CARRYOVER BASIS
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GENERAL MATTERS

The topic of carryover basis includes a few items not directly related to present law. I am thinking of the congressional activity that has received widespread attention in the newspapers. As you all know, there is considerable unhappiness among members of the practicing bar, bankers, and various members of Congress with the carryover basis provisions as they were enacted by the Tax Reform Act of 1976. Many believe that the law is going to be repealed. There was, in fact, recent action taken by the Senate Finance Committee which would affect some of the aspects of the law with which this lecture will deal. But, it is simply not wise to think that these laws are going to be repealed. It is a possibility, but it is a very remote one.

Early in March of this year, I discussed the legislative situation with a staff member of the Senate Finance Committee who is knowledgeable about the various bills. He has participated in the discussions with congressmen and senators who are influential in these matters. I learned from my discussion with him that, at least philosophically, he favors repeal. He did admit, though, that the chances of repeal under the present circumstances are quite slim. He placed the blame, or the credit, on Representative Ullman, the Chairman of the House Ways and Means Committee. According to this person, Chairman Ullman is absolutely opposed to repeal or delay of the law. He further told me that, according to Chairman Ullman, the increases in the marital deduction and the exemptions provided by the Tax Reform Act of 1976 were in exchange for the carryover basis rules, the rules are very important to Chairman Ullman and he is going to stand in the way of anything that would delay or repeal them.

The Technical Corrections Act was recently reported out of the Senate Finance Committee. This act would not repeal the law; it is rather a fix-up and delay measure. It simply is not realistic to believe that carryover basis is going to go away. It is the law and we have to work and plan with it.

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Perhaps at this point we should reflect for a moment on some of the reasons the carryover basis provisions were enacted. The basic reason, of course, was that too much gain was escaping taxation. According to one estimate in the year 1967 alone, the loss of revenue was in excess of sixteen billion dollars because of the provisions of prior law which permitted the step-up in basis. Several types of reform were considered. One would have imposed a capital gains tax at death. Another provided for a special surtax on unrealized gains at death. Both of those were rejected, principally, it seems, because of the liquidity problems that would have resulted. Thus, the carryover basis law was adopted.

This lecture will attempt briefly to review the basic carryover basis rules, and then examine some special problems the rules create by going through an example or two of the application of the rules, and considering certain planning and drafting problems. Finally, I will sum up the proposed legislative changes.

THE CARRYOVER BASIS RULE

The general provision, the carryover rule, is contained in the Internal Revenue Code section 1023. The rule provides that the basis of carryover basis property passed or acquired from a person dying after December 31, 1976 is the decedent's adjusted basis in the property immediately before death with certain adjustments.

Most property acquired from a decedent is carryover basis property with several exceptions. The first category of exceptions is $10,000 of personal and household effects, if the election under section 1023(b)(3) is made. Income in respect of a decedent is also excluded from the definition of carryover basis property. Life insurance is another major asset that is excluded from the definition of carryover basis property. There are five other categories of property which are excluded.

THE CARRYOVER BASIS ADJUSTMENTS

The basic rule is actually very simple. However, it gets more complex when we begin to consider the adjustments to basis. There are four adjustments which may be made to a carryover basis. The adjustments must be made in this order: (1) the fresh start adjustment; (2) the adjustment for federal and state estate taxes; (3) the $60,000 minimum basis adjustment; and (4) the
adjustment for state inheritance taxes paid by a transferee. These adjustments are to be made separately for each asset.

As I mentioned earlier, special treatment is afforded certain personal and household effects. The rule is that up to $10,000 of personal and household effects can be excluded from the carryover basis rules and, thus, a step-up in basis is achieved. In order to do this, the personal representative must make an election to exclude the property not later than the due date of the return including extensions. Regulations explaining how to make the election are expected, but as of now they are not available. Perhaps a letter or some other statement setting forth the executor's election under this section could be filed with the return.

The Fresh Start Adjustment

The adjustment, that for the next few years is going to be the most important, is: the fresh start adjustment.

If the fair market value of a carryover basis asset on December 31, 1976 was higher than its adjusted basis, the basis will be stepped-up to its December 31, 1976 value. However, there is no reason to have property appraised as of December 31, 1976, because actual value on that date, except for certain securities, is really immaterial. The fresh start adjustment is only available for purposes of determining gains, not losses, and there is some confusion as to whether it can increase basis over estate tax value.

The first major category of property to be discussed in relation to the fresh start adjustment is marketable securities. The December 31, 1976 value of securities for which a market quote was available, is the fresh start basis. The congressional history (noted in the appendix) relating to this bill and the temporary regulations explain how to determine whether certain property is eligible for treatment as a marketable security. Basically, stocks traded on national exchanges and local exchanges are marketable securities; bonds are also eligible for the adjustment under this category. When making this adjustment, securities are valued in the usual way; the mean of high and low and the other adjustments that are usually made for estate tax evaluation purposes are employed. In certain circumstances, there is some confusion as to the measurement of gain or loss, as the examples in the appendix indicate.

For carryover basis assets other than marketable securities, this adjustment becomes a little more complicated. For such
assets it would be impractical to determine the precise amount of appreciation which occurred prior to January 1, 1977, by using the actual value on December 31, 1976. For example, as an administrative problem, it would simply be impossible in the 1980’s and the 1990’s and later years to try to look back and determine exactly what a particular asset was worth on December 31, 1976. Hence, actual value on that date is immaterial.

Instead, we use a statutory formula which assumes that appreciation occurred at an even rate during the decedent’s holding period, and by this method we arrive at an assumed value as of December 31, 1976, and this is the fresh start basis. The basic formula and an example are set out in the appendix at 736. It is a four-step formula for this type of property. The first step is to determine the amount of unrealized appreciation. This is done by subtracting the decedent’s adjusted basis from the fair market value at the date of death. The second step relates to the time period involved. The “applicable fraction” must be determined. To do this, the number of days in the holding period prior to January 1, 1977, is divided by the total number of days in the holding period. This gives the applicable fraction. The third step gives the adjustment to basis. The result from step one is multiplied by the result from step two to determine that portion of the appreciation which is deemed to have occurred prior to January 1, 1977. The fourth step is to add the result from step three to the adjusted basis immediately before death and the sum is the fresh start basis.

An example of the above formula will clarify the procedure. Assume a decedent acquired a carryover basis asset on December 31, 1975, at a cost of $10,000 and died on December 31, 1978, at which time the fair market value of the asset was $20,000. Then follow the four steps outlined above. The first step determines the amount of unrealized appreciation by subtracting the decedent’s adjusted basis from the fair market value at date of death. We get $10,000 at this step. Then, to determine the applicable fraction, divide 365 by 1095 to get .33. Multiplying the applicable fraction by the amount of unrealized appreciation, we arrive at $3,333. The next step is to add that figure to the decedent’s adjusted basis, arriving at a fresh start basis of $13,333.

However, the appropriate formula and applicable steps are different if the basis of the property has been subject to certain deductions such as those for depreciation and amortization. The appropriate formula is set out in the appendix at 737 and basically attempts to restore depreciation and so forth, which was
taken prior to January 1, 1977. This gives a more accurate value for the fresh start basis. The above discussion pertains only to the fresh start basis adjustment for property other than marketable securities. Further rules relative only to this fresh start adjustment should be pointed out. In determining the holding period, the general rules of section 1223 of the Internal Revenue Code apply, except that the period will always end on the date of the decedent's death. Special valuations under section 2032(A) will have a direct effect on the fresh start formula. If property is valued under that section to thereby achieve a lower value, then the value pursuant to that section (i.e., the lower value rather than the fair market value) must be used for purposes of this formula. However, if the alternate valuation date is used, that does not affect the adjustment. The date of death values are used for purposes of the formula even though the alternate valuation may have been elected. There are several other rules regarding carryover basis contained in the appendix.

**The Estate Tax Adjustment**

The second major adjustment is the estate tax adjustment. Regarding this adjustment, there are a few basic points to remember. This adjustment is only made after the fresh start adjustment. The basis under this adjustment cannot be greater than the estate tax value. This adjustment is applicable in determining both gains and losses. The effect of the estate tax adjustment is to add to the basis the amount of estate taxes attracted by post-1976 appreciation of a carryover basis asset. The formula for determining the amount of this adjustment provides that the net appreciation in the value of the property is divided by the fair market value of all property subject to tax. Then, this figure is multiplied by federal and state estate taxes to give the adjustment. However, the effects of a possible deduction should be kept in mind. No adjustment for estate taxes is allowable for an asset with respect to which a marital or charitable deduction was allowed. The adjustment is available for property which passes tax free by reason of the orphan's deduction.

**The Minimum Basis Adjustment**

The third major adjustment is the so-called minimum basis adjustment. The rule, with respect to the minimum basis adjustment, is that after the adjustments for fresh start and for estate taxes are made a further adjustment is available if the total basis of all carryover basis assets is less than $60,000. The aggre-
gate bases of all carryover basis property may be increased to $60,000, but the value of any particular asset may not be increased above estate tax value. This is an important adjustment because it has wide application. Furthermore, if Senator Hathaway's bill becomes law, the amount of the adjustment may be increased to $175,000 and considerably broaden its application. Apportionment is required with respect to this adjustment. The increase up to $60,000 is apportioned among all the appreciated carryover basis assets. Each asset receives a share of the increase proportionate to its net appreciation as compared to the net appreciation of all carryover basis assets. An example of this adjustment can be found in the appendix at 740.

The State Inheritance Tax Adjustment

The fourth adjustment provided in section 1023 is the state inheritance tax adjustment. After the other three adjustments, this further adjustment is available by reason of inheritance taxes attributable to the tax attracted by the net appreciation in that asset. This adjustment can be made if such taxes were actually paid by the transferee of the carryover basis asset and if the estate is not liable for the tax. The appendix at 741 sets out the formula to determine the amount of this adjustment.

There is some confusion which arises under the estate tax adjustment provision. With respect to this adjustment, if under state law or under the governing instrument the estate has an obligation to pay tax, the beneficiary or transferee may not be entitled to the adjustment under this section, even though he in fact pays the tax. Hopefully, one of the effects of the several bills that are working through Congress would be to clarify this situation so that, one way or the other, the adjustment is always available. Later in this lecture I will comment more on the provisions of the pending law and its effect upon this adjustment.

SPECIAL PROBLEMS

Now that we have the fundamentals of section 1023, we will consider a number of special problems.

UNKNOWN BASIS

The first problem I will deal with is that of the "unknown basis." While there was some provision in the Tax Reform Act of 1976 for this situation, it is not all that helpful. The Act says that when basis is unknown, the basis shall be deemed to be the fair market value as of the date, or approximate date, at which
the property was acquired by the decedent or by the last pre-
ceeding owner in whose hands it did not have a basis deter-
mined by reference to its basis in the hands of a prior holder.

**INDEBTEDNESS**

Special treatment is provided with respect to indebtedness. For purposes of these adjustments, except the fresh start ad-
justment, the value of property is diminished by the indebted-
ness if three conditions are met: first, the property is subject to
the debt; second, the debt is not an estate obligation; and finally,
the property is included in the gross estate undiminished by the
debt.

**INFORMATION RETURNS**

The next "special problem" is of great importance and is
going to be of fairly immediate concern to practitioners. A re-
cent enactment to the Code, section 6039(a), provides for carry-
over basis information returns which must be filed with the
Internal Revenue Service (IRS) and provided to each benefi-
ciary. While this return requirement may create the greatest
number of administrative problems and headaches under the
new law, these returns, though burdensome, are necessary in
order to permit the administration of the carryover basis laws.
The new section provides penalties in the amount of fifty dollars
per failure with a $2,500 maximum for failure to provide infor-
mation returns to beneficiaries. The amounts are $100 per fail-
ure with a $5,000 maximum for failure to provide the returns to
the IRS. The return requirements are not limited to those es-
tates which must file estate tax returns, and, indeed, they are
not even limited to estates. For example, in a somewhat typical
family situation where most of the property is in joint tenancy,
and there is no formal estate administration following the death
of the first spouse to die, there would still be an obligation to
furnish the information returns.

The time at which the obligation begins is of some interest.
You are probably aware of the IRS news release dated October
4, 1977, in which the Service announced that temporary regu-
lations under section 6039(a) will be issued shortly. It has now
been over four months and it is still not known when the regu-
lations are going to be available. Early in March of this year I
discussed the situation with one of the individuals in the Treas-
ury who was working on the regulations. He had no certain date
by which he could predict that they would be available.
However, in spite of the fact that the regulations may not be published in the near future, I would like to consider the contents of the news release. The release stated that the regulations, when they are published, will provide that the deadline for furnishing specific information on carryover basis property to distributees will be no earlier than six months after the due date of the federal estate tax return, including any extensions, if a return is required to be filed. If no return is required, the deadline will be no earlier than fifteen months after the date of a decedent's death. However, the news release stated that the deadline for furnishing the information to the IRS and to the distributees will not be earlier than six months after the date the temporary regulations are issued. If the regulations appeared tomorrow, you would still have six months after tomorrow before the obligations arose to provide the information to the IRS and to the beneficiaries. Moreover, there may be some changes in Congress which would limit the scope of the obligation in terms of the time period.

Indeed, these information returns are going to be somewhat troublesome. It is going to be important for each of you to develop a system whereby you can produce these returns, and get them out timely to the IRS and to the beneficiaries. Furthermore, in your planning and ordinary work with your clients, it will be important to work with their accountants to encourage them to maintain records that will permit you to fulfill your obligations with respect to these returns.

PECUNIARY BEQUESTS

Another special problem which may arise relates to pecuniary bequests. Under the carryover basis rules, there could be significant exposure to tax in satisfying a pecuniary bequest. If section 1023 alone applied and low basis property were used to satisfy a pecuniary bequest, an estate could be subject to fairly burdensome income tax obligations. As a part of the carryover basis rules, section 1040 was enacted. This requires that only the gain in excess of the estate tax value be recognized if carryover basis property is used to satisfy the pecuniary bequest.

GIFT TAX ADJUSTMENTS

There are also gift tax adjustments. Under the new rules, a donee's basis is equal to his donor's basis plus federal and state gift taxes attributable to the net appreciation in the donated
property. The formula for determining the amount of this adjustment can be found in the appendix at 743.

**Asset by Asset Adjustment**

As I mentioned earlier, it is important to remember that the adjustments must be made on an asset by asset basis. For example, groups of stock of a single company, if acquired at different times, must be segregated and each group separately adjusted to arrive at the appropriate adjustments to the carryover basis. It is also possible that each item of a coin collection may have to be valued separately in order to achieve a proper adjustment, but, hopefully, there will be some regulatory relief from that kind of obligation.

**Audit Adjustments and Income Tax Return Problems**

The carryover basis rules will also affect things other than the planning and the ordinary matters that occur in the administration of an estate. Whenever there is an audit adjustment which affects carryover basis property, if an income tax return has been filed by the estate or by a beneficiary reflecting a gain or loss on carryover basis assets, those returns will have to be amended. It will be important in those circumstances to get information to the beneficiaries about adjustments, about the effects of the adjustments, and to assist and encourage them in amending their returns. On the planning side, in view of some real time problems, it will be important to consider statutes of limitations. As they become short, it might be a good practice to file protective claims because the audit adjustments will cause basis adjustments and will have income tax consequences to the estate and its beneficiaries.

**Short Term Gains on Executor Sales and Flower Bonds**

Short term gains on sales by executors may result. Under the law as it is now in effect, sales of property received from a decedent are no longer automatically granted long term status. In addition, because of the carryover basis rule, the use of flower bonds may be considerably less attractive and, when coupled with the short term gain trap for sales by executors, could create a difficult situation. Therefore, the carryover basis rules should serve notice that our tax practices have to be reexamined and possibly, some of them discarded.
BUY-SELL AGREEMENTS

I think it would be good to take a few minutes and reflect on certain areas where the reconsideration of planning techniques may be necessary. One of the most immediate areas concerns buy-sell agreements. Historically, one of the reasons buy-sell agreements have been so useful is because prior law provided a step-up in basis. It is essential, particularly as we move further away from the fresh start date, that these buy-sell agreements be reviewed with the additional capital gains taxes in mind. The use of installment payouts pursuant to section 453 for buy-sell agreements may be very important. In proper circumstances, such as a family situation, it may even be desirable to give the buyer an option to pay less than thirty percent in the year of sale. Now, more than ever, the purchase price under buy-sell agreements should be as low as can be justified. Remember that it must be only as low as can be justified, because an unreasonably low purchase price will be subject to attack by the Service.

The concept of cross-purchase buy-sell agreements, as opposed to entity purchase buy-sell agreements, necessitates some consideration. Cross-purchase plans are plans under which the commitments to purchase are made by the shareholders rather than the corporation or by the partners individually rather than the partnership. These may be better than entity plans because the acquisitions under cross-purchase plans will generally permit the purchasers to pick up additional basis in their stock. Thus the capital gains taxes to which they or their estate will eventually be subject will be relatively less. Hence, because of the new carryover basis rules entity purchase plans may generally be less attractive.

EFFECTS ON SECTION 303, SECTION 306, PERSONAL HOLDING COMPANIES, AND AGING OF ASSETS

In view of the amendments to section 303 and section 306 which were affected by the Tax Reform Act of 1976, all agreements which relate to closely held business need to be reviewed. As a result of the carryover basis rules, the technique of sheltering gain on sale of a business by use of a personal holding company will not generally be as attractive as it was under the old law. A new concept termed “aging of assets” has already been evolved out of the carryover basis rules. I refer to this concept in the appendix at 746 as an “untested loop hole” and I
think that is a fairly accurate way to describe it. The idea has occurred to some practitioners that one could take highly appreciated assets which had a relatively short holding period and contribute those assets under some tax free arrangement to an old existing corporation, which happened to have a long holding period associated with it. It is thought that if one did this, more of the unrealized gain in the newer property would be sheltered from the effects of the carryover basis rules. One could then take the position that the basis should be determined with reference to the old corporation, yielding a considerably longer period of time against which to measure the amount of the fresh start adjustment. There is simply no way to determine whether this is a useful vehicle.

Sale "In Contemplation of Death"

Another new notion that has developed in response to the carryover basis rules is the idea of a sale in contemplation of death. If an asset has a large amount of unrealized appreciation, and if no large adjustments to basis will be obtained by holding it until death, it might be advantageous to sell it just before death. This could result in total tax savings because the money which is used to pay the capital gains taxes will not be taxed for estate tax purposes.

However, there are four areas of caution to note with respect to sales in contemplation of death. First, a lifetime disposition eliminates any fresh start adjustment. Second, postmortem dispositions have the advantage of including in basis the death taxes attributable to the net appreciation in property. Third, before consumating such a sale, it is absolutely essential that the tax consequences under both alternatives, the sale in contemplation of death or holding property for postmortem disposition, be carefully calculated. Finally, the Technical Corrections Act of 1977 may reduce some of the benefits of these sales.

Gifts and Distribution

Gift planning has also been somewhat affected by the carryover basis rules. There are some general items you should keep in mind when planning gifts. It is usually more advisable to give away assets acquired after December 31, 1976, since those assets will not be eligible for the fresh start adjustment. When giving away assets held on or before December 31, 1976, a donor should prefer to give away those assets which are the most
recently acquired, have the largest amount of unrealized depreciation, and as has always been the case with respect to gifts, those which can be expected to appreciate the most in the future. It is still better in most circumstances to use highly appreciated assets when giving to charity. You should note another concept which has developed, known as "selective distribution". When you are distributing carryover basis property to an estate's distributees, it carries with it with some very definite tax liabilities which must be kept in mind.

**RECORD KEEPING**

Another consideration relates to the records that need to be maintained by lawyers, clients, accountants, and anyone else who has responsibility regarding these matters. It is absolutely essential, in order to do a competent job for your clients, to encourage the maintenance of good records.

**LEGISLATIVE PROPOSALS**

As I mentioned earlier, there are quite a number of legislative proposals which affect the carryover basis rules. The proposals fall into three basic categories. The first is the so-called fix-up legislation which would resolve a number of questions and problems which arise under the carryover basis rules. The second major area of legislation would delay implementation of some of the new rules. Finally, there are proposals which would repeal the rules.

**Fix-up Legislation**

The major fix-up legislation is the Technical Corrections Act of 1977. Some of the provisions of this Act pertain to the use of installment sales by making certain adjustments in the way the deduction for income in respect of a decedent is computed. Some of the advantages of installment sales in contemplation of death would be diminished. Provision would also be made for a fresh start adjustment to basis for tangible personal property by use of a specific formula to determine that portion of the appreciation deemed to have occurred prior to January 1, 1977.

Other fix-up legislation would increase the exemptions for household and personal effects from $10,000 to $25,000. Another feature of some of the fix-up legislation would allow the fresh start adjustment for purposes of determining loss as well as gain. Senator Hathaway's bill would increase the minimum
basis adjustment to $175,000. This provision would have a consider- 

able impact.

**Delay Legislation**

The general effect of the delay legislation would be that the carryover basis rules would not become effective until 1980. However, should that bill become law (which is questionable) it would leave unanswered questions. Even if the delay becomes law, carryover basis is still going to affect our planning and it is going to affect our recordkeeping obligations. We simply cannot forget about carryover basis in the hope that it might die in a couple of years.

**Repeal Legislation**

The third area of legislation, as I mentioned, deals with the repeal provisions. We have one bill introduced by our own Senator Curtis and there are a number of other repeal bills. The legislative prospects for these bills are very dim. Not one of the repeal bills has made any progress to this date.

**Conclusion**

I refer you to the determination of the adjusted carryover basis in the appendix. It is really not as complicated as it might appear and it would be useful to try and work an example or two to get an understanding of how it is going to be done. Many of us have seen services that are provided by accounting firms and insurance groups. These are very valuable in terms of giving information to lawyers and their clients about carryover basis. Nonetheless, we must know the rules and familiarize ourselves with the way in which these adjustments are made.
APPENDIX

I. INTRODUCTION

A. Preliminary Considerations—For many years prior to the Tax Reform Act of 1976, the “step-up” in basis at death provided by section 1014 was severely criticized, principally because tremendous amounts of unrealized gains escaped income taxation. One study estimated the revenue loss for the year 1967 alone at $16,500,000,000.

B. Reform Proposals—Three basic types of reforms were proposed: (1) a capital gains tax at death; (2) a special surtax at death on a decedent’s unrealized gains; and (3) the carryover of basis. Largely because the first two proposals would have created tremendous liquidity problems, the carryover provisions were adopted.

C. Theme of TRA ’76—The carryover basis provisions are consistent with one of the basic themes of the Tax Reform Act of 1976, i.e., affording similar treatment to lifetime transfers and transfers at death. The concept of carryover basis had existed for many years under the gift tax law and it is now applicable to transfers at death.

D. Our Discussion—The carryover basis concept for gifts has been with us for quite some time; the fundamentals of carryover basis as it relates to estate planning have been with us now for well over a year. Hence, we will spend only a small part of our time reviewing the fundamentals. We shall devote most of our time to the discussion of special problems the new rules create. We will review some examples of the application of the rules. Then we will consider various planning and drafting problems under the new law and, finally, we will summarize the present legislative activity with respect to carryover basis.

II. GENERAL CARRYOVER BASIS PROVISIONS

A. The Carryover Rule (section 1023)—The basis of “carryover basis property” passing or acquired from a person dying after December 31, 1976 is the decedent’s adjusted basis in the property immediately before death, with certain adjustments as detailed later.

B. Carryover Basis Property—Any property acquired or passing from a decedent under section 1014(b), which includes almost all property passing from a decedent. This includes not only property received by bequest, devise, or inheritance, but also property passing through a revocable trust or received as a result of a general power of appointment (and also the survivor’s share of community property). The following types of property are not carryover basis property (section 1023(b)(2) & (3)): 
(1) $10,000 of a decedent's personal or household property, if the personal representative makes the election available under section 1023(b)(3) (this election will be discussed in more detail below);

(2) section 691 income (income in respect of a decedent);

(3) life insurance proceeds;

(4) joint and survivor annuities, if payments to the surviving annuitant are taxable under section 72;

(5) payments under a deferred compensation plan to the extent they are taxable to the recipient for income tax purposes;

(6) property included in the gross estate by reason of sections 2035 (transfers within three years of death), 2038 (revocable transfers), or 2041 (powers of appointment), but only if that property was disposed of before death in a transaction in which gain or loss was recognizable (e.g., stock was given within three years of death and the donee sold it);

(7) stock or a stock option to the extent income in respect thereto is includible in gross income; and

(8) stock of certain foreign personal holding companies.

C. Adjustments to Basis—There are four adjustments which may be made with respect to each item of carryover basis property. Each of these adjustments, which will be discussed in considerable detail later, must be made in the following order:

(1) the "fresh start" adjustment;

(2) the adjustment for federal and state estate taxes attributable to the appreciation in the property;

(3) the $60,000 minimum adjustment; and

(4) the adjustment for state inheritance taxes paid by the transferee.

III. PERSONAL AND HOUSEHOLD EFFECTS

A. Inclusion—Personal and household effects will generally be deemed carryover basis property.

B. Definition—The Joint Committee Report describes personal and household effects as including "clothing, furniture, sporting goods, jewelry, stamp and coin collections, silverware, china, crystal, cooking utensils, books, cars, televisions, radios, stereo equipment, et cetera."

C. Election to Exclude—Up to $10,000 of personal and
household effects may be excluded from the carryover rules (so that a step-up in basis is achieved) if:

1. the property, in the hands of the decedent was a personal or household effect; and
2. the personal representative elects to have such property excluded by an election made not later than the due date, including extensions, of the federal estate tax return. (Regulations will be issued setting forth the manner in which the election is to be made);
3. the fair market value of all property to which the election applies cannot exceed $10,000. Thus, the personal representative may not select assets with an aggregate value in excess of $10,000 and apportion;
4. may a personal representative elect to exclude items such as paintings, diamonds, and antiques which typically appreciate in value? Probably not.

D. Property Not Excluded—For personal and household effects in excess of $10,000 (or for all such property if no timely election is made) a carryover basis is applicable for purposes of determining gains. The basis for loss purposes may not exceed the federal estate tax value.

IV. THE “FRESH START” ADJUSTMENT (section 1023(h))

A. Availability—If the fair market value of a carryover basis asset on December 31, 1976 was higher than the adjusted basis, the basis will be stepped up to its December 31, 1976 fair market value.

1. Gains and Losses—The “fresh start” is only available for purposes of determining gain, but not for loss purposes.
2. No “Step-Down”—If fair market value on December 31, 1976 was less than the decedent’s adjusted basis, there is no “step down” in basis, only a carryover.

B. Marketable Bonds and Securities

1. Statutory Definition (section 1023(h)(2)(E)(i) and Temporary Regulations, section 7.1023(h)-1(d))—The term “marketable bond or security” means any security for which, as of December 1976, there was a market on a stock exchange, in an over-the-counter market, or otherwise. This includes traded options, mutual funds, and units in a common trust fund. Marketable refers to a security traded on a stock exchange or traded locally for which quotations can be obtained from established brokerage firms. Mar-
ketability should be determined as of December 31, 1976 so that a company which "goes private" nonetheless has marketable securities. Conversely, a company which "goes public" after December 31, 1976 would not involve a marketable security and should not be considered marketable for purposes of fresh start since there are no public records on which to base a December 31, 1976 value.

(2) Valuation—Values for such securities as of December 31, 1976 are determined in accordance with the usual estate and gift tax methods of taking the mean between the highest and lowest quoted selling prices or, if there were no trades on December 31, 1976 but there were trades within a reasonable period both before and after that date, by taking the weighted average of the means for the nearest trade dates before and after December 31, 1976. The temporary regulations state that a "reasonable period" will generally be thirty days. The basis is to be reduced to reflect blockage.

(3) Ownership as of December 31, 1976—The adjusted basis of the security immediately before the decedent's death must "reflect" the adjusted basis as of December 31, 1976 and it must constitute part of his estate for estate tax purposes. However, it need not have been actually owned by the decedent on December 31, 1976. Property may "reflect" the adjusted basis on December 31, 1976, if it were received by gift or in a tax-free reorganization.

(4) One Fresh Start—A problem may exist in the case of successive estates as to whether the second estate also gets fresh start adjustment. The Technical Corrections Act would provide that there would be no increase in basis by reason of the fresh start rule if the adjusted basis of the decedent's property was a carryover basis with respect to a prior decedent.

(5) Gain Measurement—Some possible confusion exists as to how to measure gain in certain circumstances in order to determine whether the fresh start for marketable bonds and securities is applicable. Is gain measured by the amount realized over historical costs, over fair market value on December 31, 1976, over estate tax value, or over any of the above after additions to basis for fresh start and the other adjustments? Example:
Adjusted Basis Value on 12/31/76 | Adjusted Basis immediately prior to death | Amount realized | Is there gain?
--- | --- | --- | --- | ---
$100 | $200 | $100 | $210 | yes
100 | 200 | 100 | 90 | no
100 | 200 | 100 | 150 | ?

The answer appears to be that a partial fresh start adjustment occurs increasing basis to the amount realized and, thus, neither gain nor loss is recognized. This is the position taken by the temporary regulations. (Temporary Regulations Section 7.1023(h)-1(f), example (1)).

C. All Other Carryover Basis Assets

1) Theory—It would be most impractical to determine the precise amount of appreciation prior to January 1, 1977 on other assets by using actual value as of December 31, 1976. Therefore, actual value as of that date for these assets is immaterial and it is thus unnecessary to obtain appraisals for these purposes. Instead, a statutory formula, which assumes that appreciation occurred ratably during a decedent’s holding period, must be used to determine the step-up in basis to an assumed value as of December 31, 1976.

2) The Basic Formula—

Step 1—The Amount of Unrealized Appreciation
The decedent’s adjusted basis must be subtracted from the fair market value at date of death.

Step 2—The Applicable Fraction
The number of days in the holding period prior to January 1, 1977 must be divided by the total number of days in the holding period.

Step 3—Adjustment to Basis
The result from Step 1 must be multiplied by the result in Step 2 to determine that portion of the appreciation which is deemed to have occurred prior to January 1, 1977.

Step 4—The Fresh Start Basis
Add the result from Step 3 to the decedent’s adjusted basis to determine the fresh start basis.

Example: Assume a decedent acquired a carryover basis asset on December 31, 1975 at a cost of $10,000 and died on December 31, 1978, at which time the fair market value of the asset was $20,000.
CARRYOVER BASIS

Step 1 $20,000
   - 10,000
   $10,000—The Amount of Unrealized Appreciation

Step 2 $\frac{365}{1095} = .33$—The Applicable Fraction

Step 3 $10,000 \times .33 = 3,333$—The Adjustment to Basis

Step 4 $10,000 + 3,333$
   $13,333$—The Fresh Start Basis

(3) Adjustments by Reason of Depreciation, etc. (section 1023(h)2(B) — Special problems are presented when the decedent's basis has been adjusted for depreciation, amortization, or depletion because the calculations must take into account the amount of depreciation, etc. The actual appreciation in value which has occurred during the decedent's holding period is first determined and the applicable fraction of this is added to the decedent's adjusted basis. In addition, the depreciation taken for years prior to January 1, 1977 is restored. The result should be the same as the fresh start basis determined under paragraph 2 above, less depreciation taken after December 31, 1976.

Step 1—Add the total depreciation, etc. to the decedent's adjusted basis.

Step 2—Subtract the sum determined in Step 1 from the fair market value at the date of death to determine the actual appreciation.

Step 3—Multiply the result from Step 2 by the applicable fraction.

Step 4—Add to the result from Step 3 the actual adjustments to basis made for depreciation, etc., occurring before January 1, 1977.

Step 5—Add the decedent's adjusted basis to the amount obtained from Step 4 to arrive at the fresh start basis.

Example: Assume facts similar to the earlier example (Purchase for $10,000 on 12/31/75, fair market value of $20,000 on 12/31/78, the date of death) and also assume depreciation each year of $1,000.

Step 1 $3,000 (Total Depreciation)
   + 7,000 (Decedent's Adjusted Basis)
   $10,000
Step 2 $20,000 (Fair Market Value) – $10,000 (Result from Step 1)

Step 3 $10,000 x .33 = $3,333—Adjustment for Actual Appreciation

Step 4 $3,333 (Appreciation to 12/31/76) + 1,000 (Restoration of Depreciation) = $4,333—Adjustment to Decedent’s Adjusted Basis

Step 5 $7,000

$11,333—Fresh Start Basis

D. Other Rules Applicable to “All Other” Property

(1) Holding Period—The holding period for purposes of the applicable fraction is determined under the general rules of section 1223, except that the period ends on the date of decedent’s death. If any other person held the property immediately before death (such as a donee to whom it was transferred within three years of death), that person’s period of ownership is included in the holding period as long as the property is included in the estate for estate tax purposes.

(2) Special Valuation for “Qualified Real Property” (section 2032(A))—If an election is made to value qualified real property under section 2032(A), the valuation pursuant to that section rather than the fair market value must be used for purposes of these formulae.

(3) Alternate Valuation—Fair market value at the date of death, not on the alternate valuation date, must be used for these purposes.

(4) Substantial Improvements—A substantial improvement will be treated as a separate asset for purposes of the fresh start rule. The Treasury will issue regulations amplifying this situation.

(5) Recapture and Related Problems—The Joint Committee Report states that the Treasury will also issue regulations determining the application of the fresh start rule where the gain is subject to special rules taxing all or a portion of it as ordinary income (sections 306, 1245, and 1250, for example) and where the property is held by a trust or partnership in which the decedent was a beneficiary or a partner.
(6) Subsequent Depreciation—The fresh start basis with the adjustments discussed below will constitute the basis for depreciation after the decedent’s death.

V. ADJUSTMENT FOR ESTATE TAXES (Section 1023(c))

A. Preliminary Considerations—There are three items to remember as we review this adjustment:

1. It is made only after the fresh start adjustment;
2. The basis of an asset may not be greater than its value for federal estate tax purposes; and
3. This adjustment is applicable to the determination of both gains and losses.

B. Amount of Adjustment—The adjustment is equal to the amount of federal and state estate taxes attracted by the post-1976 appreciation of a carryover basis asset. “Net appreciation in value” is the fair market value less the carryover basis after the fresh start adjustment but before other adjustments.

C. Formula for Determining the Adjustment

\[
\text{Net Appreciation in Value of the Property} \times \frac{\text{Federal and State Estate Taxes}}{\text{Fair Market Value of All Property Subject to Tax}} = \text{The Adjustment}
\]

D. Marital and Charitable Deductions and the Orphans' Exclusion—No adjustment is allowable for an asset with respect to which a marital or charitable deduction was allowed. However, the adjustment is available for property which passes tax free by reason of the orphans' exclusion.

E. Definition of "Federal and State Estate Taxes"—These are defined as the taxes imposed by sections 2001 and 2101, reduced by the credits against such taxes, plus any estate, inheritance, legacy, or succession taxes for which the estate is liable and which are actually paid by the estate to any state or the District of Columbia.

VI. MINIMUM BASIS ADJUSTMENT (section 1023(d))

A. General—After the fresh start rule has been applied and an adjustment made for federal and state estate taxes on the appreciation, and if the total bases of all carryover basis property is less than $60,000, another increase in basis is allowed.
B. Amount of Increase—The aggregate bases of all carryover basis property may be increased to $60,000. However, the adjustment cannot increase the basis of any asset above its fair market value as of the date of death.

C. Property Subject to Increase—Only carryover basis property is used in determining the amount of the increase and its allocation. Thus, if the personal representative elects to exclude $10,000 of personal and household effects, that property is not included for purposes of this adjustment.

D. Special Rules—There are two special rules applicable to this adjustment.

(1) Personal or Household Effects—The basis of any personal or household effects shall not be treated as being greater than fair market value.

(2) Non-Resident Aliens—This adjustment does not apply to any property received from a non-resident alien decedent.

E. Apportionment of Increase—The increase is apportioned among all the appreciated carryover basis properties. Each asset receives a share of the increase proportionate to its net appreciation as compared to the net appreciation of all carryover basis assets.

F. Net Appreciation—Net appreciation for purposes of this adjustment is the difference between the fair market value and the basis as increased by the fresh start and estate tax adjustments.

Example: On July 1, 1974, the decedent purchased real estate for $30,000 and marketable securities for $5,000. The value of the securities on December 31, 1976 was $7,500. The decedent died July 1, 1978. At the time of his death, the fair market value of the real estate was $55,000 and of the securities was $10,000. His only other assets were personal and household effects which the executor elected to exclude. With the fresh start adjustment and assuming no taxes, the basis of the securities is adjusted to $7,500 and the basis of the real estate is adjusted to $39,411.

Step 1—Aggregate the Bases

\[\begin{align*}
39,411 \\
+ 7,500 \\
\hline
46,911
\end{align*}\]

Step 2—Determine the Excess

\[\begin{align*}
60,000 \\
- 46,911 \\
\hline
13,089
\end{align*}\]
Step 3—Allocate the Excess ($13,089)

1. Securities

\[
\text{Net securities appreciation} \times \$13,089 = \frac{10,000 - 7,500}{(10,000 - 7,500) + (55,000 - 39,411)} \times \$13,089 = \$1,808.97
\]

2. Real Estate

\[
\text{Net real estate appreciation} \times \$13,089 = \frac{55,000 - 39,411}{(10,000 - 7,500) + (55,000 - 39,411)} \times \$13,089 = \$11,280.03
\]

Step 4—The Carryover Basis

Securities \(7,500 + 1,808.97 = 9,308.97\)

Real Estate \(39,411 + 11,280.03 = 50,691.03\)

CARRYOVER BASIS

Securities \(\$9,308.97\)

Real Estate \(\$50,691.03\)

TOTAL CARRYOVER BASIS \(\$60,000.00\)

VII. STATE INHERITANCE TAX ADJUSTMENT (section 1023(e))

A. Applicability—If a transferee of a carryover basis asset actually pays state inheritance tax with respect to that asset and the estate is not liable for the tax, the basis of the asset may be increased by the amount of such tax attracted by the net appreciation in the asset.

B. Formula:

\[
\text{Net appreciation in value of the asset} \times \frac{\text{all inheritance taxes paid by such person}}{\text{Federal estate tax value of all property}} = \text{Amount of the Adjustment}
\]

(1) Net appreciation—The net appreciation in value is the amount by which the fair market value of the property exceeds the adjusted basis of the property immediately before the death of the decedent increased by the fresh start, estate taxes attributable to appreciation, and $60,000 minimum basis adjustments.

C. Definition of Inheritance Tax—These taxes include estate, inheritance, legacy, or succession taxes paid to any state or the District of Columbia.
D. Other Considerations—This adjustment is made only after the other three have been made, may not increase the basis above federal estate tax value, and is applicable in determining both gains and losses.

E. Relationship to the Other Tax Adjustment—Some clarification may be needed between this adjustment and other tax adjustment. For example, if state law provided that the transferee were liable for inheritance tax but the will directed the estate to pay the tax, no adjustment would be available under section 1023(c). Similarly, if under the will the estate is liable but the transferee pays the tax, it would appear that no adjustment is available under section 1023(e). Presumably an adjustment under one or the other should always be available.

VIII. SPECIAL PROBLEMS

A. Unknown Basis (section 1023(g)(3))—If the decedent's original basis cannot be determined, it shall be deemed to be the fair market value as of the date or approximate date at which the property was acquired by the decedent or by the last preceding owner in whose hands it did not have a basis determined in whole or in part by reference to its basis in the hands of a prior holder.

B. Indebtedness (section 1023(g)(4))—For purposes of these adjustments (except the fresh start adjustment), the value of property is diminished by the indebtedness with respect thereto if:

1. the property is subject to the debt;
2. the debt is not an estate obligation; and
3. the property is included in the gross estate undiminished by the debt.

C. Information Returns—The requirements regarding information about carryover bases which must be supplied to the IRS and beneficiaries will generate tremendous administrative problems for both taxpayers and the Service. The new section 6039(A) requires the executor to furnish adjusted basis information for carryover basis property to beneficiaries and also to furnish the Treasury with such information as the regulations shall prescribe. Penalties for failures to inform beneficiaries are provided in the amount of $50 per failure with a $2,500 maximum; penalties for failures to inform the Treasury are $100 per failure with a $5,000 maximum. The basis reporting requirements are not limited by statute to those estates in which a federal estate tax return is due or a personal representative is qualified. Unless regulations provide to the contrary, for example, a surviving spouse will have to file the basis report on assets received as joint property when there is no qualified personal representative and the estate is not large. Last October the IRS announced that it would shortly issue temporary regulations concerning information that the executor of an estate would be required to supply to the IRS and to distributees of carryover
basis property. The regulations will provide that the deadline for furnishing the information to distributees will be no later than six months after the due date of the federal estate tax return, including extension, if a return is to be filed. If no return is required, the deadline will be no earlier than fifteen months after the date of the decedent's death. However, the deadline for furnishing the information to the IRS and the distributees will not be earlier than six months after the date the temporary regulations are issued.

D. Pecuniary Bequests (section 1040)—If a pecuniary bequest is satisfied with appreciated carryover basis property, the general rule is that only gain in excess of estate tax value need be recognized. The balance of unrecognized appreciation is then carried over to the transferee.

E. Gift Tax Adjustment—A similar change has been made with respect to appreciated carryover basis property given after December 31, 1976. The donee's basis is equal to the donor's basis plus federal and state gift taxes attributable to the net appreciation (excess of fair market value over adjusted basis) in the donated property. The adjustment is made in accordance with this formula:

\[
\text{Net appreciation} \times \frac{\text{gift tax}}{\text{Value of gift}} = \text{Gift Tax Adjustment}
\]

F. Asset by Asset Adjustment—Each carryover basis asset must be adjusted separately. Groups of stock of a single company, if acquired at different times, must be segregated and each group separately adjusted. It will also be necessary to separate each item of, for example, a coin collection to effect a proper adjustment.

G. Recapture—The recipient apparently stands in the shoes of the decedent with respect to any recapture or other provisions which would require gain to be taxed as ordinary income.

H. Section 691 Income—section 691(c) has been amended and the effects of the change bear on numerous areas.

1. Average vs. Marginal Rates—The section 691 deduction is now computed with reference to the gross estate rather than the taxable estate, so that the amount of the credit will be determined by an estate's average rate of tax rather than its marginal rate.

2. Not Carryover Basis Property—It should be remembered that section 691 income is not treated as carryover basis property.

I. Audit Adjustments and Income Tax Return Problems—Because of the change in the manner of computing the section 691 deduction, every individual income tax return reflecting such a deduction will be incorrect if any changes are made on the audit on the federal estate tax return. The same will be true for income tax returns showing a capital gain or loss on carry-
over basis property. We should be mindful of the relationships between these areas and be careful to amend income tax returns and, when statutes of limitations are about to expire, we should file protective claims for refunds.

J. Short Term Gains on Sales by Executors—Section 1223(11), which treated all sales by executors of assets owned at death as long term, is no longer applicable. The estate may, however, tack on as part of its holding period the entire period of prior ownership of the assets received by the estate from the decedent. Thus, there is an ordinary income trap for personal representatives of estates with capital assets with short-holding periods. This result may be changed by the Technical Corrections Act.

The use of flow bonds, particularly in large amounts, is considerably less attractive now (and may even be harmful) because of the exposure to capital gains on the difference between cost and par value.

IX. PLANNING: OPPORTUNITIES AND PROBLEMS

A. Introduction—The new basis rules and other related changes present some new planning opportunities and create difficulties regarding techniques planners have been using. We will briefly consider some of the major areas affected by these changes.

B. Buy-Sell Agreements—The step-up in basis which was available at death under prior law was fundamental in buy-sell agreements. The additional taxes which will be generated by reason of the carryover of basis requires us to reconsider the economic reality of these agreements. This may be more true in later years after the relative benefit of the fresh start diminishes. It is essential that every buy-sell agreement be reviewed in light of the new bases problems.

(1) Use of Installment Payouts—Provisions for installment payouts pursuant to section 453 may do much to lessen the harmful tax effects of the carryover rules. In family or other appropriate situations, it may be desirable to give the buyer and election to pay thirty or less of the purchase price in the year of sale.

(2) Over-Funded Agreements—If the obligations under a buy-sell are over-funded with insurance, consideration might be given to transferring the excess insurance directly to the surviving spouse or other beneficiary. Will such a transfer result in a dividend, compensation, and/or gift?

(3) Adjustments to Purchase Price—Consider minimizing the purchase price applicable to buy-sell agreements thereby minimizing estate
and income tax. Any additional amounts to the survivor may be covered directly by insurance. Note, however, that the Service may attack an unreasonably low price.

(4) Cross Purchase vs. Entity Plans—Consider cross-purchase plans as opposed to entity purchase plans. Cross-purchase plans are now more attractive since the purchasers pick up an additional basis which minimizes the income taxes which will result from the sale of their stock. However, unless there is a subchapter S corporation involved with the shareholders already paying tax on all the corporation income, the cost of funding a cross-purchase agreement with insurance may be excessive since the shareholders will be using funds on which they and the corporation probably have paid income tax.

Caution: If you wish to change existing entity purchase plans to cross-purchase plans, consider not only whether the rearrangement might result in a dividend, compensation, or gift, but also review section 101(a)(2) which provides that if life insurance is transferred for valuable consideration the proceeds will be taxable for income tax purposes.

C. Section 303 Redemptions—Several important changes were made in the stock redemption rules.

(1) Qualification for a 303 Redemption—Qualified stock must equal more than fifty percent of the adjusted gross estate. Capital gain treatment under section 303 is limited to those cases where the owner of the stock is chargeable with a portion of the liability of the estate for debts, expenses, or taxes. Thus, a testator’s will should be drawn so that the stock is bequeathed to the appropriate individuals.

(2) Time for Redemption—The period of time for redeeming stock has been extended until the due date of the last installment of estate taxes. Note, however, that for any redemption made more than four years after the decedent’s death, capital gains treatment under section 303 is available only for an amount which is the lesser of: (a) the amount of the qualifying death taxes and administration and funeral expenses which are unpaid before the distribution; or (b) the aggregate of these amounts which are paid within one year after the distribution.

D. Section 306 Stock—Section 306 stock is usually preferred stock which was received as a non-taxable stock divi-
dend or in a non-taxable corporate reorganization or separation. The sale or redemption of section 306 stock may result in ordinary income. Under prior law, section 306 stock lost its ordinary income taint at death. Under the Tax Reform Act, it appears that the taint will not be removed at death. Thus, a redemption of section 306 stock may be treated as a dividend distribution to the extent that the corporation has earnings and profits. Does section 303 capital gain treatment override section 306 dividend treatment? A literal reading of the statute would require a "No" answer; however, the Technical Corrections Act would change this result.

E. Personal Holding Companies—The technique of sheltering gain on the sale of a business by use of a personal holding company will not be as attractive in the future.

F. Installment Sales—Installment sales will require more careful examination as an alternative when assets contain large elements of unrealized appreciation.

(1) To minimize income tax liability, one should consider that: (a) installments resulting in gain of $50,000 or less result in lowest capital gain bracket; and (b) installments resulting in gain of $20,000 or less result in no minimum tax (fifteen percent) on tax preferences (assuming no other tax preference items).

(2) If the sale is made pursuant to a buy-sell agreement and the parties desire immediate payment of the insurance proceeds or an amount greater than the thirty percent, the excess should be paid the following year. Note: the estate may be able to select a short fiscal year ending immediately after the initial payment.

G. Aging Assets—an untested loophole?

(1) Appreciated assets with a short holding period may be transferred to an existing "old" corporation which has a long holding period.

(2) If a client transfers property to an existing corporation, do not take additional stock which would have a separate basis and a new holding period. Caution: This may constitute a "substantial improvement" under section 1023(h)(2)(D).

(3) You may be able to create an "old" corporation by transferring capital assets or section 1223(1) assets with a long holding period to a new controlled corporation.

H. Sales in Contemplation of Death—If an asset has a significant amount of unrealized appreciation and if no large adjustments to basis will be obtained by retaining it until death, it may be advisable to sell the asset in contemplation of death.
because the monies required to pay the income taxes thus generated will either be removed from the estate or a deduction will be available for the taxes under section 2053.

(1) Note that a lifetime disposition will cause a loss of any possible fresh start adjustment.

(2) Post-mortem dispositions have the advantage of including in basis an increase equal to the amount of federal and state estate taxes allocable to the net appreciation in value of such property.

(3) Before consummating a sale in contemplation of death, calculations should be made under both alternatives to determine which method is preferable.

(4) Note that the Technical Corrections Act may affect these calculations. (page 749 of this appendix).

I. Gifts—There are several considerations relative to basis which should be remembered when planning gifts:

(1) It will generally be more advisable to give away assets acquired after December 31, 1976, since those assets will not be eligible for the fresh start step-up in basis.

(2) When giving assets held on or before December 31, 1976, a donor should prefer to give assets which are the most recently acquired, have the largest amount of unrealized appreciation, and can be expected to appreciate the most in the future.

(3) It is still better in most circumstances to use highly appreciated assets when giving to charity.

J. Tax Allocation Clauses—In view of the necessity of conferring tax payment obligations on an estate for purposes of the adjustment provided for in section 1023(c), and on a transferee to enable him to make the adjustment permitted by section 1023(e), care must be taken in drafting tax allocation clauses. We can expect some further amendment to resolve the ambiguities between the operation of these subsections.

K. Selective Distributions—The carryover basis rules provide new planning opportunities and create new problems regarding distributions to beneficiaries.

(1) Pecuniary Legacies—Satisfaction of a pecuniary legacy with inkind low basis assets might be quite disadvantageous and the legatee can be expected to express dissatisfaction with the distribution unless the governing instrument clearly expresses the intention of the testator that the legacy may be satisfied in kind
rather than in cash. Even then, a legatee might object if the assets used to satisfy the legacy have a basis materially lower than the average relative basis of the assets available for distribution.

(2) Marital Shares—Consider satisfying the marital deduction with relatively high basis assets so as to minimize income tax consequences should the surviving spouse need cash. Also, high basis assets generally would be more desirable for gift-making purposes and on the subsequent death of the surviving spouse, high basis assets would be available to be sold to pay taxes and costs of administration.

(3) Residuary Shares—Consider leaving low basis assets to the residuary trust where they would be subject to tax and have the most net appreciation so that the estate would get the largest possible increase in basis from adjustment for taxes.

(4) Charitable Interests—Wherever possible, it would be best to distribute highly appreciated assets to charity.

(5) Other Considerations—Allocation of low basis assets to the material deduction bequest would, if the assets are sold, result in a reduction in the size of the surviving spouse's estate. It would seem to be advisable to confer upon a personal representative the discretion to select whatever assets he deems appropriate for distribution. This would permit him to distribute highly appreciated assets to the most appropriate beneficiary. However, this could raise problems with the marital and charitable deductions. Rev. Proc. 64-19, 1964-1 C.B. 682.

L. Private Annuities—Over the long range, practitioners may find that private annuities are one of the best ways to pass property from one generation to the next with the least possible tax problems arising because of the carryover basis.

M. Recordkeeping—The maintenance of records relating to basis is now more important than ever. This may be more of an accounting function and we are encouraged to alert our clients to this problem and work with their accountants to see that the most complete records possible will be maintained.

X. LEGISLATIVE PROPOSALS

A. Reaction to Carryover Basis—The carryover basis provisions of the Tax Reform Act of 1976 represent a major change in estate planning, administration, and taxation patterns, but were a last minute addition to the bill. As a result, there are
numerous technical and practical problems with the provisions, and almost as soon as they were enacted, moves were afoot to reform or repeal carryover basis. The legislative proposals fall into three categories: (1) "fix-up", (2) delay and restrict and (3) repeal.

B. Fix-Up (H.R. 6715)—The major fix-up bill is the Technical Corrections Act of 1977 (H.R. 6715). It passed the House October 17, 1977 and went to the Senate Finance Committee. As passed by the House, H.R. 6715 would make the following changes:

1. Section 306 Stock—As a result of carryover basis, section 306 stock no longer loses its taint if held until death. H.R. 6715 provides that if section 306 stock is redeemed in a 303 redemption, the distribution will be treated as a gain rather than ordinary income. Also, for section 306 stock distributed prior to January 1, 1977, and acquired from a decedent dying after December 31, 1976, the taint is removed up to the value of the fresh start basis.

2. Installment Sales in Contemplation of Death—Many have concluded that deathbed sales on an installment or deferred payment basis can produce significant tax savings (if no significant step-up in basis would be achieved by holding the property until death), because the heirs could take both a capital gains deduction and a deduction for income in respect of a decedent. The amendment attempts to equalize the income tax deductions for pre-death and post-death sales, by providing that, for purposes of computing the long-term capital gains deduction, the amount of gain is reduced by the amount of any applicable deduction for estate taxes attributable to a gain treated as income in respect of a decedent.

3. Tangible Personal Property—Currently there are two categories used when determining the fresh start adjustment to basis: (a) marketable bonds and securities and (b) property other than marketable bonds and securities. The amendments provide a third: tangible personal property. If a decedent held tangible personal property on December 31, 1976, the fresh start adjustment may be made by working backward from the date of death and assuming the appreciation occurred at eight percent a year. A formula is provided. This will provide a minimum basis for the property.

4. Indebtedness Against Property—As reported for federal estate tax purposes, the fair market
value of property is reduced by the value of any indebtedness against it if the property is subject to the debt. If the decedent is personally liable, the value of the property is not reduced. This can make considerable difference when basis adjustments are made. Thus, the amendment provides that for purposes of the basis adjustments, the fair market value of property is to be determined without regard to indebtedness.

(5) Only One Fresh Start—The amendment makes it clear that property is only to receive one fresh start adjustment to basis even though it passes through successive estates.

(6) Holding Period—The original carryover basis provisions would have resulted in heirs having a holding period determined by when the decedent acquired the property. The amendment restores the automatic long-term treatment.

(7) Adjustment for State Estate Taxes—The law currently allows an adjustment to basis for state estate taxes paid on appreciation for property subject to federal estate tax. Thus if property is subject to state, but not federal tax, no adjustment is available. The amendment provides that the basis adjustment for state estate taxes will be determined by reference to the inclusion and valuation rules of state law.

(8) Adjustment for Taxes Paid by Heir—The amendment makes it clear that the fourth adjustment to basis (for state tax paid by transferee) is available if the taxes are actually paid by the heir even if the estate may technically be liable for payment of the taxes.

(9) No Recalculation—If carryover basis property is sold at a loss, the fresh start adjustment does not apply. Since adjustments for taxes and minimum basis are made after the fresh start adjustment, the question arose concerning whether, if the fresh start adjustment was not applicable because a sale at a loss occurred, the tax and minimum basis adjustments would have to be recomputed. Under the amendment, no recomputation would be required. The basis of the property would be the same for gain or loss, except that there would be no fresh start adjustment.

(10) With the exception of the provision discussed in paragraph (2) above, the amendments would all be retroactive to January 1, 1977.

C. Other Fix-Up Proposals—In addition to H.R. 6715, which was initially introduced almost a year ago, there are bills
CARRYOVER BASIS

which have been introduced this year and which would make substantial changes. At the end of January, Senator William Hathaway introduced S. 2461 which was developed with assistance from the Treasury and has strong Treasury support. Similar bills have been introduced in the House by Representative Martha Keys (H.R. 10636) and Representative William Steiger (H.R. 10617). The most far-reaching proposals of these bills are discussed later as “delay and restrict” proposals. The fix-up provisions of these bills include the following:

(1) The exemption for household and personal effects would be raised from $10,000 to $25,000.

(2) The adjustment to basis for federal death taxes on appreciation would be made on the basis of the highest marginal federal estate tax rate rather than the average rate. This would be based on the highest rate before taking the credit for state death taxes into account. Therefore, no separate adjustments for state death taxes would be needed. Thus, the three death tax adjustments would be consolidated into one.

(3) The fresh start adjustment would be allowed for purposes of determining loss as well as gain; but no fresh start adjustment could increase basis above federal estate tax values.

(4) Nonmarketable preferred stock with a stated redemption price would be treated for fresh start purposes as a marketable security with a market value on December 31, 1976 equal to its stated redemption price. Authority would be granted to extend this method by regulation to other nonmarketable property with relatively fixed values.

(5) Stock redemption plans funded by insurance and in existence on December 31, 1976, would be allowed to be changed into cross-purchase plans with no adverse tax consequences if done before 1981.

D. Delay and Restrict—Bills introduced recently contain two far-reaching proposals for carryover basis:

(1) Three-year Delay—S. 2461 proposes that the carryover basis not become effective until 1980. This would give Congress and practitioners more time to review and revise the law. This three-year delay has been accepted by the Senate Finance Committee.

(2) $175,000 Minimum—S. 2461, H.R. 10636, and H.R. 10617 would eliminate small and moderate size estates from coverage under the carryover basis rules. The $175,000 roughly approximates
the exemption equivalent of the fully implemented unified credit. This would mean that about ninety-eight percent of all estates would be exempt from carryover basis.

E. Repeal—Numerous bills, including S. 1954 introduced by Senator Carl Curtis of Nebraska, have been introduced. The changes of complete repeal, however, appear remote.

CALCULATION OF ESTATE ASSET BASIS

(If fair market value exceeds decedent's adjusted basis)

A. Fresh start adjustment: (By Asset)
Fair market value at date of death $ __________
Less: Decedent's adjusted basis $ __________

Unrealized Appreciation $ __________
Less: All adjustments to basis for depreciation, amortization, or depletion for entire holding period to date of death $ __________
Net actual unrealized appreciation $ __________
Net actual unrealized appreciation \times \text{applicable fraction} $ __________

\textit{Calculation of the Applicable Fraction}

\begin{align*}
(1) & \text{Number of days in the holding period before January 1, 1977} \quad \text{days} \\
(2) & \text{Total number of days of holding period} \quad \text{days} \\
(3) & \text{divided (1) by (2)} \\
\text{Plus:} & \text{Adjustments to basis (depreciation, etc.) for portion of holding period prior to 1-1-77} $ __________
\end{align*}

Fresh Start Adjustment $ __________
Plus adjusted basis immediately before death adjusted basis to the Successor with Fresh Start Adjustment $ __________

B. Estate tax adjustment (for gain by asset)
Fair market value \times \text{Federal & State Estate Taxes} \frac{\text{Fair market value of all property subject to Estate Tax}}{\text{Aggregate property taxed to individual}}

C. Inheritance Tax Adjustment (gain or loss) \frac{\text{(Item: FET value \text{-- adjusted basis from B}) \times \text{all inheritance tax paid by such person}}}{\text{FET value all such property}}

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