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Step-Up vs. Carryover Basis for Capital Gains: Implications for Estate Tax Repeal

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Step-Up vs. Carryover Basis for Capital Gains: Implications for Estate Tax Repeal

Summary

Current income tax law provides for a "step-up" in the basis of an inherited asset to its fair market value at the time of the decedent's death. When the heir sells the asset, the capital gain for income tax purposes is measured by the difference between the heir's selling price and the stepped-up basis of the asset. (The basis is no longer the asset's cost at the time when the decedent acquired it. That would be known as a "carryover" basis.) As a result, there is no income tax liability on the appreciation in the asset's value during the decedent's period of ownership (lifetime) – for the decedent as well as the heir.

If the federal estate tax were repealed but the step-up in basis of assets at death continued, the appreciation in value of capital assets during a decedent's lifetime could avoid both the estate tax and the income tax. If the estate tax were repealed but inherited assets received a carryover rather than stepped-up basis, a capital gains tax would be due on this appreciation in value when the assets were sold by the heirs.

As shown by numerical examples, estates that are subject to substantial estate tax liability under current law would face a much lower overall tax liability under an exchange of the estate tax for a capital gains tax on inherited assets. However, for estates which are not subject to estate tax liability under current law, repealing the estate tax in exchange for a carryover basis could mean an increase in income tax liability on capital gains relative to current law for heirs, unless a step-up in basis was preserved for some amount of a decedent's assets. (The estates of most decedents do not face an estate tax liability under current law, primarily because assets of married decedents often pass to the surviving spouse under the unlimited marital deduction, and/or because the remaining assets are less than the estate tax exclusion amount of $675,000 in 2001, rising to $1 million by 2006.)

Most bills to repeal the estate tax would retain the current unlimited step-up in basis. However, a few bills would institute a carryover basis for inherited assets in exchange for repealing the estate tax. H.R. 8 (as passed by 106th Congress, but vetoed by President Clinton in August 2000) would have replaced the step-up in basis with a carryover basis when the estate tax was fully repealed, with a limited amount of assets entitled to receive the step-up in basis. H.R. 8 (Dunn and Tanner) was reintroduced in the 107th Congress, substantially amended by the Ways and Means Committee, and passed by the House on April 4, 2001. The new bill retains the previous step-up exceptions of $1.3 million for transfers to any beneficiaries plus $3 million to a surviving spouse. For a nonresident alien decedent, the step-up is limited to $60,000 rather than $1.3 million. H.R. 8 (107th) also makes the exclusion of $250,000 per person for the capital gain on the sale of a principal residence available to the heir. S. 275 (Kyl) would repeal the estate tax, retain a step-up in basis for $2.8 million in assets, and provide a carryover basis for assets in excess of that limit. There are many questions about how either a carryover or step-up in basis of inherited assets could be administered in the absence of a federal estate and gift tax. This report will be updated to reflect other bills introduced in the 107th Congress to change the estate tax and the accompanying basis rules for inherited assets.

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Step-Up vs. Carryover Basis for Capital Gains: Implications for Estate Tax Repeal

Policy Issues

If the federal estate tax were repealed but the step-up in basis of assets at death continued, the appreciation in value of capital assets during a decedent's period of ownership (lifetime) could avoid both the estate tax and the income tax on capital gains – for the decedent as well as the heir. Several basic policy questions arise:

- If the estate tax is repealed, should the appreciation in the value of assets during a decedent's lifetime be subject to tax?
- If the appreciated value is to be taxed, when should it be? At the time of the person's death, or only when the assets are sold by heirs?
- What are the overall tax implications of trading off a repeal of the estate tax for a repeal of the step-up in basis? Are the tradeoffs different for large (taxable) estates than for smaller (nontaxable) estates?
- What are the administrative concerns about administering either a step-up or carryover basis, in the absence of an estate tax?

Current Tax Law Regarding Basis and Capital Gains

Under current tax law, assets transferred at death receive a step-up in basis, while assets transferred as a gift (*inter vivos,* while the giver is alive) retain a carryover basis. The basis affects the capital gains tax due when the heir or gift recipient sells the asset. This section provides an explanation of these two cases and some simple numerical examples, which are summarized in Table 1. (This part of the report does not address the estate and gift taxes that may also be due on the transfer of assets, either at death or during the giver's lifetime, for estates large enough to be liable for estate and gift taxes.)

Capital Gains Tax and Step-up in Basis for Inherited Assets

The capital gains tax is part of the income tax, not the estate tax. In the context of the estate tax, capital gains taxes are the concern of heirs who want to sell or liquidate assets they inherit. A capital gains tax only becomes due when an asset is sold by an heir or, as tax practitioners say, when the gains are "realized." No income tax is owed as long as an heir continues to hold an inherited asset, or passes it along to future generations. The capital gains tax is levied on the profit or "net gain" on the sale, measured by the difference between the sales proceeds and the cost or "basis" of the asset.

In contrast, the estate tax is calculated starting with the "gross" current market value of assets owned at the time of a person's death.[1] This typically includes some if not substantial "unrealized" capital gains on appreciable assets.[2] One defense of the estate tax is that it serves as a backup to the income tax by taxing the unrealized capital gains that accrued during the decedent's period of ownership (lifetime) and that will not be subject to the income tax even when realized by the heirs, for the following reason.

In what can be considered as a partial tradeoff for the estate tax, the income tax law permits a so-called "step-up" in the basis of inherited assets.[3] For the heir or recipient, that means the basis becomes the fair market value of the asset at the time of the decedent's death.[4] When the heir sells the asset, the capital gain for income tax purposes is measured by the difference between the heir's selling price and the stepped-up basis of the asset. (This is in contrast to using the decedent's basis, generally the cost of the asset when originally purchased by the decedent, which would be known as the "carryover" basis.) As a result, any gain in the asset's value during the decedent's lifetime is permanently forgiven from the income tax on capital gains.[5]

Numerical example of capital gains tax liability on an inherited asset with a step-up in basis. Assume that a man purchased stock in 1980 for $100. When he died in 1999, the market value of the stock was $1,000. This $1,000 value becomes the stepped-up basis of the stock. Assume that his son, who inherited the stock, sold it in 2000 for $1,100. Also suppose that the man and his son both faced a capital gains tax rate of 20%.

If the man had sold the stock for $1,000 just before he died in 1999, he would have owed a capital gains tax of $180. The $180 is equal to a 20% tax on the $900 in capital gains during his period of ownership ($1,000 - $100 = $900). (See "Sale by Original Owner Before Death" in the first column of Table 1.)

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[1]Certain deductions are permitted from the gross estate in determining the taxable estate, such as the marital deduction, charitable deduction, deduction of expenses for the funeral and the administration of the estate, and payment of debts of the decedent.

[2]Not all assets are appreciable and therefore candidates for a step-up in basis. For example, bank accounts or savings bonds are not subject to a capital gain (or loss).

[3]The step-up in basis also applies to assets transferred to a surviving spouse under the unlimited marital deduction.

[4]The value of an estate's assets may be established either as of the decedent's date of death or the alternate valuation date, six months later, if the value of the gross estate and the estate tax due would be lower as of the later date.

[5]Although "step-up" is commonly interpreted to mean an increase in the value of an asset, it technically refers to moving up the point in time, or date, at which the value of an asset is established. In fact, for an asset that has decreased in value since the decedent purchased it, such as an automobile, or stocks or real estate after a decline the market, the stepped-up basis can be lower than the original cost. As a consequence of the step-up in basis rule, the loss in value during the decedent's period of ownership cannot be claimed as a capital loss when an inherited asset is sold.

Instead, when the son sold the stock after his father's death for $1,100, he owed a capital gains tax of $20. The $20 is equal to a 20% tax on the son's $100 in capital gains subsequent to the time of the father's death ($1,100 - $1,000 = $100).[6] (See "Inherited Asset" in the middle column of Table 1.) The $180 in capital gains tax that would have been owed on the increase in value from $100 to $1,000 during the father's period of ownership is forgiven. These capital gains tax rules apply under the income tax, whether or not the father's estate was large enough to be subject to the estate tax.

Table 1. Capital Gains Tax Due at Sale on Inherited Asset with Stepped-up Basis vs. Gifted Asset with Carryover Basis

	Sale by Original Owner Before Death	Inherited Asset	Gifted Asset
Sales price in 2000		$1,100	$1,100
Sales price in 1999	$1,000		
Cost basis:			
Stepped up basis in 1999		1,000	
Carryover basis from 1980	100		100
Capital gain (sales price - cost basis)	900	100	1,000
Capital gains tax rate	20%	20%	20%
Capital gains tax (.20 x capital gain)	180	20	200

Source: Author's assumptions and calculations.

Carryover Basis for Gifted Assets

In contrast to an asset transferred at death, an asset transferred to another person by gift, during the giver's lifetime (*inter vivos*), retains a "carryover basis." Under a "carryover basis" the basis of the former owner is transferred to the new owner. As with inherited assets, the capital gains tax liability is deferred until the recipient sells the gifted asset. Unlike the case of inherited assets, however, at the time of sale, the

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[6]If the son had sold the stock for $1,000, no capital gains tax would have been due ($1,000 - $1,000 = $0).

recipient owes a capital gains tax on the increase in value during the giver's period of ownership as well as during the recipient's period of ownership.[7]

Numerical example of capital gains tax liability on a gifted asset with a carryover basis. Assume the father who purchased stock for $100 in 1980 instead gave that stock to his son as a gift in 1990. Assume that the market value of the stock had risen to $500 in 1990. Nevertheless, the father would not owe any capital gains tax upon making the gift. Suppose again that the son sold the stock in 2000 for $1,100. If the son had records to prove that his father purchased the stock for $100, the $100 would be the son's "carryover basis."[8] The son would owe a capital gains tax of $200 [20 percent of ($1,100 - $100) = $1,000]. The $200 is equivalent to the $180 in tax (forgiven in the preceding inheritance example) on the $900 increase in the stock's value from the time of the father's purchase until the time of his death, plus the $20 tax due on the $100 increase in value since the time of the father's death.[9] The same capital gains tax rules would apply if the son had sold the gifted stock while his father was still alive.[10] (See "Gifted Asset" in the last column of Table 1.)

Discussion of Policy Issues

Taxing Unrealized Appreciation

A common criticism of the estate tax is that many of the assets in an estate have already been taxed at least once under the income tax. A portion of the estate is likely to reflect, for example, invested savings from wages, dividends, interest, business profits, realized capital gains, and other forms of income on which the decedent paid income taxes. An exception to this criticism, however, are the unrealized gains in the value of appreciated assets held at the time of death. Unrealized gains have not been subject to income tax. If the federal estate tax were repealed but the step-up in basis of assets at death continued, the appreciation in value of capital assets during a decedent's lifetime could avoid both the estate tax and the income tax.

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[7]This example assumes that the value of the asset increased during both the giver's and recipient's periods of ownership.

[8]If the son did not have proof of the father's original purchase costs, the basis of the gifted asset would be set at $0 and the son would owe a capital gains tax of $220 or 20% of the entire $1,100 in sales proceeds.

[9]The $500 value of the stock at the time of the gift transfer is not relevant to this tax calculation.

[10]This report does not discuss the gift tax which becomes due on a current basis (not at death) once the cumulative total of a person's taxable gifts exceeds the lifetime exclusion amount for the "unified estate and gift tax." Like the estate tax, the gift tax is based on the full current value of the asset transferred, and not just the gain in value during the donor's period of ownership, nor the basis. Gifts of up to $10,000 per donor, per recipient, per year do not count against the lifetime exclusion amount and are thereby exempt from the gift tax.

Taxation at Death or When Assets Are Sold

Another criticism of the estate tax is that the tax liability is triggered by the death of the asset-holder rather than by the sale or liquidation of assets (hence the name "death tax"). The estate may be forced to sell assets in order to raise the cash needed to pay the tax. This issue is particularly important to estates dominated by a single, large, indivisible and illiquid asset, such as a family-owned business or farm, piece of real estate, or art masterpiece. The complaint is that the family may have to part with its major asset, possibly at a substantial discount, in order to raise the cash needed to pay the estate tax. (It should be noted that Section 6166 of the Internal Revenue Code currently gives estates dominated by closely held business interests effectively 15 years to pay the estate tax due on those interests. Alternatively, some individuals purchase insurance during their lifetime to pay the estate tax due upon their death.)

Alternative Approaches to Taxing Unrealized Capital Gains

There are two main approaches to taxing unrealized capital gains that accrue during a decedent's lifetime, in the absence of an estate tax. One is the approach followed in Canada of taxing the unrealized capital gains, calculated at the time of a person's death, as part of the decedent's final income tax. Like the current U.S. estate tax, this tax liability is triggered by a person's death. However, Canadian income tax law provides that the tax on the "deemed disposition of property at death" can be paid in installments over a 10-year period.

The other approach to taxing the gains unrealized by the decedent is to give the heir a carryover basis for the inherited asset instead of a step-up in basis. Any capital gains tax liability is thus deferred until the time that the asset is sold by the heir. It is due as part of the heir's income tax. This second approach is the one generally followed in the bills described in the final section of this report.

These two possibilities are among the options to increase revenues included by the Congressional Budget Office (CBO) in its compendium of *Budget Options* issued in February 2001.[11] CBO provides the Joint Committee on Taxation's estimates of additional revenues from both of these options, shown in Table 2 below. Unlike the legislative proposals described in the last section of this report, these estimates assume that the estate tax is still in place and that there is no partial step-up in basis exception to the new carryover basis rules. Revenue estimates are provided for each fiscal year from 2002 to 2006; for the five years 2002-2006; and for the 10 years 2002-2011.

Including accrued capital gains in the last income tax return of decedents is projected to generate approximately $11.6 billion per year in FY2003 when first fully phased in, then dropping gradually to $10.1 billion in 2006. The five-year revenue gain is estimated at $43.4 billion, and the 10-year revenue gain at $86.4 billion.[12] Enacting a carryover basis for capital gains held until death is estimated to generate revenues of $1.2 billion in 2003, rising gradually each year to $4.7 billion in 2006.

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[11]U.S. Congressional Budget Office. *Budget Options*. Washington, February 2001. Available on the Internet at [http://www.cbo.gov]. REV-28-A, p. 421 and REV-28-B, p. 422.

[12]CBO, *Budget Options*, February 2001, REV-28-A, p. 421.

The five-year revenue gain is estimated at $11.5 billion, and the 10-year revenue gain at $52.5 billion.[13] The revenue gain is lower under the second option of carryover basis for heirs because liability for the tax depends upon the heirs selling the assets. Under the first option of including the capital gains in the last income tax return of decedents, the tax would be due whether or not the assets were sold by the heirs.

Table 2. Estimated Revenue Gains from Including Capital Gains in Decedent's Last Income Tax Return and from Enacting a Carryover Basis for Capital Gains Held Until Death, FYs 2002-2011
($ billions)

Fiscal Year	Include Accrued Capital Gains in Decedent's Last Income Tax Return	Enact Carryover Basis for Capital Gains Held Until Death
2002	a	a
2003	11.6	1.2
2004	11.1	2.2
2005	10.6	3.4
2006	10.1	4.7
2002-2006	43.4	11.5
2002-2011	86.4	52.5

[a] Less than $50 million.

Source: U.S. Congressional Budget Office. *Budget Options*. February 2001. p. 421-22. Revenue gain estimates made by the Joint Committee on Taxation.

Replacing the Estate Tax with Full Carryover Basis for Inherited Assets

This section compares the combined estate tax and capital gains tax liability under current law with an alternative system that would repeal the estate tax and instead tax the capital gains "unrealized" by the decedent. Separate estimates are made for an estate of $10 million that would be subject to estate tax under current law (Estate A, an estate above the exclusion amount), and an estate of $1 million that

[13]CBO, *Budget Options*, February 2001, REV-28-B, p. 422.

would not be subject to estate tax under current law as of 2006 (Estate B, an estate below the exclusion amount). As illustrated by the numerical examples in the text and summarized in Table 3, estates like Estate A, currently subject to the estate tax, would face a much lower overall tax liability under an exchange of the estate tax for a capital gains tax on inherited assets. However, for estates like Estate B that are currently exempt from the estate tax because of the $1 million exclusion (and/or by using the unlimited marital deduction or other deductions), repealing the estate tax in exchange for a full carryover basis could mean an increase in tax liability relative to current law because of the potential new capital gains tax liability for heirs.

The examples presented in this section assume a full carryover basis on all assets transferred at death. This helps illustrate the concern being raised on behalf of smaller estates in relation to proposals that would repeal both the estate tax and all step-up in basis. Acknowledging this concern, the bills described in the final section of this report would preserve a step-up in basis for some amount of assets passed along by each decedent.

The capital gains tax liability estimated in these examples is equal to what would be due if a capital gains tax were collected upon the death of the decedent (i.e., a tax due with certainty, not dependent upon sale of the assets). This is equivalent to the potential tax due on the appreciation in value of the assets during the decedent's period of ownership, if and when the heirs sold the assets and realized that capital gain.

Numerical Example of Trading Off the Estate Tax for Full Carryover Basis, for an Estate Now Liable for Estate Tax. Imagine being an heir in 2006 to an estate with a taxable value of $10 million (after deductions).[14] Assume that of that total, $5 million represents the unrealized appreciation in the value of assets during the decedent's lifetime.[15] Then, consider being offered the choice

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[14]In the year 2006, under current law, the applicable exclusion amount under the estate and gift tax is scheduled to reach $1 million. Using an example from 2006 thus simplifies the numerical comparison between a large estate of $10 million and a smaller estate of $1 million.

[15]Because unrealized appreciation in the value of assets is not subject to taxation, no information is collected about it on federal estate tax returns, and hence no data are available from the Internal Revenue Service. Some estimates have been made in an academic study based on data from the 1998 Survey of Consumer Finances. Poterba and Weisbenner estimated that for all estates, in the aggregate, unrealized capital gains represented about 36% of the total value of estates measured according to their definition of "insurance-augmented net worth." For estates with insurance-augmented net worth of $10 million or more, unrealized capital gains represented about 56% of the total value of the estates. For estates in the range of $500,000 to $1 million, the figure was 34.0%. For estates in the range of $1 million to $5 million, it was 34.6%. See: Poterba, James M. and Scott Weisbenner. The Distributional Burden of Taxing Estates and Unrealized Capital Gains at the Time of Death. National Bureau of Economic Research, Inc. (NBER) Working Paper 7811. July 2000. Table 8, p. 36. Available from the NBER Web site [www.nber.org].

For purposes of the simplified example in Table 3 above, this report uses 50% as the estimate of unrealized capital gains as a percentage of the taxable value of both the $1 million (continued...)

between the current system of paying an estate tax at graduated rates of 37% up to 55%, or an alternative system of paying a capital gains tax of 20% on the appreciated value of $5 million in the estate, but no estate tax.

Table 3. Tradeoff of Estate Tax for Full Carryover Basis and Capital Gains Tax
(Current law as of 2006, with a $1 million estate tax exclusion)

Taxable status of estate	Estate A: with estate tax liability under current law		Estate B: with no estate tax liability under current law	
Taxable value of estate	$10,000,000		$1,000,000	
Market value of appreciated assets at death	8,000,000		800,000	
Unrealized capital gains at death	5,000,000		500,000	
Decedent's basis	3,000,000		300,000	
Tax Regime	Current law	No estate tax but full carryover basis	Current law	No estate tax but full carryover basis
Estate tax due	4,795,000	0	0	0
Capital gains tax due on decedent's unrealized gain when heirs sell the assets, at 20% tax rate	0	1,000,000	0	100,000

Source: Author's assumptions and calculations.

Under current law, the tentative estate tax on $10 million, before tax credits, would be $5,140,800. After subtracting the unified estate and gift tax credit of $345,800 (for decedents dying in 2006 or after), the net estate tax would be $4,795,000.[16] In comparison, a capital gains tax of 20% on $5 million would be $1

[15](...continued)
and $10 million estates. This may overstate the capital gains tax liability likely for the smaller estate. According to the Poterba-Weisbenner estimates, approximately 34% of an estate of $1 million, or $340,000 would be unrealized capital gains. At a 20% capital gains tax rate, the tax would be $68,000, in contrast to the $100,000 shown in Table 3.

[16]For decedents dying in 2000 and 2001, the applicable exclusion amount is $675,000, with (continued...)

million.[17] (In Table 3, see the last two rows, first two columns, corresponding to Estate A.)

Your choice of tax system might differ depending on the specific terms of your inheritance. If you were entitled to receive a fixed percentage of the estate remaining after taxes, you would likely prefer the capital gains tax regime. However, if you were designated to receive a particular asset, such as a certain piece of real estate, you might be concerned with the capital gains tax that would be due on the sale of your particular asset, but not the estate taxes that would alternatively be paid by the estate as a whole. As a group, however, heirs of a large estate would seem better off choosing the capital gains tax with carryover basis instead of the estate tax.

Numerical Example of Why Estates Not Liable for Estate Tax under Current Law Could Be Worse Off under Estate Tax Repeal with Full Carryover Basis. Proposals to accompany the repeal of the estate tax with a full repeal of the step-up in basis – and to fully replace it with a carryover basis – face the criticism that smaller estates could be worse off than under current law. That is because, under current law, estates with taxable assets less than or equal to the applicable exclusion amount ($675,000 in 2001, and $1 million in 2006 and thereafter) are not only free from the estate tax, but the heirs are also free from capital gains taxes on the appreciation in value during the decedent's lifetime when they sell the inherited assets.[18]

Estates smaller than the exclusion amount would not receive any estate tax saving if the estate tax were repealed. However, if the step-up in basis were fully repealed, the heirs would owe a capital gains tax of $100,000 on the $500,000 appreciation in value during the decedent's lifetime.[19] (In Table 3, see the last two rows and last two columns, corresponding to Estate B.) The possibility of a capital gains tax liability for the heirs is why the bills listed in the final section of this report include limited step-up provisions. These step-up allowances are intended to provide heirs protection from capital gains taxation that is equivalent to the protection provided under current law for estates up to a certain size (i.e., estates with unrealized capital gains of up to the amount specified in the bills) .

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[16](...continued)
a unified tax credit of $220,550. Credits against the federal estate tax are also permitted for a limited amount of state death taxes and foreign death taxes. For further explanation, see CRS Report RS20857, *How to Calculate the Estate Tax*, by Nonna A. Noto.

[17]If the appreciated value of assets represented $8 million, instead of $5 million, of the $10 million estate, a capital gains tax of 20% would equal $1.6 million.

[18]The estates of most decedents do not face an estate tax liability under current law, primarily because assets of married decedents often pass to the surviving spouse, with a step-up in basis, under the unlimited marital deduction, and/or because the remaining assets are less than the estate tax exclusion amount of $675,000 in 2001, rising to $1 million by 2006.

[19]See explanation in footnote 15.

Administrative Concerns in Establishing Basis

A previous effort to institute a carryover basis was enacted by the Tax Reform Act of 1976.[20] Its implementation was postponed by three years by the Revenue Act of 1978[21] and repealed before it ever took effect by the Crude Oil Windfall Profit Tax Act of 1980.[22,23] Leading up to the repeal, practitioners pointed out the difficulties in trying to determine the historical cost basis of an inherited asset.

Repealing the estate tax would remove the current incentive to hold down the valuation of assets at the time of death in order to reduce estate tax liability. Instituting a capital gains tax in place of the estate tax would instead create incentives to overstate the carryover basis of assets, so as to reduce the eventual calculation of capital gains.

Furthermore, permitting some assets to receive a step-up in basis while others retain a carryover basis would introduce still more complexities into the administration of the tax system.[24]

Bills to Restrict the Step-Up in Basis in Exchange for Repealing the Estate Tax

In the Internal Revenue Code, the step-up in basis is not part of the estate tax law, but rather is found in the portion of the Code that defines the basis of assets for income tax purposes.[25] It would thus require additional legislative language, beyond repealing the estate tax, to replace the step-up in basis with a carryover basis for inherited assets. Such a provision was included in H.R. 8 which passed in the second session of the 106th Congress, but was vetoed by President Clinton on August 31, 2000. The legislative language of H.R. 8 was reintroduced as Subtitle B of the companion bills H.R. 627 (Boehner) and S. 333 (Lugar), introduced in the 107th Congress on February 14, 2001.

H.R. 8 (Dunn) was reintroduced in the 107th Congress, substantially amended by the Ways and Means Committee, and passed by the House on April 4, 2001. The new

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[20]Sec. 2005 of H.R. 10612, P.L. 94-455.

[21]Sec. 515 of H.R. 13511, P.L. 95-600.

[22]Sec. 401 of H.R. 39319, P.L. 96-223.

[23]See CRS Report 95-444 A, *A History of Federal Estate, Gift, and Generation-Skipping Taxes*, by John R. Luckey. p. 13-14.

[24]For a detailed discussion of some of the complexities involved in administering a carryover basis regime, see: AICPA (American Institute of Certified Public Accountants). Reform of the Estate and Gift Tax System. *Tax Notes*, vol. 91, no. 2, April 9, 2001. p. 307-35. See also: Tucker, Stefan F. Thoughts on Radical Estate and Gift Tax Reform. Testimony before the Senate Finance Committee, Subcommittee on Taxation and IRS Oversight, March 15, 2001. Reprinted in *Tax Notes*, vol. 91, no. 1, April 2, 2001. p. 163-70.

[25]Internal Revenue Code. Section 1014. Basis of property acquired from a decedent.

bill retains the previous step-up exceptions of $1.3 million for transfers to any beneficiaries plus $3 million to a surviving spouse. For a nonresident noncitizen decedent, the step-up is limited to $60,000 rather than $1.3 million. H.R. 8 (107th) also makes the exclusion of $250,000 per person for the capital gain on the sale of a principal residence available to the heir. S. 275 (Kyl) would repeal the estate tax, retain a step-up in basis for $2.8 million in assets, and provide a carryover basis for assets in excess of that limit.

Most other bills introduced to repeal the estate tax would retain the current step-up in basis rules, simply by omitting any provisions to change them. The brief descriptions which follow focus on how the bills treat the basis for inherited assets, and provisions the bills make for the administration and implementation of the step-up and carryover bases.

106th Congress

H.R. 8. *The Estate Tax Elimination Act of 2000*. H.R. 8 passed the 106th Congress but was vetoed by President Clinton. Title I of H.R. 8 would have repealed the step-up in basis at the time when the estate tax was fully repealed. However, to hold taxpayers harmless relative to current law, H.R. 8 preserved a certain amount of step-up in basis.

Specifically, H.R. 8, after an initial nine-year phase-down period from 2001 to 2009, would have repealed the estate, gift, and generation-skipping transfer taxes entirely in 2010. At that time, the step-up in basis at death would also have been repealed, with two exceptions. A step-up in basis would have continued to apply to $1.3 million in transfers from a decedent to any beneficiaries. An additional $3 million of transfers from a decedent to his or her surviving spouse also would have received a step up in basis.[26] Property in excess of these amounts would have a carryover basis. That is, the cost basis to the heir would be the cost at which the decedent acquired the asset. H.R. 8 provided that the executor would elect which assets received a step-up in basis and which a carryover basis. (H.R. 8 contained several other provisions not described here.[27])

The step-up exceptions in H.R. 8 are a way to hold taxpayers harmless relative to the amount of estate that is free from tax under current law. Under current law, in 2006 and thereafter, a decedent will be able to transfer $1 million in assets to heirs free from estate tax, and all those assets could receive a step up in basis. Decedents owning qualifying farms and closely held businesses can already (as of 1998) pass along $1.3 million in assets free from estate tax. The $1.3 million step-up exception would cover both of these exclusions. Under current law, spouses may inherit unlimited transfers untaxed and with a step-up in basis. H.R. 8 preserved an

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[26]These amounts would have been indexed annually for inflation after 2010, with upward adjustments to be made only in multiples of $10,000.

[27]For further discussion of H.R. 8 in the 106th Congress, and the Democratic substitute amendments offered in its place, see CRS Report RS20592, *Estate Tax Legislation: A Description of H.R. 8, The Death Tax Elimination Act of 2000*, by Nonna A. Noto.

additional step-up in basis for $3 million in assets transferred by bequest specifically to a surviving spouse.

107th Congress

H.R. 8 (Passed by the House). *The Death Tax Elimination Act of 2001.* H.R. 8 (Dunn and Tanner) was reintroduced in the 107th Congress on March 14, 2001, replaced by an amendment in the nature of a substitute by the Ways and Means Committee on March 29, 2001, and passed by the House on April 4, 2001. H.R. 8 (107th) contains provisions related to the estate and gift tax in addition to the provisions described below, which focus on the treatment of step-up and carryover basis.[28]

H.R. 8 would gradually lower the marginal estate tax rates during a nine-year phasedown period from 2002 through 2010. The estate and gift tax would be fully repealed effective in 2011. At that time, the step-up in basis provisions would be repealed and replaced with a modified carryover basis.

Title IV of the new bill retains from H.R. 8 (106th Congress) the step-up exceptions of $1.3 million per decedent (the aggregate basis increase) for transfers to any beneficiaries, plus $3 million for assets transferred to a surviving spouse (the spousal property basis increase). For decedents who are non-resident non-citizens (also known as non-resident aliens), the new bill would limit the aggregate basis increase to $60,000 rather than $1.3 million. The dollar amounts of these three step-up basis exceptions would be indexed for inflation after 2010. In addition, H.R. 8 would make the exclusion of $250,000 per person for the capital gain on the sale of a principal residence available to the inheritor of the residence. Other assets would receive a carryover basis. That is, the basis of an inherited asset would be the lesser of the adjusted basis of the decedent or the fair market value of the property at the date of the decedent's death. The executor of the estate is given the responsibility of allocating the step-up exceptions and carryover basis to individual assets.

Compared with the previous H.R. 8 passed by the 106th Congress, H.R. 8 as passed by the House in the 107th Congress contains numerous definitions and restrictive or explanatory provisions. These frequently address the current interplay between the income tax and the estate tax. There are also numerous provisions pertaining to non-resident aliens. For example, H.R. 8 provides that the step-up in basis limit could be increased by unused built-in losses and loss carryovers for assets; this would apply to all decedents other than non-resident aliens. Liabilities in excess of basis (such as loans or mortgages on an asset in excess of the adjusted basis of the asset) would be disregarded in determining whether gain is recognized on the acquisition of property from a decedent. There are rules governing the treatment of appreciated carryover basis property used to satisfy a pecuniary bequest. The bill would exclude stock in certain foreign investments from receiving a step-up in basis. The bill contains definitions for qualified spousal property and many other terms

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[28] For further discussion of H.R. 8 in the 107th Congress, and the Democratic substitute amendments offered in its place, see CRS Report 30912, *H.R. 8: The Death Tax Elimination Act of 2001*, by Nonna A. Noto.

referring to property. To help protect income tax revenues, the bill would establish reporting requirements for the transfer of assets to recipients, both for large lifetime gifts and assets passing upon death. Cash penalties would be imposed on lifetime donors and executors for failure to provide the required information to beneficiaries or the IRS. The bill contains anti-abuse rules related to purported gifts made under certain conditions and transfers of assets to nonresidents.

H.R. 627 (Boehner)/ S. 333 (Lugar). *Rural America Prosperity Act of 2001*. Companion bills introduced February 14, 2001. Subtitle B, on Estate and Gift Tax Relief, reintroduces the legislative language of H.R. 8 from the 106th Congress, with the years referred to updated by one year.

H.R. 627/S. 333 would gradually phase down estate tax rates during the initial nine year period from 2002 through 2010. After December 31, 2010, H.R. 627/S.333 would repeal the estate, gift, and generation-skipping taxes entirely. At that time, the bill would also repeal the step-up in basis at death. Instead, property acquired from a decedent would have a carryover basis, with two exceptions. A step-up in basis would be retained for $1.3 million in aggregate adjusted fair market value of property transferred to any heirs, plus $3 million for property transferred to a surviving spouse. These excepted amounts would be indexed for inflation after 2011, in increments of multiples of $10,000. The executor is to allocate the step-up exceptions among the assets. Like H.R. 8 (106th), H.R. 627/S. 333 contain provisions related to the estate and gift tax in addition to those described here.

S. 275 (Kyl). *Estate Tax Elimination Act of 2001*. Introduced February 7, 2001. S. 275 was described, upon introduction by its sponsor, as a bill to replace the federal estate tax with a tax on the capital gains earned from inherited assets, due when those assets are sold.[29] S. 275 would repeal the federal estate and gift taxes and the tax on generation-skipping transfers immediately upon enactment. S. 275 would formally establish by name in the Internal Revenue Code (IRC) a "step-up in basis" as the general rule for determining the basis of property acquired from a decedent. However, it would limit the aggregate fair market value of property that could receive the step-up treatment to the decedent's basis in the property, plus $2,800,000.[30] Additional property acquired from or passed from a decedent would have a carryover basis.[31] In essence, for estates with assets containing more than $2.8 million in unrealized capital gains in the aggregate, S. 275 would replace the federal estate tax (now levied on the full market value of assets at the time of the

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[29]Floor statement by Sen. Jon Kyl on introduction of S. 275, Estate Tax Elimination Act of 2001. *Congressional Record*, Daily Edition, Feb. 7, 2001. p. S1131.

[30]The $2.8 million amount would be indexed for inflation, to be adjusted only in increments which are a multiple of $10,000.

[31]Assets in excess of the step-up limit would generally be governed by the carryover basis rules that currently apply to property acquired by gifts (IRC section 1015), with some exceptions. S. 275 makes an exception for annuities described in IRC section 72. Gross income in respect of a decedent is not considered carryover basis property. Capital gain treatment is permitted for inherited artwork even though the basis for the heir may be linked to the basis for the deceased artist by the carryover provision (IRC section 1221(a)(3)(C) would be amended).

decedent's death and due at the time of death), with a tax on capital gains (earned from the time the decedent purchased the asset until the asset is sold by the heir, due at the time the asset is sold).

The $2.8 million figure can be described as a "step-up allowance." It serves to hold smaller estates better than harmless relative to current law. The $2.8 million figure far exceeds the total amount of assets excluded from estate and gift taxation under current law. Section 2057 of the IRC currently provides that estates with qualifying family-owned business interests are eligible for an estate tax deduction (combined with exclusion) of up to $1.3 million per decedent. All other estates have an applicable exclusion amount of $675,000 for decedents dying in 2001 (scheduled to rise to $1 million by 2006), without regard to the types of assets held.

The bill language of S. 275 does not give specific directions as to how the step-up in basis and carryover basis are to be administered or allocated among specific assets. The bill does, however, contain the following three general instructions:

> (1) If the aggregate fair market value of the estate exceeds the dollar limit for the step-up in basis (the aggregate original basis plus $2.8 million), the executor is to allocate the $2.8 million allowance among the assets.
> (2) The Secretary [of the Treasury] is to prescribe the regulations needed to carry out the intent of the new step-up provision.
> (3) Every executor is required to provide the Secretary [of the Treasury] with information on the property acquired from a decedent to which either the step-up or carryover basis applies, in accordance with regulations to be issued by the Secretary.