that the largest estates might reap disproportionate benefits from an exemption based on a fixed amount of appreciation or fair market value.

\textsuperscript{128} See Zelenak, supra note 51, at 416-17 (describing cliff effect as “grossly unfair”); id. at 421 (pointing out similar cliff effect if losses allowed for estates above threshold but not for those below threshold).
assets.\textsuperscript{129} By contrast, carryover basis offers virtually unlimited flexibility in the timing and selection of assets for realizing gains after death. The tax advantages of deferral will be artificially enhanced to the extent the exemption is allocated to assets that are to be sold soon after death.\textsuperscript{130} While limited discretionary allocations might make sense as a relief measure if assets have to be sold to pay a deathtime gains tax,\textsuperscript{131} there is no reason to allow the exemption to be manipulated simply to maximize deferral.\textsuperscript{132}

The most obvious response is to require that any basis adjustment be allocated among appreciated assets strictly in proportion to their built-in gain, as was done in the 1976 legislation.\textsuperscript{133} The difficulty with this approach is that the

\textsuperscript{129} Presumably, the exemption would be allocated first (and perhaps exclusively) to appreciated capital assets, up to fair market value, and only thereafter (if at all) to ordinary income assets. See Zelenak, supra note 51, at 422. Allocation problems may arise if any remaining exemption is available for assets passing to a surviving spouse, see infra note 151 and accompanying text, or for ordinary income assets. If the existing treatment of IRD remains unchanged, see supra note 103, such items would presumably be ineligible for any basis adjustment. Such treatment might appear particularly harsh in the case of qualified pension assets — the single largest category of IRD — if portfolio appreciation is attributable mainly to capital assets. See generally John B. Shoven & David A. Wise, The Taxation of Pensions: A Shelter Can Become a Trap, in FRONTIERS IN THE ECONOMICS OF AGING 173 (David A. Wise ed., 1998).

\textsuperscript{130} H.R. 8 would have allowed the executor discretion to allocate the exemption, apparently without restriction. See H.R. 8, supra note 1, § 103 (proposed section 1022(b)(4)). In the absence of a fair-market-value ceiling, the exemption might even be used to generate artificial losses.

\textsuperscript{131} A similar liquidity problem arose under the 1976 legislation. A sale of appreciated assets to pay the estate tax could trigger a capital gains tax, in turn making it necessary to sell additional assets. See BACKGROUND AND ISSUES, supra note 112, at 19 (describing "mushrooming" tax problem). In response, one commentator suggested allowing the executor to apply certain basis adjustments to reduce the gain on assets sold to pay the estate tax. See Estate and Gift Tax Carryover Basis, supra note 50, at 144, 145 (statement of Edwin S. Cohen).

\textsuperscript{132} Furthermore, unlimited discretion would put the executor in the position of balancing potentially conflicting duties to minimize the overall tax burden without favoring any one beneficiary over another. The calculations necessary to determine the optimal allocation would be quite complicated, and even a diligent executor acting in good faith would have cause for concern about liability to disgruntled beneficiaries.

\textsuperscript{133} See former I.R.C. § 1023 (requiring that aggregate basis adjustment be allocated to appreciated assets based on the ratio of each asset's net appreciation to net appreciation of all such assets); see also supra note 129 (discussing priority of allocation to appreciated
amount of exemption allocated to each asset depends on the basis and value of every other appreciated asset, which may be unascertainable as long as the built-in gain in any asset remains unrealized.\textsuperscript{134} As a result, executors may be unable to determine the basis of appreciated assets or the amount of gain realized on their disposition during estate administration, and recipients of in-kind distributions may be faced with similar uncertainty for a potentially indefinite period of time.\textsuperscript{135}

In addition to a general exemption, further exemptions may be proposed for specific categories of assets. The most defensible categorical exemption is for items of non-business tangible personal property having de minimis value (e.g., not exceeding $5,000).\textsuperscript{136} The rationale for such an exemption is simply that the administrative burden of ascertaining the basis of such property outweighs any conceivable benefit, and that any attempt to enforce a basis reporting requirement for such property would be futile.\textsuperscript{137} The per-item value limit is intended to ensure that the exemption cannot be used to shelter items of substantial value (e.g., jewelry, art works, and collectibles).\textsuperscript{138} Other categorical exemptions might be

\begin{itemize}
\item The same would be true if the aggregate basis of all assets (including any minimum basis allowance) were automatically reallocated to produce a uniform basis-to-value ratio for all of the decedent's assets. \textit{Cf.} 1969 \textsc{treasury proposals}, supra note 10, at 344-45 (proposing mandatory reallocation).
\item Whatever allocation method is chosen, it would presumably be necessary to provide procedures for auditing and final determination of basis as well as value. \textit{Cf.} former I.R.C. \textsection 1023(b)(3) ($10,000 exclusion for personal and household effects); 1969 \textsc{treasury proposals}, supra note 10, at 342-43 (proposing exemption for $1,000 per item of "ordinary personal and household effects"); Canadian Income Tax Act \textsection 46 (deemed minimum basis and amount realized of $1,000 on disposition of "personal-use property" during life or at death).
\item See \textit{Graetz}, supra note 42, at 843-44; \textit{Zelenak}, supra note 51, at 424-27.
\item Such an exemption inevitably raises definitional problems, especially in the case of a set or collection of items. See \textit{Estate and Gift Tax Problems}, supra note 50, at 147-49 (statement of Erwin N. Griswold, complaining of difficulty of determining basis in stamp collection); see \textit{generally Zelenak}, supra note 51, at 425-28.
\end{itemize}
allowed for property such as personal residences, farms, and closely held businesses. Although some sort of liquidity relief (e.g., provisions for deferred payment) may be appropriate for such property, allowing an exemption in the form of a tax-free basis step-up can be explained only in terms of political expediency.

In one respect, repeal of the transfer taxes might simplify the implementation of carryover basis. One major complaint about the 1976 legislation focused on a pair of cumbersome basis adjustments in connection with appreciated property that was subject to federal or state death taxes. These

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139 Exempting gain on a deathtime transfer of a personal residence might be rationalized as an extension of the existing $250,000 gain exclusion for lifetime dispositions under section 121. The substitution of a gain exclusion for the rollover provision of prior law was intended both to alleviate recordkeeping burdens and to remove barriers to sales by homeowners who did not wish to purchase "larger and more expensive houses." See H.R. Rep. No. 105-148, at 347 (1997). Although the latter purpose does not apply to post-death sales, it could be argued that a parallel deathtime exemption would be necessary to avoid creating an undesirable incentive for deathbed sales. Cf. President's 1963 Tax Message, supra note 41, at 132 (proposing exemption for gain on deathtime transfer of personal residence); Canadian Income Tax Act § 40(2)(b), (6) (limited exemption for gain on disposition of principal residence).

140 Cf. I.R.C. §§ 2032A (special valuation for real property used in farm or closely held business), 2057 (deduction for qualified family owned business interests); Canadian Income Tax Act § 110.6(2), (2.1) (capital gain exemption for disposition of qualified farm property or qualified small business corporation shares).

141 See Gutman, supra note 10, at 1259-69 (discussing and criticizing existing liquidity relief provisions); Dodge, supra note 64, at 1859 (suggesting carryover basis exception to deathtime gains tax for "hard to value nonliquid interests in closely held businesses and farms"). See also BIRD & BUCOVETSKY, supra note 112, at 49 (suggesting that "the difficulty in devising politically satisfactory solutions to the liquidity problem in large part reflects the fact that the problems are not really those of liquidity at all but rather are of a more deep-seated psychological nature"); Douglas G. Hartle, Some Analytical, Political and Normative Lessons from Carter, in THE QUEST FOR TAX REFORM: THE ROYAL COMMISSION ON TAXATION TWENTY YEARS LATER 397, 419 (W. Neil Brooks ed., 1988) (suggesting that the real reason for most sales of family businesses was "the founder's lack of faith in the business acumen of his family" and that the liquidity problem was invented as a "convenient excuse" for sales that would have occurred in any event).

142 See former I.R.C. § 1023(c), (e). The main problem with these adjustments was that the amount of the adjustments depended on the aggregate value of property subject to tax, which often could not be ascertained until the marital share was fully funded. In addition, liquidity problems prompted one commentator to suggest that the executor be allowed to allocate the adjustments to reduce the gain on assets sold to pay the estate tax. See supra note 131.
adjustments were intended to achieve more neutral tax treatment where gain was realized after death rather than during life.\textsuperscript{143} In the absence of federal transfer taxes, such adjustments would be needed only if the continuing burden of state death taxes were thought sufficient to justify the additional complexity.\textsuperscript{144} Repeal of the federal transfer taxes might well encourage the states to slash their remaining death taxes in a "race to the bottom" to attract wealthy residents.\textsuperscript{145}

\textbf{B. Marital and Charitable Bequests}

Any regime that provides differential treatment for bequests to a surviving spouse or charitable organization involves added complexity. As a threshold matter, it is necessary to identify which recipients and forms of disposition qualify for special treatment. In the case of marital bequests, the existing estate tax marital deduction provisions illustrate the difficulty of defining the requisite level of beneficial enjoyment and control, short of absolute ownership, that constitutes deemed ownership by a surviving spouse.\textsuperscript{146} Although those provisions could be borrowed as a starting point for an analogous provision under a deathtime

\textsuperscript{143} In the case of carryover basis property with unrealized appreciation, the basis adjustments were intended to compensate for the lack of a reduction in the estate tax that would have arisen from the payment of a gains tax had the property been sold before death. See Graetz, \textit{supra} note 42, at 834 n.14. Cf. I.R.C. § 1015(d) (providing similar basis adjustment for property acquired by gift).

\textsuperscript{144} Failure to provide a basis adjustment would encourage states to repeal their own death taxes and create a barrier to any subsequent attempt to reintroduce death taxes at the federal or state level. Cf. PETER W. HOGG ET AL., \textit{PRINCIPLES OF CANADIAN INCOME TAX LAW} 152 (3d ed. 1999) (noting abolition of death and gift taxes in all Canadian provinces following 1971 repeal of federal transfer taxes).

\textsuperscript{145} Presumably, the existing section 2011 credit for state death taxes would disappear along with the federal estate tax, thereby eliminating in a single stroke the "sponge" or "pick-up" taxes currently imposed by most states. See Joufaian, \textit{supra} note 12, at 30 (noting that section 2011 credit dampens interstate competition for wealthy decedents).

\textsuperscript{146} See I.R.C. § 2056(b) (setting forth terminable interest rule and exceptions).
gains tax or a carryover basis regime, repeal of the transfer taxes would offer an opportunity to start with a clean slate. Any definition of qualifying marital transfers would undoubtedly raise concerns about incentives affecting the allocation of ownership and control of property between spouses.147

The complexity of special treatment for marital bequests could be avoided simply by subjecting them to the same treatment as other bequests. Under a deathime gains tax, this would mean taxing built-in gain in assets passing to the surviving spouse without regard to the concept of the married couple as a single taxable unit.148 Alternatively, in a carryover basis regime, all assets could receive the same carryover basis treatment without regard to the identity of the recipient. It seems unlikely, however, that Congress would resist political pressure to afford preferential treatment to marital bequests, under a deathime gains tax or a carryover basis regime, to compensate for the loss of the marital deduction under the existing estate tax.

The complexity is especially acute under a deathime gains tax that provides carryover basis treatment for marital bequests. Such a regime requires a detailed mechanism to identify and coordinate at least three different tiers of assets


148 See supra note 86 and accompanying text; Graetz, supra note 42, at 844-45 (recommending this approach on grounds of simplicity).

149 See Zelenak, supra note 51, at 396 (suggesting that politically viable deathime gains tax must provide marital exemption). Cf. 1969 TREASURY PROPOSALS, supra note 10, at 343 (proposing deathime gains tax with carryover basis for marital bequests); President's 1963 Tax Message, supra note 41, at 130-32 (same).

150 For example, H.R. 8 provided a tax-free basis step-up for up to $3,000,000 of property passing to a surviving spouse in a form eligible for the existing estate tax marital deduction. See H.R. 8, supra note 1, § 103 (proposed section 1022(b)(2)(C)). Thus, even after the repeal of the estate tax, the income tax would be haunted by a spectral version of the terminable interest rule and its various exceptions.
governed by distinct sets of rules: assets fully subject to the general regime of deemed realization at death; assets passing to a surviving spouse in a form qualifying for carryover basis treatment; and assets eligible for a tax-free basis step-up pursuant to one or more exemptions. For example, a general exemption might well be allocated first to non-marital assets to minimize the amount of gain realized at death and preserve a pure carryover basis for assets passing to the surviving spouse.\textsuperscript{151}

A deathtime gains tax that allows carryover basis for marital bequests also raises the issue of an executor’s ability to maximize deferral by selecting low-basis assets to fund a marital bequest. One possible response to such “cherry picking” is to allow carryover basis treatment only for marital bequests of specifically identifiable assets,\textsuperscript{152} though this limitation seems rather draconian. Alternatively, the basis of all the decedent’s assets could be subject to mandatory reallocation at death,\textsuperscript{153} though this would involve heavy burdens of administration and compliance.\textsuperscript{154} An arguably more workable solution would allow carryover basis treatment as long as the basis-to-value ratio of assets used to

\textsuperscript{151} See Zelenak, supra note 51, at 423-24. The question remains whether, in the event that the non-marital assets do not absorb the available basis adjustment (i.e., because those assets have relatively little built-in gain), the remaining adjustment can be allocated to the marital share. This question cannot be answered simply by reference to the concept of the married couple as a single taxable unit, see id. at 423-24, but leads instead to the intractable issue of whether the exemption for a married couple should be equal to or less than twice the exemption for an unmarried individual. See Gutman, supra note 10, at 1219-35 (discussing marriage penalties and bonuses in context of transfer taxes). The same issue concerning the treatment of married couples arises in a carryover basis regime if marital bequests qualify for a tax-free basis step-up, as provided in H.R. 8.

\textsuperscript{152} Cf. Graetz, supra note 42, at 847 (suggesting similar rule, coupled with gross-up requirement, for charitable bequests).

\textsuperscript{153} The 1969 Treasury proposals recommended this approach “to eliminate any tax incentive for the decedent or his executor to transfer any particular piece of property to any particular person or entity.” 1969 TREASURY PROPOSALS, supra note 10, at 344-45.

\textsuperscript{154} See Graetz, supra note 42, at 839-40, 844-45; Zelenak, supra note 51, at 400.
fund the marital share is no less than that of all assets available to satisfy the bequest.\textsuperscript{155}

A more serious issue raised by a carryover basis rule for marital bequests under a deathtime gains tax involves the problem of "suspended basis." Prior to full funding of a pecuniary bequest,\textsuperscript{156} the executor does not necessarily know how assets will ultimately be allocated between the surviving spouse and the other beneficiaries, and it is therefore impossible to determine the amount of gain on an interim sale of assets.\textsuperscript{157} In the absence of a workable solution to the problem of suspended basis, the most sensible approach may be simply to abandon the notion of special treatment for marital bequests under a deathtime gains tax,\textsuperscript{158} though this may present insuperable political difficulties.

In general, it seems desirable to conform the treatment of lifetime gifts between spouses as closely as possible to that of deathtime bequests to a surviving spouse. Thus, under a

\begin{enumerate}
\item \textsuperscript{155} Cf. Rev. Proc. 64-19, 1964-1 C.B. 682 (responding to analogous problem under existing estate tax by requiring that bequest be funded with assets "fairly representative of appreciation or depreciation").
\item \textsuperscript{156} The problem of suspended basis generally arises only to the extent that the executor (or another person) has discretion to select assets in funding a pecuniary bequest (i.e., a bequest defined by reference to a specified amount or value of property, as distinguished from a specific bequest or a residuary bequest). A pecuniary bequest defined by a formula intended to minimize the amount of gain realized upon funding could require an interrelated computation in which the choice of assets depended on the amount of gain and the amount of gain in turn depended on the choice of assets. See Graetz, supra note 42, at 845 n.43.
\item \textsuperscript{157} One possible response is to allow carryover basis treatment only to the extent the marital bequest is actually funded by the time the decedent's final return is filed and to treat any interim sale as fully taxable even if the sale proceeds are used to fund the marital share. See Zelenak, supra note 51, at 398 & n.166. This approach does not appear promising, however, because the time required to fund a pecuniary marital bequest routinely exceeds any reasonable deadline for filing the final return, and extending the deadline would merely perpetuate the underlying problem of suspended basis. Alternatively, the executor might be permitted to claim "tentative exemptions" based on reasonable expectations concerning the final distribution. See id. at 399. This "wait and see" solution, however, would inevitably create an administrative nightmare of amended returns and refund claims. See id. at 398 (noting similar problem in connection with 1976 carryover basis legislation).
\item \textsuperscript{158} See Graetz, supra note 42, at 844-45.
\end{enumerate}
Death Without Taxes?

Deathtime gains tax that provides carryover basis treatment for marital bequests, the same treatment should apply to gifts made by one spouse to the other during life. Arguably, carryover basis for lifetime gifts between spouses is defensible, even if marital bequests are fully subject to the deathtime gains tax, on the ground that this allows married couples in common law states to achieve tax-free estate splitting similar to that available to couples in community property states.159

For the most part, the issues raised by marital bequests also arise with respect to charitable bequests. For example, a carryover basis rule for charitable bequests under a deathtime gains tax raises problems of asset selectivity.160 One important difference, however, arises from the existing income tax incentives favoring lifetime charitable gifts relative to charitable bequests.161 Simple repeal of the transfer taxes (including the transfer tax charitable deduction) would amplify the preference for lifetime charitable gifts. Under a deathtime gains tax, assuming that the existing income tax treatment of lifetime charitable gifts remains unchanged, the obvious way to reduce this tax disparity is to provide an exception to the rule of deemed realization at death coupled with an income tax deduction for the value of assets passing to charity.162 Under a carryover

159 See id. at 845 n.44 (recommending repeal of section 1014(b)(6)).

160 One possible solution would be to allow the deathtime income tax charitable deduction only for specific bequests and require that charitable bequests be grossed up by the amount of the decedent's tax savings. See id. at 847. Cf. Zelenak, supra note 51, at 403 (“It is not apparent, as a matter of policy, why selectivity by [a living donor] should be permitted but selectivity by the executor should not.”). One reason for special concern about asset selectivity by executors is that the volume of charitable bequests is around 15 times that of lifetime charitable gifts. See Joulfaian, supra note 12, at 20 & tbl.14 (estimating aggregate value of lifetime contributions in 1981 as six percent of charitable bequests in 1982).

161 See supra notes 92-94 and accompanying text.

162 Cf. I.R.C. § 170. If a deduction for the full value of charitable bequests is allowed on the decedent's final return, it might be appropriate to relax the percentage limits applicable to lifetime charitable gifts or perhaps to permit free transferability of any unused deduction.
basis regime, no special exception for assets passing to charity is necessary; an income tax deduction for charitable bequests would offer a tax incentive to compensate for the absence of the estate tax charitable deduction.

C. Lifetime Gifts

Repeal of the transfer taxes has important implications for the tax treatment not only of bequests but also of lifetime gifts. The gift tax has long served as a dual-purpose buttress to the income and estate taxes; repeal of the gift tax would remove a significant check on opportunities to shift income from high-bracket donors to low-bracket donees. Lifetime gifts raise special policy and administrative concerns because they offer significant opportunities for tax planning through the selection of assets and the structure and timing of transfers. Furthermore, to the extent that lifetime gifts represent shared consumption within a family unit, there may be grounds for treating them differently from deathtime transfers.

Under a deathtime gains tax, a central issue is whether lifetime gifts should generally be treated as realization events to the donor (giving rise to a fair-market-value basis in the donee's hands) or whether the non-realization rule of existing law (with a carryover basis in the donee's hands) should continue to apply. Most proposals favor a constructive realization rule, which limits opportunities for indefinite deferral of gain and income-shifting while minimizing

163 Of course, income-shifting is subject to other limitations as well, see I.R.C. §§ 671-678 (grantor trust rules), 1(g) ("kiddie tax"), but these provisions are much more narrowly targeted than the gift tax.

164 See generally George Cooper, A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance, 77 COLUM. L. REV. 161 (1977) (discussing tax avoidance techniques involving lifetime gifts); Bernheim, supra note 80, at 114, 116-20.

165 See AMERICAN LAW INSTITUTE, FEDERAL ESTATE AND GIFT TAXATION (1969) (proposing gift tax exemption for consumption gifts); cf. I.R.C. §§ 151(c) (dependent deduction), 2503(e) (gift tax exclusion for medical and educational payments).
disparities in the treatment of lifetime and death time transfers. The normal limitations on loss deductions would apply in the case of lifetime gifts, to prevent taxpayers from selectively realizing losses while deferring gains.

A constructive realization rule for lifetime gifts might reasonably provide one or more exemptions similar to those allowed with respect to death time transfers. In terms of administrability, a categorical exemption would almost certainly be necessary for gifts of non-business tangible personal property of de minimis value. Such an exemption would provide only a mild incentive for lifetime gifts, in view of the limitations on the type and value of property involved. It is not clear, however, that a general exemption for cumulative lifetime and death time transfers would be necessary or even useful, in view of the types of property that donors routinely give away during life. Moreover, a cumulative exemption would introduce considerable complexity. On the other hand, a general exemption

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166 See 1969 TREASURY PROPOSALS, supra note 10, at 348-49; President's 1963 Tax Message, supra note 41, at 139-40; Zelenak, supra note 51, at 423-24 (recommending carryover basis treatment for lifetime gifts covered by general exemption, even though appreciated assets transferred at death would receive a tax-free basis step-up). Cf. Canadian Income Tax Act § 69(1)(b), (c).

167 See 1969 TREASURY PROPOSALS, supra note 10, at 349; Zelenak, supra note 51, at 436.

168 See supra notes 121-141 and accompanying text.

169 See supra notes 136-138 and accompanying text; Zelenak, supra note 51, at 427.

170 See Dodge, supra note 64, at 1856 (“there is no reason to create any unnecessary exemptions for gifts”). It seems likely that most donors who make gifts of appreciated property during life would retain sufficient assets at death to absorb most or all of the available exemption. Furthermore, most routine gifts of non-business tangible personal property either would have no appreciation or would be eligible for a separate categorical exemption.

171 The problem is accentuated if the general exemption takes the form of a vanishing minimum basis allowance. Only at death would it be possible to determine whether the transferor’s aggregate basis in all transferred property exceeded the minimum basis allowance; any excess would require that amounts previously allowed be “recaptured” through a downward adjustment in the basis of property transferred at death. See Zelenak, supra note 51, at 418-19. Presumably, if the aggregate basis of property owned at death were less than the required downward adjustment, the difference would trigger taxable gain on the decedent’s final return.
applicable to bequests but not to lifetime gifts might encourage some taxpayers to retain property until death to avoid wasting the exemption.  

Issues of timing and valuation account for much of the complexity in the existing transfer taxes, and these issues would be no less controversial under a death time gains tax. The definition of property passing from a decedent would be crucially important both to identify the assets subject to a gains tax at death and to differentiate transfers made at death from those completed during life. 76 After repeal of the estate tax, it would be necessary either to retain the concept of the gross estate solely for purposes of determining gain or basis under the income tax 74 or to draw a new line of demarcation between death time and lifetime transfers. The stakes would be especially high under a death time gains tax that allowed carryover basis treatment for lifetime gifts, since taxpayers would have a strong incentive to avoid realizing gains at death by transferring appreciated assets during life. It would be possible to borrow the timing rules from the existing transfer taxes with all their familiar shortcomings, but in the absence of transfer taxes the preferable approach might be to start afresh and formulate a new, uniform

172 The tax-free basis step-up at death under current law provides a similar incentive in the case of transfers that are sheltered from the estate tax due to the unified credit or the marital deduction.

173 Under current law, the concept of the gross estate serves not only to measure the estate tax base but also to identify property eligible for a death time basis step-up. See I.R.C. § 1014(b) (defining property acquired from a decedent by reference to inclusion in gross estate).

174 This is the approach adopted by recent carryover basis proposals. See H.R. 8, supra note 1, § 103 (proposed section 1022(b)(1)); H.R. 2488, supra note 1.

175 As with the existing estate tax, will substitutes and lifetime transfers would pose difficult definitional issues concerning the meaning of deemed ownership at death. Cf. I.R.C. §§ 2035-2038 (lifetime transfers), 2039 (survivorship annuities), 2040 (joint and survivor tenancies), 2041 (general powers of appointment), 2042 (life insurance).

176 For such a proposal, see Zelenak, supra note 51, at 410 (discussing timing rules).
Valuation problems with respect to certain types of property (e.g., interests in closely held businesses or trusts and interests subject to special restrictions) would be just as intractable as under the existing transfer taxes.\(^{178}\)

A related but distinct concern under a deathtime gains tax involves the use of long-term trusts to circumvent periodic realization at death.\(^{179}\) This issue is also familiar from the existing transfer taxes, and it would be possible to borrow the conceptual apparatus of the generation-skipping transfer tax to identify the timing and amount of taxable transfers under a deathtime gains tax.\(^{180}\) But again, in the absence of transfer taxes it is not clear that such a complex superstructure would be desirable.\(^{181}\)

Problems of timing and valuation would be minimized in a carryover basis regime that provided uniform treatment for lifetime and deathtime transfers. However, timing and valuation issues would remain significant to the extent that either type of transfer qualified for more favorable treatment than the other. For example, an exemption resulting in a limited basis step-up may be unavoidable for deathtime transfers, but there is no need to encourage accelerated


\(^{178}\) For a proposal to borrow the valuation provisions from the existing transfer taxes, see Zelenak, supra note 51, at 413-14.

\(^{179}\) Indeed, as several states move to relax or repeal traditional perpetuities restrictions, the phenomenon of perpetual private trusts is likely to become increasingly widespread and controversial. See Jesse Dukeminier, The Uniform Statutory Rule Against Perpetuities: Ninety Years in Limbo, 34 UCLA L. REV. 1023 (1987).

\(^{180}\) For such a proposal, see Zelenak, supra note 51, at 411-13. Compare Dodge, supra note 64, at 1849 (finding no problem with deferral through trusts, but arguing that if problem is considered significant, deemed realization should occur every 10 or 20 years rather than at “the death of a beneficiary or the passing of generations of beneficiaries”) with id. at 1850 (proposing different rule in “a nontrust situation where a legal life estate or term interest is followed by a remainder”).

\(^{181}\) Cf. Canadian Income Tax Act § 104(4) (periodic tax on appreciated assets held in trust).
transfers of appreciated property by providing a parallel exemption for lifetime gifts.

D. Transitional Relief

A transition to a deathtime gains tax or a carryover basis regime raises both technical issues concerning the method of implementation and distributional issues concerning winners and losers. In theory, the new regime could fall anywhere on the spectrum between full retroactivity (i.e., applicable to all transfers after the enactment date, without regard to when the transferor acquired the property) and full prospectivity (i.e., applicable only to property acquired after the enactment date).

Most proposals strike a pragmatic compromise between retroactivity and prospectivity by allowing a limited tax-free basis step-up for appreciated assets held on the enactment date. One potential difficulty with this so-called "fresh start" approach stems from the need to value assets as of the date of enactment. In theory, taxpayers could be required to obtain a one-time appraisal of all assets, but this may prove quite expensive and burdensome. Accordingly, some proposals provide an optional valuation method in which date-of-death values are discounted back to the enactment date at a

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Full retroactivity would be least costly in terms of revenue and most efficient in terms of minimizing behavioral distortions, but would almost certainly be politically unacceptable. Administrative difficulties might also arise in requiring proof of basis for certain types of property acquired before the enactment date. See Graetz, supra note 42, at 854; Zelenak, supra note 51, at 382-88.

\[2\]

Although full prospectivity avoids the political and administrative problems of a retroactive approach, it is extremely costly in terms of revenue and confers an unwarranted windfall on holders of accumulated wealth. See Graetz, supra note 42, at 854; Zelenak, supra note 51, at 382-88.

\[3\]
The appraisal would be irrelevant for assets that were disposed of in a taxable sale or exchange before death; and even for assets retained until death, the appraisal would presumably have no binding effect in subsequent valuation proceedings. These concerns should not be overstated, however. In Canada, the capital gains tax enacted in 1971 provided transitional relief in the form of a national appraisal date which appears to have facilitated implementation of the new tax. See BIRD & BUCOVETSKY, supra note 112, at 51.
specified interest rate. The flexibility of an optional valuation method, however, may be outweighed by the complexity and uncertainty involved in calculating different results under multiple alternative methods. In the interest of simplicity, therefore, it may be desirable to provide "fixed rules with as few options as possible," while recognizing that the burden of valuation represents a one-time transition cost of implementing the new regime.

In sum, both a death-time gains tax and a carryover basis regime would involve substantial complexity and accordingly would increase the time, effort, and expense of administering decedents' estates. Indeed, any realistic proposal would have to confront many of the same problems that have proved most intractable under the existing transfer taxes: identifying property passing from a decedent at death; specifying when a transfer becomes wholly or partially complete during life or at death; valuing interests in closely held businesses with unusual capital structures or custom-tailored restrictions; defining the types of marital transfers that merit special treatment; and curbing the use of long-term trusts as tax avoidance devices. If these issues would prove no less troublesome under a death-time gains tax or a carryover basis regime, it is reasonable to ask whether it ultimately makes sense to adopt either system as a replacement for the existing transfer taxes.

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185 See former I.R.C. § 1023(h) (as amended in 1978, providing discount formula for valuing tangible personal property); H.R. 4694, 96th Cong., § 2(a) (1979) (unenacted bill proposing discount formula for valuing property other than marketable securities, subject to 25 percent floor).

186 Graetz, supra note 42, at 856. For example, taxpayers could be given the option to use the decedent's actual basis instead of actual fair market value as of the enactment date. See id. at 856-57; cf. 1969 TREASURY PROPOSALS, supra note 10, at 351 (proposing fresh start basis equal to higher of decedent's basis or actual date-of-enactment value for purposes of capital gains; lower-of rule for loss purposes). In the absence of sufficient proof, basis might be presumed under a default rule to be no less than the value of the asset at the time of acquisition by the decedent. See Graetz, supra note 42, at 839.
IV. TOWARD A MORE PERFECT INCOME TAX?

The income tax treatment of unrealized gain raises related but distinct issues concerning the treatment of the transferred property in the recipient's hands. Current law expressly excludes gifts and bequests from the recipient's gross income.\(^{187}\) The exclusion is often criticized as an unwarranted departure from an ideal accretion-type income tax, and numerous commentators have proposed that such transfers be included in the recipient's income tax base.\(^{188}\) An income tax on gifts and bequests has also been described as an "elegantly simple and economically attractive alternative" to the existing transfer taxes.\(^{189}\) Both rationales — perfecting the income tax base and replacing the transfer taxes — deserve further scrutiny.

In general, an accretion-type income tax measures taxable capacity as the sum of a taxpayer's consumption and increase in wealth during the accounting period.\(^{190}\) Accordingly, a comprehensive income tax would treat gifts and bequests as income to the recipient, since such transfers represent accessions to wealth similar to taxable receipts from other sources (e.g., earnings, gains and windfalls).\(^{191}\) In addition,

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\(^{187}\) See I.R.C. § 102.


\(^{190}\) See Simons, supra note 188, at 50 (defining personal income as "the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question"); Robert Murray Haig, The Concept of Income — Economic and Legal Aspects, in The Federal Income Tax 1, 7 (Robert Murray Haig ed., 1921) (defining income as the "money value of the net accretion to one's economic power between two points of time").

some proponents of a comprehensive income tax argue that gifts and bequests should be subject to a second level of income tax in the transferor's hands, on the ground that such transfers are analogous to acts of consumption by the transferor.\textsuperscript{192} In the case of a transfer of cash, the second level of income tax is achieved simply by denying a deduction to the transferor, so that the transfer is made from after-tax wealth. Furthermore, to provide parity of treatment for a transfer of appreciated property, the transferor should be taxed on the built-in gain at the time of the transfer.\textsuperscript{193} Failure to tax the built-in gain would replicate some of the inequity of the tax-free basis step-up under current law, since the recipient would presumably take a basis equal to the amount included in income, i.e., the fair market value of the transferred property.

Despite its theoretical plausibility, the notion of imposing two levels of income tax on gifts and bequests would undoubtedly prove controversial and invite charges of unfair "double taxation."\textsuperscript{194} In this respect, the Canadian experience is instructive. The Royal Commission on Taxation, in its influential 1966 report setting forth a comprehensive program for reform of the Canadian income tax, recommended taxing the transferor on built-in gains and also taxing the recipient on the full value of the transferred property.\textsuperscript{195} A capital gains tax was eventually enacted in 1971, but the proposal to tax gifts and bequests as income to

\textsuperscript{192} Compare Simons, supra note 188, at 49-50 (defining consumption as an exercise of rights "in destruction of economic goods") with Dodge, supra note 90, at 1186-88 (describing act of transfer as "voluntary exercise of ... economic power" indicating transferor's "ability to pay"). Cf. DAVID F. BRADFORD, UNTANGLING THE INCOME TAX 20-21 (1986) ("tax theorists are divided on whether money an individual gives away or bequeaths at death should be regarded as consumed by the giver").

\textsuperscript{193} See Simons, supra note 188, at 56-58, 162-68, 211-12; Dodge, supra note 90, at 1189.

\textsuperscript{194} See supra note 105 and accompanying text (noting similar objection to transfer taxes).

\textsuperscript{195} See ROYAL COMMISSION REPORT, supra note 191, at 465-69.
the recipient was summarily dropped. Significantly, the introduction of the new capital gains tax coincided with the repeal of the Canadian federal transfer taxes.

Even in a comprehensive income tax, gifts and bequests may properly be subject to only one level of income tax. The tax base is closely related to the definition of the basic taxable unit: Transfers between individuals within the same taxable unit do not constitute taxable events. In theory, the taxable unit may be defined by reference to individuals, married couples or other groups. For example, the Royal Commission recommended a family-based system in which transfers between spouses and between parents and their dependent children would have no tax consequences; only a transfer outside the family unit (including property removed from the unit by a child at the age of majority) would constitute a taxable event. Although neither Canada nor the United States has embraced a full-fledged system of family-based taxation, such a system would in theory make all transfers between family members exempt from tax.

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196 See Hogg et al., supra note 144, at 152.

197 See id.; see also John Bossons, Economic Overview of the Tax Reform Legislation, in 1971 CONFERENCE REPORT: REPORT OF PROCEEDINGS OF THE TWENTY-THIRD TAX CONFERENCE OF THE CANADIAN TAX FOUNDATION 45, 54 (1972) ("In a very crude sense, eliminating the tax on estates can be thought of as an offset for the imposition of a tax on accrued, unrealized gains, deemed to be realized at death. Nevertheless, the offset is very crude.").

198 See Karen C. Burke & Grayson M.P. McCouch, A Consumption Tax on Gifts and Bequests?, 17 VA. TAX REV. 657, 675-76 (1998) ("a taxable unit cannot make a gift to itself"); William A. Klein, An Enigma in the Federal Income Tax: The Meaning of the Word "Gift," 48 MINN. L. REV. 215, 253 (1963) (noting that if the family is regarded as a unit for tax purposes, then transfers of assets within the unit have "no tax significance").

199 See ROYAL COMMISSION REPORT, supra note 191, at 466-67 (explaining that proposed system "would probably exempt from tax a large proportion of all gifts").

200 Current law does contain some elements of family-based taxation. See I.R.C. §§ 1(a) (joint return for married couples), 1(g) ("kiddie" tax), 24(a) (credit for qualifying children under age 17), 25A (credit for qualifying educational outlays), 151 (c) (dependent deduction). But cf. Joseph M. Dodge, Taxing Gratuitous Transfers Under a Consumption Tax, 51 TAX L. REV. 529, 541 (1996) (characterizing family-based taxation as a "radical departure from current law").
More generally, a single level of income tax on gifts and bequests can be defended on the theory that "there is only one source of earnings and one case of spending." Technically, a single level of income tax can be structured to fall either on the recipient or the transferor. The former result can be achieved by taxing the transfer as income to the recipient while allowing a deduction to the transferor. In contrast, allowing an exclusion to the recipient while denying a deduction to the transferor (and treating the transfer as a constructive realization event) produces the latter result. If transferors are generally assumed to be in higher rate brackets than recipients, taxing the transferor rather than the recipient may be justified as a measure to prevent income shifting. Aside from rate bracket differences, however, the issue of whether a tax is nominally imposed on the transferor or the recipient is likely to be of essentially theoretical interest. To the extent that the tax reduces the amount of potential transfers, the economic burden of the tax is likely to fall primarily on recipients.

Setting aside transfer taxes for the moment, current law may be viewed as a rough sort of single level income tax

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201 Michael J. Graetz, Implementing a Progressive Consumption Tax, 92 HARV L. REV. 1575, 1624 (1979). Cf. William D. Andrews, Personal Deductions in an Ideal Income Tax, 86 HARV. L. REV. 309, 349 (1972) (suggesting that income tax may be understood as "an indirectly measured tax on personal consumption and accumulation"); William A. Klein, Timing in Personal Taxation, 6 J. LEGAL STUD. 461, 468 n.28 (1977) (noting that gifts and inheritances may be regarded "not as windfalls to the transferees but rather as allocations within family units of the power to consume").

202 The deduction would be equal to the transferor's tax-paid basis in the transferred property (i.e., pre-transfer basis increased by any gain recognized as a result of the transfer). Thus, in the case of appreciated property, a deduction equal to fair market value would be allowed only if the transfer were treated as a constructive realization event.

203 See supra note 15 (discussing incidence assumptions); see also Gale & Slemrod, supra note 7, at 34 (noting that transferors may respond in a way that keeps constant either the "net-of-tax inheritance received" or the "gross (pre-tax) bequest"; in a partial equilibrium setting, the estate tax burden falls on transferors in the former case and on recipients in the latter case).
Because the transferor realizes no gain and receives no deduction, the transferred property is in effect subject to income tax in the transferor's hands to the extent of basis, and the carryover basis provisions preserve any unrealized gain in the recipient's hands. At the same time, however, the transferred property which escapes inclusion in the recipient's income tax base is subject to a separate transfer tax (nominally imposed on the transferor). Thus, from a broader perspective, current law may be viewed as embodying an imperfect approximation of a double level tax model with one level of income tax and one level of transfer tax. Furthermore, — leaving aside for the moment significant differences in rates, exemptions and timing — the transfer taxes may be understood as partially compensating for the failure to tax the transferred property as income to the recipient.

Ultimately, the decision whether to tax gifts and bequests to both parties or only one of them cannot be deduced from first principles but must be resolved in terms of underlying policy concerns. The following table summarizes alternative forms of a “single level tax” model and a “double level tax” model. A single level tax model involves one level of income tax on either the recipient (top row) or the

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204 See David F. Bradford & U.S. Treasury Tax Policy Staff, Blueprints for Basic Tax Reform 33-35 (2d ed. 1984); Bradford, supra note 192, at 29-30. Current law falls short of a full single level tax, since unrealized appreciation at death escapes income tax altogether, but a deathtime gains tax would fill this gap.

205 For purposes of determining loss, however, the recipient's basis cannot exceed the fair market value of the transferred property at the time of the gift. See I.R.C. § 1015(a).

206 The carryover basis provisions preserve unrealized gain in the recipient's hands but also allow indefinite deferral through successive gifts (or complete forgiveness if the recipient retains the property until death). Moreover, the transfer taxes exempt substantial amounts of property from tax by means of the unified credit.

207 See Bradford, supra note 192, at 21 (“the preferred policy is to be sought not in abstract reasoning but in concrete comparisons of the effect on tax burdens and other characteristics of the tax system”); id. at 30-31 (discussing “bestowal-inclusive” and “bestowal-exclusive” models).
A double level tax model involves either an income tax on both parties (top row) or an income tax on one party coupled with a separate transfer tax (bottom row).\textsuperscript{209}

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<th>Single Level Tax</th>
<th>Double Level Tax</th>
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<tr>
<td>Income tax on recipient</td>
<td>Transferor deducts transfer; Recipient includes transfer in income.</td>
<td>Transferor realizes gain (no deduction); Recipient includes transfer in income.</td>
</tr>
<tr>
<td>No income tax on recipient</td>
<td>Transferor realizes gain (no deduction); Recipient excludes transfer from income.</td>
<td>Transferor realizes gain (no deduction); Recipient excludes transfer from income (but separate transfer tax imposed on transferor).</td>
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In theory, a single level tax model can be implemented at the recipient level. This approach would require that the value of the transferred property be included in the recipient's income and would allow a matching deduction to the transferor. Imposing the tax at the recipient level is objectionable, however, on grounds of policy because it creates virtually unlimited opportunities for high-bracket transferors to shift income to low-bracket recipients.\textsuperscript{210} Furthermore, including gifts and bequests in the recipient's income tax base implies not only that the recipient would

\textsuperscript{208} The single level of income tax could also be split between the transferor and the recipient, as under current law. See supra notes 204 & 205 and accompanying text.

\textsuperscript{209} In a double level tax model, the income tax could be imposed nominally either on the transferor or on the recipient; similarly, the transfer tax could be recast as a tax on the recipient (e.g., an inheritance or accessions tax).

\textsuperscript{210} The problem would be even more severe in the event of a mismatch of character, i.e., if the transferor's deduction reduced ordinary income and the recipient reported the receipt as capital gain.
receive the transferred property with a fair-market-value basis (reflecting the amount included in income) but also that the transferor would realize any built-in gain at the time of the transfer. The resulting treatment of both parties is consistent with a constructive taxable exchange of property (paid by the transferor to the recipient) for services (rendered by the recipient to the transferor). Thus, taxing gifts and bequests as income to the recipient may be more constraining than appears at first glance. Although some proponents hesitate to make the point explicitly, treating gifts and bequests as income to the recipient appears to be feasible primarily, and perhaps exclusively, in the context of a full double level tax model.

A double level tax model raises the issue of whether gifts and bequests should be taxed both to the transferor and to the recipient under the income tax or, alternatively, subjected to one level of income tax coupled with a separate transfer tax. Assuming that such transfers are subject to at least one level of income tax, there may be sound reasons to implement the second level of tax through a separate tax on transfers (or accessions). A separate tax on gifts and bequests may serve

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211 Allowing the recipient to take a stepped-up basis without requiring the transferor to realize built-in gain would give rise to the same sort of inequity arising from the tax-free basis step-up for property acquired from a decedent under current law. Transferors would have unlimited opportunities to eliminate capital gains tax liability through lifetime gifts.

212 Some economists account for gratuitous transfers in similar terms of a deemed exchange. See B. Douglas Bernheim et al., The Strategic Bequest Motive, 93 J. POL. ECON. 1045 (1985); Donald Cox, Motives for Private Income Transfers, 95 J. POL. ECON. 508 (1987); Maria G. Perozek, A Reexamination of the Strategic Bequest Motive, 106 J. POL. ECON. 423 (1998).

213 See Dodge, supra note 90, at 1189 & n.57 (noting that proposal to include gifts and bequests in recipient's income "would not preclude additionally taxing the transferor on previously unrealized appreciation, resulting in full double taxation on transfers of appreciated property," but insisting that proposal "is not founded upon a notion of full double taxation"); cf McNulty, Fundamental Alternatives, supra note 189, at 95 (noting that "some theorists would even insist on a new deduction for the donor if the donee is to be taxed on a gift as income; others would vehemently disagree").

214 See Klein, supra note 198, at 255 (noting that "there may be acceptable reasons for exempting inheritances from the income tax and subjecting them to a separate tax system," even though the estate tax may be a "clumsy device" to achieve presumed goals); Burke &
multiple functions which cannot be adequately served by the income tax, no matter how comprehensive its base.\textsuperscript{215} Thus, the costs of administering a separate tax may be offset by gains in flexibility — i.e., the availability of a cumulative lifetime base and a separate structure of progressive rates for gifts and bequests.\textsuperscript{216} Indeed, a system with several countervailing taxes may be preferable to a single, uniform tax base in terms of equity, efficiency, and administrability.\textsuperscript{217}

Alternative methods of taxing gifts and bequests deserve serious attention in proposals for a double level tax model. In the current political climate, however, the prospects for implementing a full double level tax model in any form appear remote indeed. There is no reason to believe that a proposal to tax gifts and bequests as income to the recipient would be greeted more enthusiastically than a reformed transfer tax or an accessions tax. Hard-core opponents of the existing transfer taxes show no interest in improving the operation of those taxes or replacing them with a more effective alternative. Their goal is to eliminate all taxes on wealth transfers, not to change their form.

V. CONCLUSION

Recent Congressional initiatives to repeal the transfer taxes highlight the inequitable treatment of unrealized

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McCouch, supra note 198, at 699-704 (discussing alternative vehicles for separate tax on gifts and bequests).

\textsuperscript{215} For example, the goals of taxing gifts and bequests might include (1) reaching non-pecuniary benefits associated with wealth; (2) curbing accumulation and encouraging dispersion of wealth; and (3) providing differentiated treatment for inherited and saved wealth. See Institute for Fiscal Studies, The Structure and Reform of Direct Taxation: Report of a Committee Chaired by Professor J.E. Meade 317-18 (1978) (Meade Report).

\textsuperscript{216} For proposals contemplating differential tax rates for inherited as distinguished from earned wealth, see Meade Report, supra note 215, at 518; Eugenio Rignano, The Social Significance of the Inheritance Tax (William J. Shultz trans., 1924); William Vickrey, Agenda for Progressive Taxation 224-48 (1947).

appreciation at death under the existing income tax. Eliminating the estate tax would create new pressure to address the anomalous basis step-up for appreciated property passing from a decedent. In response, Congress could either impose a death-time gains tax or adopt a carryover basis regime. The choice between these two alternatives has changed fundamentally since 1976, when carryover basis was enacted as an income tax measure in conjunction with structural reform of the transfer taxes. Today, the central goal of transfer tax activists has shifted from reform to outright repeal; any accompanying change in the income tax represents no more than a concession to make elimination of the transfer taxes politically palatable.

Carryover basis may be politically expedient and reasonably capable of practical implementation. Especially in the absence of transfer taxes, however, a death-time gains tax may be preferable in terms of distributional impact and revenue-raising capacity as well as effectiveness in curbing deferral and ameliorating lock-in. Both a death-time gains tax and a carryover basis regime would bring added complexity and administrative difficulties in establishing basis and defining appropriate exemptions. In addition, many familiar problems in the transfer taxes — identifying death-time transfers and distinguishing them from lifetime gifts, defining marital transfers qualifying for special treatment, and valuing assets — would reappear in the income tax context. While hardly insuperable, these issues should not be ignored or minimized, even by the most ardent opponents of transfer taxes.

The renewed assault on the transfer taxes hearkens back to the tax-cutting fervor of the early 1980s, which led to a dramatic yet temporary reduction in the progressivity of the federal tax system. The experience of the last two decades, however, suggests that such radical tax policy initiatives may be self-limiting. Replacing the existing transfer taxes with a death-time gains tax or a carryover basis regime is fraught
with difficult technical and policy issues as well as potentially serious distributional implications. Those who favor abolishing the transfer taxes should clarify whether their goal is to reduce the progressivity of the existing tax system or to trade one tax instrument for a different but equally progressive one.\textsuperscript{218} Instead of focusing narrowly on the shortcomings of the existing transfer taxes, the debate should include more careful and thoughtful consideration of the repercussions of repeal on the larger tax system.

\textsuperscript{218} See Gale & Slemrod, \textit{supra} note 7, at 19.