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THE CARRYOVER BASIS TAX

INTRODUCTION

During the House-Senate conference on the Tax Reform Act of 1976, an amendment which significantly expanded the capital gains for inherited property was accepted. Subsequently approved by both Houses, the carryover basis tax was viewed by proponents as a major and long awaited reform of the estate tax.

Since that time many have come to regret the haste in which Congress acted. Carryover has proven to be extremely complex and costly, if not impossible, to administer. The burden of both the tax and the cost of compliance falls disproportionately on smaller estates. The agricultural community finds the carryover tax a threat to family farming. From an economic perspective, carryover presents a barrier to efficient capital allocation and thus hurts economic performance.

Senator Robert Dole (R-Kans.), ranking minority member of the Senate Finance Committee, has offered a bill (S.112) which would repeal the carryover provision. His House Ways and Means counterpart, Barber B. Conable, Jr. (R-N.Y.), has also introduced a bill, one of many in the House (H.R.13), to eliminate carryover. It is anticipated that the Senate will attach carryover repeal as an amendment to its windfall profits tax bill. Representative Joseph L. Fisher (D-Va.) has introduced an Administration-supported bill (H.R. 4694) which attempts to clean up the flaws in carryover without repealing it entirely.

CARRYOVER BASIS TAX

Prior to 1976, the capital gains tax on inherited property was assessed against the appreciation from the date inherited to the date disposed of. The Tax Reform Act of 1976 increased the

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tax liability by broadening the basis to include not only the appreciation accrued during the inheritor's ownership but also the gains made during the decedent's possession.

The 1976 action exempted estates of $60,000 or less from the carryover tax. It also permitted an executor to exempt $10,000 of household or personal effects from the capital gains tax. Life insurance policies were specifically excluded from the estate.

The Act established December 31, 1976 as the fresh start date. The original value for all property inherited would be, for carryover purposes, its value on December 31, 1976. Thus property inherited in 1979 and disposed of in 1981 would be subjected to a tax on the capital gains incurred from January 1, 1977 to the date of disposition.

Congress, through the Revenue Act of 1978, revealed its misgivings about the 1976 legislation by postponing the application of carryover until January 1, 1980. It was observed that time was needed to review the viability of the law.

EQUITY

The major argument advanced in favor of carryover was the disparate treatment of assets disposed of before death and those passed on intact. The tax burden on the latter was, in many cases, significantly less. Proponents of carryover believed that the more generous treatment of assets retained until death was inequitable. For example, an asset of $100 held until death will result, without carryover, in a net bequest of $50. (Table 1) If sold before death, the net bequest, after both capital gains and estate tax, will be only $36. The 14 percent effective tax difference, according to carryover advocates, is unjustified.

Table 1
Net Bequests

	Sale before death	Asset retained until death
Amount of gain or appreciation...	$ 100	$ 100
Capital gains tax................	28	0
Amount included in gross estate................	72	100
Estate tax.......................	36	50
Net amount to beneficiary..	$ 36	$ 50

Source: Joint Committee on Taxation

The demand for equal treatment is based on the presumption that retention of an asset is solely an attempt to avoid taxes. This view fails to account for the possibility that investors have different assessments of risks and returns. For example, an investor, aware of the tax consequences, chooses to sell an asset and reinvest the proceeds in a presumably more lucrative venture. Another investor, faced with the identical circumstances, may forego the sale and instead, because of a more cautious outlook, retain the asset. If the seller's judgement is correct, he will leave his heirs a larger bequest than the more cautious investor. If incorrect, the bequest will be smaller. Carryover penalizes the cautious and correct investor by equating his tax burden with the unsuccessful seller's.

Furthermore, even acceptance of the desirability for a strict tax equality between sales before death and the retention of assets does not necessarily lead to an acceptance of carryover. There are two means of achieving equality, either tax inherited property at a higher rate or reduce the combined capital gains and estate tax burden on sales before death. The latter may be more equitable choice.

The use of carryover to achieve equity was based solely on the relative burden of private taxpayers. Notably absent was the consideration of equity between the taxpayer and the federal government. The inflation of the 1970s, in combination with the unindexed tax system, has distorted both income and capital gains taxes. Assets which have increased in value at a pace slower than inflation have declined in real value. The failure of both Standard and Poor's and the New York Stock Exchange indexes to keep up with inflation (Table 2) suggests that this is a common phenomenon. The capital gains tax exacerbates this loss by taxing the inadequate inflation adjustment. Certainly the inequity of this situation merits consideration.

Table 2
Inflation and Stock Values
(1970=100)

	1971	1972	1973	1974	1975	1976	1977	1978
Consumer Price Index	104.29	107.73	114.44	126.99	138.23	146.60	156.06	168.01
N.Y. Stock Exchange	118.59	131.86	125.59	95.88	100.02	119.09	117.38	117.58
Standard & Poor's Corp.	118.10	131.21	129.09	99.55	102.34	122.57	117.97	115.48

The Fisher bill proposes that the carryover exemption be increased from $60,000 to $175,000. It is estimated that this will free 97 percent of estates from the carryover tax. However, this exemption is an abandonment of the equity sought in 1976. Unless the estate is among the highest three percent, the discrepancy between a sale before death and an asset retained until

death will continue to exist. A law ostensibly passed as an equity measure would become, if the Fisher proposal is accepted, merely a punitive tax on wealth.

LOCK-IN

It was argued that the pre-carryover, or step-up, treatment created a "lock-in" effect. Owners of property faced with the prospect of a substantial capital gains tax upon sale chose instead to retain the asset. The heirs upon disposition would receive the appreciation achieved during the decedent's possession but only pay taxes on the gains achieved during their possession.

Rather than alleviating the "lock-in" effect, carryover has extended it along inter-generational lines. As an asset increases in value the threat of a large capital gains tax makes disposition increasingly difficult. Although other investments may offer higher returns, the smaller principle available for investment after the capital gains tax discourages the shift in investment.

The "lock-in" effect impedes the most efficient allocation of resources. In a market economy the return on assets serves to direct capital. An enterprise or endeavor with greater efficiency or potential will be able to secure resources by offering a higher return. The "lock-in" effect, by focusing the asset holder's attention on the absolute dollar return rather than on alternative rates of return, drives a wedge between market signals and investors' response.

The aggregate economic effects of carryover have been estimated by economist Norman B. Ture. He found that carryover could reduce 1980 employment by 40,000 jobs, lower G.N.P. by $5 billion, and cut consumption by $2 billion. Acceptance of carryover and its economic effects is at odds with the recent concern with capital investment and economic performance.

Table 3
Economic and Tax Revenue Effects of Implementing Carryover Basis
(As amended by the Tax Reduction Act of 1978)

Increase or Decrease (-) in:	1980	1982	1984	1989
	(Dollar Amounts in Constant 1977 Dollars)			
Employment (thousands of full-time equivalent employees)	(40)	(50)	(60)	(100)
Annual Wage Rate	$(30)	(40)	(50)	(80)
Gross National Product (billions)				
Total	$(5)	(7)	(10)	(17)
Business sector	$(4)	(6)	(7)	(13)

Gross Private Domestic Investment (billions)				
Total	$(3)	(6)	(10)	(8)
Nonresidential	$(2)	(5)	(9	(6)
Consumption (billions)	$(2)	(1)	(0)	(10)
Federal Tax Revenues (billions)				
Net of feedback	$(1)	(1)	(1)	(1)
Initial Impact	$ 0	0	0	1

Note: The figures are the differences between the estimated amount of the respective economic magnitudes under the tax change and under present law in each year.

Amounts shown in parentheses are decreases from present law in that year, not from the preceding year under the tax change.

Source: Norman B. Ture, Inc.

Repeal of carryover and the return to the step-up treatment would greatly weaken the "lock-in" effect. The Fisher bill, although exempting all but the largest estates, would still subject a sizable amount of assets to "lock-in." Furthermore, because the bill does not index the estate exemption for inflation, the number of estates subject to carryover will continually increase.

ADMINISTRATION

It is possible to find carryover theoretically appealing yet reject any attempt to implement it as impossible. During the brief period it was in effect, tax practitioners found the carryover basis difficult to calculate, extremely complex, and costly to administer.

A critical impediment to carryover is the often arduous and time consuming task of proving the basis for each asset. Although a fresh start, as of January 1, 1977 was established, it is necessary to determine the original value in order to prorate the appreciation over the lifetime of the asset. Stocks and bonds are an exception since their value on January 1, 1977, in most cases, can be easily obtained. For many estates, however, records do not exist for a great number of the assets subject to carryover. In addition most people lack the tax sophistication to correctly and economically maintain the necessary records.

The complexity of the carryover provision is illustrated by the numerous and varied bases for each asset. To prevent the combined federal and state taxes from exceeding the total appreciation, the carryover basis of each asset is adjusted for federal and state death taxes. Since the appreciation subject to state

tax is not necessarily the same as the federal, there will be several bases. The difficulty of calculating the proper basis is heightened by the adjustment for personal and household exemptions and the determination of the minimum basis.

Carryover has significantly raised the cost of administering estates. Citibank, for instance, has estimated that carryover causes a 20 to 30 percent increase in the time required to administer estates. (Table 4) The expense falls disproportionately upon the smaller estates. In a sense, costs mandated by the law are a form of the tax. The incidence of costs makes the carryover regressive. Furthermore, the ability to deduct the progressive estate tax from the basis results in a regressive tax. Smaller estates with smaller death taxes will pay proportionately more in carryover basis.

Table 4

Percentage Increase in Time Required to Administer Estates Due to Carryover

Bank	Percentage
Chemical Bank	15
Citibank	20-30
Iowa-Des Moines Bank	5-20
Riggs National Bank	20-30
Security Trust Company	20

Source: American Bankers Association

The difficulty of estimating carryover is exacerbated by the tentativeness of the tax. Since the carryover tax is a residue of the federal and state death taxes, the lengthy resolution of these taxes, often a matter of years, will impede the carryover calculation. The uncertainty of the appropriate tax is compounded by the lack of a final ruling on the correct basis. The Internal Revenue Service does not possess a deadline for challenging the calculated payment.

The Fisher bill attempts to simplify the fresh start determination of difficult assets by discounting the estate tax value back to December 31, 1976 at a 6 percent interest rate. This approach has the virtue of simplicity, but unfortunately lacks equity. There is no reason to believe that all assets have increased at a yearly rate of 6 percent. Assets increasing at a slower rate, or which have not increased in value since 1976, will be overtaxed.

The cleanup proposal does avoid the problem of the multiple bases by consolidating the death tax adjustment into a single computation. It also reduces the uncertainty of the correct carryover tax by permitting the executor to request an IRS audit. Should the IRS fail to audit, the executor's determinations will be binding.

FIDUCIARY RESPONSIBILITIES

Carryover creates some perplexing problems regarding fiduciary responsibility. Under carryover an executor must consider not only an asset's yield and growth potential but also its basis. The basis could be a factor not only in deciding which assets to dispose of but also how to divide assets among beneficiaries. These considerations apply to estate planning as well. The Fisher bill increases the executor's discretion and further exposes estate administrators to suits filed by disgruntled heirs.

AGRICULTURE

The carryover tax places a particularly onerous burden on the farm community. Farms experience roughly three times the liquidity problems of other estates. In addition, farm land values have increased at a rate substantially exceeding the general inflation rate, yet bearing little relation to the real return on farming. Estate taxes may force the sale of certain assets which will then have a mushroom effect, forcing the sale of more assets.

Unlike stock or bond portfolios, which are highly divisible, a farm and its equipment are not. A minimum investment is required before economic activity becomes profitable. Sale of certain assets may very well reduce the efficiency and profitability of the entire farm.

Carryover also creates severe proof of basis problems for farmers. The ordinary difficulty of determing basis is multiplied several fold when dealing with physical plant improvements or livestock. Each animal, for instance, must have its own basis.

CONCLUSION

The Carryover Basis Tax hinders economic performance and imposes a significant burden on smaller estates. The Fisher amendment, while correcting some technical deficiencies, fails to address the critical flaws of carryover. The regressive impact on the growing number of eligible estates, the bias against the family farm, and the impediment to capital allocation loom as problems far greater than the inequality which motivated the creation of carryover.

Eugene J. McAllister
Walker Fellow in Economics