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CARRYOVER BASIS RULES FOR INHERITED PROPERTY

ROBERT S. HIGHTOWER*

I. INTRODUCTION

One of the most, if not the most, far-reaching revisions of the Tax Reform Act of 1976 is new section 1023—Carryover Basis for Certain Property Acquired from a Decedent Dying after December 31, 1976.¹ In summary, this new Internal Revenue Code section provides that the basis of property in the hands of a person acquiring it from a decedent dying after December 31, 1976, shall be the adjusted basis of the property in the hands of the decedent immediately before his or her death—a carryover basis instead of the stepped-up basis which is provided by section 1014. In addition, newly enacted section 6039A provides for new carryover basis informational returns which are to be filed by all executors² with the Service and with each beneficiary, and section 6694 sets forth civil pecuniary penalties for the failure to so file.

In the past, many estate planning techniques were founded on the stepped-up basis rule of section 1014—that the cost or basis of property acquired from a decedent was its fair market value at the date of death.³ The basic concept of these techniques was that

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1. Tax Reform Act of 1976, Pub. L. No. 94-455, § 1023, 90 Stat. 1520 [hereinafter 1976 Act]. The following conventions will be observed in citations in this article. Citations to the Internal Revenue Code (I.R.C.) will refer to the Internal Revenue Code prior to the changes effected by the 1976 Tax Reform Act. Citations to the 1976 Act will refer to the Code sections as created or amended by the 1976 Tax Reform Act.

2. The term "executor" is no longer used in Florida. The term "personal representative" now refers to what has been known as an executor or administrator. FLA. STAT. § 731.201(25) (1975). This article will use the term "executor" because that term is employed by the Internal Revenue Code.

3. The pertinent part of § 1014 provides:

(a) In General.—Except as otherwise provided in this section, the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, *be the fair market value of the property at the date of the decedent's death*, or in the case of an election under . . . section 2032 . . . , its value at the applicable valuation date prescribed by [that section].

I.R.C. § 1014(a) (emphasis added).

appreciated property should be held until the decedent's death in order to secure a step-up to fair market value and to escape income taxation of the appreciation.⁴ For example, under prior law if decedent Alex purchased Blackacre in 1961 for \$100 and watched it appreciate to \$200 at his death in 1974, Alex's estate would take Blackacre with a stepped-up basis of \$200, and the appreciation between \$100 and \$200 would never be subject to federal income tax.⁵ (Of course, Blackacre would be included in Alex's estate at its \$200 fair market value.) By contrast, if Alex had sold Blackacre for \$200 in 1973, the year prior to his death, and invested the proceeds in Whiteacre which had a fair market value of \$200 at Alex's death, Alex would have been required to report \$100 of capital gain in 1973 and would still be required to include Whiteacre in his gross estate at \$200. By disposing of Blackacre prior to his death in the second hypothetical, Alex incurs an income tax on the \$100 appreciation in Blackacre that would never have been due had he died holding the property.⁶ Clearly, prior to the enactment of section 1023 there was an incentive for Alex to hold his appreciated property until his death.

II. CARRYOVER BASIS PROPERTY

In order to eliminate this difference in income tax treatment between property sold before death and property held until death,⁷

4. By contrast, loss property would frequently be sold prior to death to recognize the loss which would otherwise disappear should the property's basis be stepped-down to its fair market value at the decedent's death. HOUSE COMM. ON WAYS AND MEANS, ESTATE AND GIFT TAX REFORM ACT OF 1976, H.R. REP. NO. 94-1380, 94th Cong., 2d Sess. 36-37 (1976) [hereinafter cited as ESTATE AND GIFT TAX REPORT].

5. See *id.* at 36. See also 1 S. SURREY, W. WARREN, P. MCDANIEL AND H. AULT, FEDERAL INCOME TAXATION 919-23 (1972); Covey, *Possible Changes in the Basis Rule for Property Transferred by Gift or at Death*, 50 TAXES 831 (1972).

6. A somewhat similar result obtained if Alex had made a gift of the property prior to his death. Under the pre-1977 rule, upon the gift the donee would take the donor's carryover basis (here \$100), increased by the amount of any gift taxes paid on the transfer, but the sum could not exceed the fair market value of the property at the date of the gift. I.R.C. § 1015(a), (d). In this case, the donee's basis would be \$100, plus gift taxes paid; if the donee immediately sold the property for \$200 he would report the difference as gain.

It should be noted that the basis rule for gifts made after December 31, 1976, has also undergone change. For these gifts the new basis rules limit the amount of the adjustment made for gift taxes paid to the gift taxes allocable to the appreciation in the property. 1976 Act § 1015(d)(6); ESTATE AND GIFT TAX REPORT, *supra* note 4, at 44.

7. There also has been commentary to the effect that one of the purposes of the change was to eliminate the incentive for holding property until death which arguably created an undesirable economic "lock-in" of capital assets which had appreciated substantially since acquisition. ESTATE AND GIFT TAX REPORT, *supra* note 4, at 36-37; Covey, *Possible Changes in the Basis Rule for Property Transferred by Gift or at Death*, 50 TAXES 831, 832, 835 (1972).

Congress included in the 1976 Act a provision—section 1023—to end the step-up in basis for most types of property. Under this section, the basis of “carryover basis property” in the hands of a person acquiring it from a decedent dying after December 31, 1976, is the adjusted basis of the property in the hands of the decedent just before his death (a carryover basis), with some adjustments.⁸ Thus in the Blackacre example above, if Alex dies after December 31, 1976, and if he holds Blackacre at that time, his estate would receive Blackacre with a carryover basis of \$100 (with adjustments), rather than with a \$200 stepped-up basis.

What then constitutes “carryover basis property”? As is provided by section 1023(b)(1), “carryover basis property” means any property which is acquired from or passed from a decedent within the meaning of section 1014(b) and which is not excluded pursuant to paragraphs (2) and (3) of section 1023(b). Inasmuch as the provisions of section 1014(b) are rather extensive,⁹ for practical purposes it can be stated

8. 1976 Act § 1023(a)(1). Property not classified as “carryover basis property” continues to be subject to the step-up basis rule of § 1014 or other applicable basis rules. ESTATE AND GIFT TAX REPORT, *supra* note 4, at 37.

9. I.R.C. § 1014(b) provides in pertinent part:

(b) Property Acquired from the Decedent.— . . . [T]he following property shall be considered to have been acquired from or to have passed from the decedent:

(1) Property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent;

(2) Property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent, with the right reserved to the decedent at all times before his death to revoke the trust;

(3) In the case of decedents dying after December 31, 1951, property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent with the right reserved to the decedent at all times before his death to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust;

(4) Property passing without full and adequate consideration under a general power of appointment exercised by the decedent by will;

(5) In the case of decedents dying after August 26, 1937, property acquired by bequest, devise, or inheritance or by the decedent's estate from the decedent, if the property consists of stock or securities of a foreign corporation, which with respect to its taxable year next preceding the date of the decedent's death was, under the law applicable to such year, a foreign personal holding company. In such case, the basis shall be the fair market value of such property at the date of the decedent's death or the basis in the hands of the decedent, whichever is lower;

(6) In the case of decedents dying after December 31, 1947, property which represents the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State, Territory, or possession of the United States or any foreign country, if at least one-half of the whole of the community interest

that "carryover basis property" constitutes all property acquired or passed from a decedent, unless it is specifically excepted.¹⁰

The following items of property are statutorily exempt from treatment as carryover basis property, and thus the basis of such property is determined by rules other than section 1023:

- (A) Income in respect of a decedent described in section 691;¹¹
- (B) Proceeds of life insurance described in section 2042;
- (C) Joint and survivor annuities taxed under section 72;
- (D) Payments under a deferred compensation plan or stock option plan, if taxable to the beneficiary;
- (E) Stock in a foreign personal holding company (section 1014(b)(5)); and
- (F) Property included in the decedent's gross estate by reason of section 2035, 2038, or 2041 which has been disposed of before the decedent's death in a transaction in which gain or loss is recognizable.¹²

Additionally, some items of tangible personal property and household goods may escape carryover basis property classification in certain

in such property was includible in determining the value of the decedent's gross estate under chapter 11 of subtitle B (section 2001 and following, relating to estate tax) or section 811 of the Internal Revenue Code of 1939;

.....

(9) In the case of decedents dying after December 31, 1953, property acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment), if by reason thereof the property is required to be included in determining the value of the decedent's gross estate under chapter 11 of subtitle B or under the Internal Revenue Code of 1939. In such case, if the property is acquired before the death of the decedent, the basis shall be the amount determined under subsection (a) reduced by the amount allowed to the taxpayer as deductions in computing taxable income under this subtitle or prior income tax laws for exhaustion, wear and tear, obsolescence, amortization, and depletion on such property before the death of the decedent. Such basis shall be applicable to the property commencing on the death of the decedent. This paragraph shall not apply to—

- (A) annuities described in section 72;
- (B) property to which paragraph (5) would apply if the property had been acquired by bequest; and
- (C) property described in any other paragraph of this subsection.

10. Stansbury & Blazek, *Revamped Basis Rules for Inherited Property Have Far-reaching Implications*, 46 J. TAX 14 (1977) (hereinafter cited as Stansbury & Blazek).

11. Income in respect of a decedent and several of the other types of property are exempt from carryover basis property status because the beneficiary of these items of property will have to report the income. It should be noted that income in respect of a decedent was likewise excluded from the stepped-up basis rules of § 1014(a). I.R.C. § 1014(c).

12. 1976 Act § 1023(b)(2); Stansbury & Blazek, *supra* note 10, at 14.

circumstances.¹³ A closer look at the basis rules governing personal and household effects is merited.

Under section 1023(b)(3), an executor can exempt personal and household effects with a fair market value of up to \$10,000 from carryover basis property classification upon making a timely election.¹⁴ As such, the property designated by the executor would be subject to the general pre-1977 rule which provides the property with a step-up to the date of death fair market value or the alternative value under section 2032.¹⁵ While the rationale for such a rule is not readily apparent, it should be made clearer by a review of several rules governing the carryover of unrealized losses, particularly in the case of personal property.

Since the carryover basis rules of section 1023 will result in the carryover of unrealized gain to the decedent's estate, it will likewise usually result in the carryover of unrealized loss.¹⁶ Thus, if at his death Thor held ten shares of AT&T with a basis of \$60 each and a fair market value of \$45 each, as a general rule his estate would get a carryover basis of \$60 for each share. The estate could then promptly sell the stock and realize a \$15 loss per share.

Congress did not intend to allow any such unrealized losses on personal effects or household goods to be carried over by means of a carryover basis in excess of an asset's fair market value.¹⁷ Thus, if Thor dies owning an automobile with a basis of \$5,000 and a fair market value of \$1,000, the \$5,000 cost basis cannot be used by his estate to compute a \$4,000 loss.¹⁸ Section 1023(a)(2) specifically precludes the possibility of such a loss carryover by providing that

[i]n the case of any carryover basis property which, in the hands of the decedent, was a personal or household effect, for purposes of determining loss, the basis of such property in the hands of the person acquiring such property from the decedent shall not exceed its fair market value.¹⁹

That such a provision is reasonable given the present tax law can hardly be questioned. No loss deduction would have been allowed to the

13. 1976 Act § 1023(b)(3).

14. As is provided in section 1023(b)(3)(C), this election must be made by the executor not later than the date provided in I.R.C. § 6075(a) for filing the estate tax return (9 months after the decedent's death) including extensions.

15. ESTATE AND GIFT TAX REPORT, *supra* note 4, at 38.

16. *Id.* at 37-38.

17. *Id.* at 38.

18. It should be noted that under the foregoing rules should the amount realized on sale of the personal asset exceed its fair market value at death but be less than the asset's basis, no gain or loss will be recognized. *Id.*

19. 1976 Act § 1023(a)(2).

decedent had he sold the loss property prior to his death.²⁰ It is, of course, unfortunate that much, if not most, of the average decedent's personal and household effects will have depreciated since their acquisition.²¹

Congress had a two-fold rationale in adopting the section 1023(b)(3) provision which allows certain personal property to be excluded from carryover basis treatment. First, as a practical matter, since most personal property depreciates in value, the election to use the stepped-down fair market value will have no effect; it merely reinforces the rule of section 1023(a)(2) which precludes the carryover of unrealized loss on personal and household effects.²² Second, by such an election the executor will be relieved of the burden of proving the actual basis for such property if, as is the usual case, the executor can prove that the personal property has depreciated since acquisition.²³

Nevertheless, there are situations where the election of section 1023(b)(3) can provide significant tax savings, and as fortune would have it, these situations occur more frequently in the case of the wealthy. For example, take the case of the decedent, Edmund, who dies owning an old, secondhand Rolls Royce purchased in England for the paltry sum of \$1,000 years ago and now worth at least \$10,000 on the market. Under the new section 1023(b)(3) election, Edmund's executor would be able to designate²⁴ this personal asset²⁵ for stepped-up basis treatment and have the estate claim a \$10,000 basis. The estate could then sell the Rolls Royce for \$10,000 without recognizing gain. Are we to assume that the poor have personal and household effects which appreciate in value as did Edmund's motor car? Clearly, the point of this example is that, where practical, personal assets which have appreciated significantly may be designated in the section 1023(b)(3) election to avoid the status of carryover basis property.

III. ADJUSTMENTS TO CARRYOVER BASIS

A. Fresh-start Adjustment

As has been discussed above, the general concept of the new section

20. I.R.C. § 262.

21. ESTATE AND GIFT TAX REPORT, *supra* note 4, at 38.

22. *Id.*

23. *Id.* at 41.

24. It appears clear that the executor is given the power to select the assets which are to be excluded from carryover basis treatment. See 1976 Act § 1023(b)(3)(C); Stansbury and Blazek, *supra* note 10, at 14.

25. It is assumed that the Rolls Royce was an asset held for personal use and not for investment. Query, however, whether the I.R.S. would attempt to argue an investment motive in situations such as this.

1023 is that the basis of carryover basis property in the hands of the person acquiring the property from a decedent dying after December 31, 1976, will be the adjusted basis of the decedent immediately before his or her death.²⁶ The step-up to fair market value of section 1014 will no longer be provided as to most property acquired from a decedent.

A number of adjustments must be made to this carryover basis.²⁷ By far, the most important adjustment is that pursuant to section 1023(h) of the 1976 Act, which provides for purposes of computing gain (but not loss), a fresh-start basis for carryover basis property held by the decedent on December 31, 1976. Generally speaking, the fresh-start adjustment allows the carryover basis to be increased by the excess of the fair market value of the property on December 31, 1976, over its adjusted basis on that date. The adjustment takes two different forms: one for marketable securities and another for all other types of property.

The "fresh-start" rule of section 1023(h)(1) provides that if marketable bonds or securities²⁸ were held²⁹ by the decedent on December 31, 1976, and if the December 31, 1976, value exceeded the adjusted basis of the property on that date, then the market value on December 31, 1976, is to be used in arriving at the fresh-start adjustment.³⁰ Thus,

26. 1976 Act § 1023(a)(1).

27. See 1976 Act § 1023 (c), (d), (e), and (h).

28. Section 1023 defines "marketable bond or security" as "any security for which, as of December 1976, there was a market on a stock exchange, in an over-the-counter market, or otherwise." 1976 Act § 1023(h)(2)(E). The committee report elaborates somewhat on this definition and clarifies the "otherwise" language somewhat when it states:

Marketable bonds or securities are securities which are listed on the New York Stock Exchange, the American Stock Exchange, or any city or regional exchange in which quotations appear on a daily basis, including foreign securities listed on a recognized foreign national or regional exchange; securities regularly traded in the national or regional over-the-counter market, for which published quotations are available; securities locally traded for which quotations can readily be obtained from established brokerage firms; and units in a common trust fund.

HOUSE COMM. ON WAYS AND MEANS, TAX REFORM ACT OF 1976—CONFERENCE REPORT TO ACCOMPANY H.R. 10612, H.R. REP. NO. 94-1515, 94th Cong., 2d Sess. 613 (1976) [hereinafter cited as CONFERENCE REPORT].

29. Technically, the adjustment is not limited to property held by the decedent on December 31, 1976. Section 1023(h)(1) provides for the fresh-start adjustment if the adjusted basis of the property immediately before the decedent's death "reflects the adjusted basis [of the property] on December 31, 1976." The Conference Committee Report noted that, "[t]hus, property held by the decedent at his death which he acquired in a nontaxable exchange with other property which the decedent held on December 31, 1976, is eligible for the 'fresh start' provision." CONFERENCE REPORT, *supra* note 28, at 612.

30. 1976 Act § 1023(h)(1). While the statute does not specify a method for valuing these marketable securities, the CONFERENCE REPORT, *supra* note 28, at 613, indicates

in the case of a decedent who purchased one share of AT&T at \$45 on January 1, 1976; held that one share of AT&T at \$60 on December 31, 1976; and died with that same share of AT&T at \$75 on December 31, 1977; the \$45 carryover basis of that property will be increased to the December 31, 1976, value of \$60.³¹

A somewhat more complex rule is involved in the case of property other than marketable securities. Simply stated, this rule treats any appreciation of such property as though it occurred ratably from the date of acquisition of the property by the decedent until his or her date of death, and gives the beneficiary a basis equal to the carryover basis of the property plus the amount of appreciation allocable to the holding period prior to December 31, 1976. Thus, if the decedent purchased undeveloped realty on December 31, 1973, for \$1,000 and died six years later on December 31, 1979, when the value of the realty had appreciated to \$2,000, the carryover basis of \$1,000 would get a fresh-start adjustment in the amount of \$500 ($\$1,000 \times 1/2$), inasmuch as one-half of the appreciation would be attributed to the holding period from December 31, 1973, to December 31, 1976.³²

The fresh-start adjustment rules become more complex when depreciable property is at issue. As is explained by section 1023(h)(2)(B) of the 1976 Act:

that the valuation technique used should be the same as that in § 20.2031-2(b) of the Treasury Regulations, as though the decedent died on that date. The regulations provide that "[i]f there is a market for stocks or bonds, on a stock exchange, in an over-the-counter market, or otherwise, the mean between the highest and lowest quoted selling prices on the valuation date is the fair market value per share or bond." Treas. Reg. § 20.2031-2(b) (1958).

31. Assume another hypothetical where the cost was \$200 in 1971; the December 31, 1976, value of the security was \$400; and the date of death value was \$300. If the property is subsequently sold for \$450, arguably the gain will be only \$50. This is true since the fresh-start adjustment is available in the case of gains. 1976 Act § 1023(h)(1); CONFERENCE REPORT, *supra* note 28, at 612. But query whether the fresh-start adjustment can increase the basis in excess of the date of death fair market value. See generally 1976 Act § 1023(f)(1); CONFERENCE REPORT, *supra* note 28, at 612; Lecture by Marshall H. Barkin, The Florida Bar Continuing Legal Education Seminar on Major Estate and Gift Taxation—Changes of the 1976 Tax Reform Act, New Rules for Basis, in Tampa, Florida (Dec. 3, 1976) [hereinafter cited as Barkin Lecture].

By contrast, assume that the property was subsequently sold for \$225. If the fresh-start basis were allowed in this case, a \$175 loss would be created. This is precluded by limiting the use of the fresh-start basis to situations of gain only. However, in this situation there should be no gain, inasmuch as the committee reports express the intent not to tax gains realized prior to January 1, 1977. See generally CONFERENCE REPORT, *supra* note 28, at 612-13; Barkin Lecture.

32. Technically, the appreciation element is multiplied by a fraction based on the number of days the property was held prior to January 1, 1977, over the total number of days that the property was held. 1976 Act § 1023(h)(2)(C).

The amount of the increase . . . is the sum of—

- (i) the [extent to which the value of such carryover basis property exceeds the adjusted basis of such property immediately before the death of the decedent], reduced by an amount equal to all adjustments for depreciation . . . for the holding period of such property, and then multiplied by the applicable fraction . . . , and
- (ii) the adjustments to basis for depreciation . . . which are attributable to that portion of the holding period for such property which occurs before January 1, 1977.³³

An example may help to clarify the foregoing rule. Assume the purchase of fully depreciable, carryover basis property on January 1, 1972, at a cost of \$18,000. Assume straight line depreciation, a useful life of 30 years, and annual depreciation deductions of \$600. On January 1, 1982, the decedent dies and at this time the property has a value of \$40,000. Inasmuch as the property was held exactly five years before January 1, 1977, and exactly ten years in total, the applicable fraction is one-half.³⁴

Pursuant to section 1023(h)(2)(B), the carryover basis of this property is determined as follows:

- (1) The total depreciation deductions taken are \$6,000, so the adjusted basis at the date of death is \$12,000 (\$18,000-\$6,000).
- (2) The fair market value of the property at the date of death is \$40,000.
- (3) The excess of the fair market value at the date of death (\$40,000) over the adjusted basis (\$12,000) is \$28,000.
- (4) The total amount of depreciation deductions equal \$6,000, so the total appreciation in the property from acquisition to the date of death is \$22,000 (\$28,000 - \$6,000).
- (5) The applicable fraction is one-half.
- (6) The appreciation allocable to the period before January 1, 1977, is \$11,000 (\$22,000 x 1/2).
- (7) The depreciation allocable to the period before January 1, 1977, is \$3,000 (\$6,000 x 1/2).
- (8) The addition to basis is \$14,000 (\$11,000 plus \$3,000).
- (9) The total fresh-start basis is \$26,000 (\$14,000 adjustment plus \$12,000 date of death adjusted basis).³⁵

33. 1976 Act § 1023(h)(2)(B).

34. See 1976 Act § 1023(h)(2)(C).

35. This hypothetical was based on an example in Barkin, *New Rules for Basis*, in MAJOR ESTATE AND GIFT TAXATION—CHANGES OF THE 1976 TAX REFORM ACT 3.3 (1976) (outline of Barkin Lecture, *supra* note 31, available from The Florida Bar, Continuing Legal Education).

Several aspects of this special valuation rule for the fresh-start adjustment must be noted. First, this special valuation rule to arrive at the December 31, 1976, value is required and must be used even if it is different than an actual December 31, 1976, value which was obtained by an appraisal.³⁶ Second, for purposes of this adjustment, the fair market value of property on the date of the decedent's death is to be determined under section 2031, or 2032A in the case of electing farms or closely-held businesses, but not under the alternate valuation date rules of section 2032.³⁷ Last, it may be expected that the Internal Revenue Service will adopt treasury regulations to treat certain substantial improvements on property as separate property for purposes of this adjustment.³⁸

After determination of the fresh-start adjustment of the carryover basis property, several other basis adjustments must be made.³⁹ First, the carryover basis is increased by federal and state estate taxes attributable to the appreciation in the carryover basis property.⁴⁰ If after this adjustment the total adjusted carryover basis does not exceed \$60,000 then such adjusted basis is increased by the excess of \$60,000 over such adjusted basis.⁴¹ Finally, the basis of any appreciated carryover basis property is then increased by any state death taxes *paid by a distributee of carryover basis property* which are attributable to any remaining appreciation in the carryover basis property received by the distributee.⁴² In all events, however, no basis of any asset may be increased by the foregoing adjustments in excess of the asset's fair market value on the decedent's date of death.⁴³

B. Adjustment for Federal and State Estate Taxes— "Appreciation Adjustment"

The first adjustment increases the basis of the appreciated carry-

36. 1976 Act § 1023(h)(2)(A); CONFERENCE REPORT, *supra* note 28, at 613.

37. *Id.*

38. 1976 Act § 1023(h)(2)(D); CONFERENCE REPORT, *supra* note 28, at 613.

39. Authority for the proposition that the "fresh-start" adjustment precedes all other adjustments is found in the following language of the committee reports: "Any increase in basis permitted by the 'fresh-start' rule is made before any other adjustments are made to the property's basis for Federal and State death taxes and minimum basis." CONFERENCE REPORT, *supra* note 28, at 613. Further support for this proposition is found in parenthetical language in § 1023(c), (d), (e), and (f)(2) of the 1976 Act.

40. 1976 Act § 1023(c).

41. *Id.* § 1023(d).

42. *Id.* § 1023(e). In Florida, there are no such state succession taxes paid by a beneficiary. Rather, Florida's tax is imposed on the estate. *See* FLA. STAT. § 198.02 (1975); lecture by Sydney S. Traum, The Florida Bar Continuing Legal Education Seminar on Fiduciary Accounting—Tax Aspects of Fiduciary Accounting, in Jacksonville, Florida (May 27, 1977) [hereinafter cited as Traum Lecture].

43. *Id.* § 1023(f)(1), (g)(1).

over basis property "which is subject to tax"⁴⁴ by an amount which bears the same ratio to the federal and state estate taxes as the "net appreciation" in value of such property bears to the fair market value of all property which is subject to estate taxation.⁴⁵ As is stated in the committee reports,⁴⁶ the purpose of this adjustment is to prevent a portion of the appreciation of carryover basis assets from being subject to both an estate tax and an income tax. Although it can be said that the amount of the increase provided for by subsection 1023(c) is the unknown, as will be demonstrated by the following discussion, the other variables in this computation are hardly "knowns" at the outset. The computations involved in arriving at this "appreciation adjustment" are best understood by considering the computation of each variable individually, and then inserting each one into the formula to find the unknown.

First, federal and state estate taxes must be determined. Section 1023 defines federal and state estate taxes as follows:

(A) the tax imposed by section 2001 [estate tax on decedent citizen or resident of U.S.] or 2101 [estate tax on decedent nonresident, not U.S. citizen], reduced by the credits against such tax, and

(B) any estate, inheritance, legacy, or succession taxes, for which the estate is liable, actually paid by the estate to any State or the District of Columbia.⁴⁷

44. The manner of determining the amount "subject to tax" is discussed in text at notes 52-58 *infra*.

45. 1976 Act § 1023(c). The formula set forth in section 1023(c) can be represented by the following fraction:

$$\frac{\text{amount of increase (unknown)}}{\text{federal and state estate taxes}} = \frac{\text{"net appreciation" in value of carryover basis property subject to tax}}{\text{fair market value of all property which is subject to tax}}$$

However, inasmuch as the "federal and state estate taxes" and the "property subject to tax" elements of the fraction will remain constant for any given estate while the net appreciation will vary for each item of property, it would appear that the following fraction would be easier to work with than that suggested by the Code:

$$\frac{\text{Amount of increase (unknown)}}{\text{federal and state estate taxes}} = \frac{\text{"net appreciation" in value of carryover basis property subject to tax}}{\text{fair market value of all property which is subject to tax}} \times \frac{\text{federal and state estate taxes}}{\text{fair market value of all property which is subject to tax}}$$

This formula would allow use of a constant (taxes over property subject to tax) which is to be multiplied times the net appreciation in value of each item of carryover basis property subject to tax.

46. ESTATE AND GIFT TAX REPORT, *supra* note 4, at 39.

47. 1976 Act § 1023(f)(3).

In analyzing this statutory language, it should first be noted that the federal estate tax is to be reduced by all credits prior to computation.⁴⁸ Second, "estate taxes" for purposes of the section 1023(c) computation include state estate taxes where the estate is liable for the tax *and* where the taxes are actually paid by the estate.⁴⁹ Thus, state succession taxes paid by one other than the estate, such as the widow or widower, will not be considered "estate taxes" for purposes of this computation.⁵⁰

After computation of the federal and state estate taxes, a determination must be made of the "fair market value⁵¹ of all property which is subject to the [estate tax]."⁵² It is first necessary to determine what property is subject to tax. The Code provides some assistance in section 1023(f)(4) which states that

[f]or purposes of [1976 Act § 1023(c)] . . . , property shall be treated as not subject to a tax—

(A) with respect to the tax imposed by section 2001 or 2101, to the extent that a deduction is allowable with respect to such property under section 2055 or 2056 or under section 2106(a)

(2)

Thus, property for which a charitable or marital deduction is allowed for estate tax purposes is not considered "subject to tax."⁵³ For

48. Credits against estate tax take various forms including, among others, the unified credit (1976 Act § 2010), the credit for state death taxes (1976 Act § 2011), the credit for gift taxes (1976 Act § 2012), the credit for taxes on prior transfers (1976 Act § 2013) and the credit for foreign death taxes (1976 Act § 2014).

49. 1976 Act § 1023(f)(3)(B). Florida's estate tax is of this variety. *See* FLA. STAT. § 198.02 (1975).

50. ESTATE AND GIFT TAX REPORT, *supra* note 4, at 39-40, 42.

51. For purposes of section 1023, "fair market value" is defined as the value as determined under chapter 11; that is, the value for federal estate tax purposes. 1976 Act § 1023(g)(1).

Thus, if property is valued under the alternate valuation method [I.R.C. § 2032] or the special valuation method [1976 Act § 2032A] in the case of a farm or closely held business, that alternate or special value is to be used to determine the amount of appreciation for purposes of making all the adjustments to the carryover basis.

ESTATE AND GIFT TAX REPORT, *supra* note 4, at 39.

52. 1976 Act § 1023(c)(2).

53. The committee reports express an intent that only the property "actually used" to fund the marital or charitable bequest will be deemed not subject to tax.

For example, assume that the decedent makes bequests of specific property to his children and then leaves the residue of his estate to his surviving spouse. Property in the residue that is used to pay administration expenses and estate taxes does not qualify for the marital deduction and, consequently, such property is "subject to tax" under this rule even though the property was originally part of the residue.

ESTATE AND GIFT TAX REPORT, *supra* note 4, at 40 (footnote omitted).

example, if a decedent dies with a gross estate of \$400,000 consisting of \$10,000 fair market value personal property and \$390,000 fair market value stock, and assuming he or she leaves the entire estate to the spouse (thereby securing a \$250,000 marital deduction),⁵⁴ the fair market value of all property "subject to tax" for purposes of section 1023(c)(2) is \$150,000.⁵⁵

In addition to the foregoing rules, section 1023(g)(4) requires another adjustment in arriving at the amount "subject to tax" in the case of mortgaged property.⁵⁶ Simply stated, this provision requires, for purposes of the section 1023 appreciation adjustment, that the fair market value of property treated as included in the gross estate be computed net of any mortgages or indebtedness.⁵⁷ For example,

54. 1976 Act § 2056(c)(1)(A).

55. In addition to the foregoing rule regarding marital deduction and charitable bequest property, the committee reports indicate that the "surviving spouse's share of community property is not considered to be 'subject to tax'" inasmuch as it is not considered part of the decedent's gross estate. ESTATE AND GIFT TAX REPORT, *supra* note 4, at 40.

56. 1976 Act § 1023(g)(4) provides in pertinent part that if

- (A) there is an unpaid mortgage on, or indebtedness in respect of, property,
- (B) such mortgage or indebtedness does not constitute a liability of the estate, and
- (C) such property is included in the gross estate undiminished by such mortgage or indebtedness,

then the fair market value of such property to be treated as included in the gross estate shall be the fair market value of such property, diminished by such mortgage or indebtedness.

57. 1976 Act § 1023(g)(4); ESTATE AND GIFT TAX REPORT, *supra* note 4, at 40-41. While the rule of section 1023(g)(4) is simple to state, the rationale for the provision is somewhat more complex. Basically, the necessity for the provision arises as a result of different treatment under the estate tax provisions for recourse and nonrecourse mortgages. Under present estate tax law, where the estate is liable for the amount of the mortgage, the full fair market value of the property subject to mortgage or indebtedness is included in the gross estate and the amount of the indebtedness constitutes a deduction under section 2053. Treas. Reg. § 20.2053-7. By contrast, in the case of a nonrecourse mortgage where the estate is not liable, the mortgaged property is included in the decedent's gross estate at the net value (the fair market value less the amount of the mortgages). Thus, while the estate tax is based on the net value of the property in both cases, in the recourse situation the gross estate is greater. The section 1023(g)(4) adjustment is required to insure that property subject to a nonrecourse mortgage will be treated equitably for purposes of section 1023(c). ESTATE AND GIFT TAX REPORT, *supra* note 4, at 40-41.

A simple example demonstrates the necessity of the mortgage adjustment rule. Assume the case of estate A with the sole asset consisting of realty with a fair market value of \$500,000, a fresh-start basis of \$50,000, and a recourse mortgage in the amount of \$250,000. The estate tax computations would be as follows assuming no deductions other than the mortgage:

Gross Estate	\$500,000
Less: Deductions (Mortgage)	250,000
Taxable Estate	<u>\$250,000</u>
Tax	<u>\$ 70,800</u>
Less: Unified Credit (1977)	30,000
Estate Tax	<u><u>\$ 40,800</u></u>

By contrast, assume that estate *B* has a sole asset of realty with a fair market value of \$500,000, a fresh-start basis of \$50,000 and a nonrecourse mortgage of \$250,000. Pursuant to section 20.2053-7 of the Treasury Regulations, the estate tax computations would be as follows:

Gross Estate	\$250,000
Less: Deductions	-0-
Taxable Estate	<u>\$250,000</u>
Tax	<u>\$ 70,800</u>
Less: Unified Credit (1977)	30,000
Estate Tax	<u><u>\$ 40,800</u></u>

In spite of the different types of mortgages involved, both hypotheticals produce the same estate tax, \$40,800.

Absent the mortgage adjustment rule of section 1023(g)(4), however, the appreciation adjustments provided by section 1023(c) for the two estates would be different, as demonstrated below.

Appreciation Adjustment—Estate A	
Federal and state estate taxes	= \$40,800
Fair market value of all property "subject to tax" (absent 1976 Act § 1023(g)(4))	= 500,000
Net appreciation of carryover basis property subject to tax (500,000 - 50,000)	= 450,000

Applying the formula at note 45 *supra*, the following appreciation adjustment is obtained:

X	=	\$450,000
<u>\$40,800</u>	=	<u>\$500,000</u>
X	=	.9 x 40,800
X	=	\$36,720

Thus, the fresh-start basis of \$50,000 would be increased by \$36,720 to \$86,720.

By contrast Estate *B* would have the following results:

Appreciation Adjustment—Estate B	
Federal and state estate taxes	= \$40,800
Fair market value of all property "subject to tax" (absent 1976 Act § 1023(g)(4))	= 250,000
Net appreciation of carryover basis property subject to tax (250,000 - 50,000)	= 200,000

Applying the formula at note 45 *supra*, the following appreciation adjustment is obtained:

assume a hypothetical gross estate consisted primarily of real estate which was worth \$1,000,000 with a basis of \$50,000, and upon which there was an unpaid mortgage of \$500,000 that was not an obligation of the estate. Under section 1023(g)(4), the fair market value of the real estate for purposes of increasing the basis of the property by federal and state estate taxes is only \$500,000. This \$500,000 is the amount which created additional estate taxes. As such, only the estate tax attributable to the appreciation in that amount (\$500,000) of the real estate should be allocated to the property. Since the basis is \$50,000, there is net appreciation of \$450,000. Consequently, the federal and state estate taxes attributable to the \$450,000 net appreciation are added to the fresh-start basis of the real estate.⁵⁸

X	=	\$200,000
<u>\$40,800</u>	=	<u>\$250,000</u>
X	=	.8 x \$40,800
X	=	\$32,640

Thus, the fresh-start basis of \$50,000 would be increased by \$32,640 to \$82,640.

Obviously, the recipient of the real property from Estate *A* (recourse mortgage) would be inequitably benefitted to the extent of \$4,080 (\$86,720 - \$82,640). The effect of section 1023(g)(4) will be to put both estates on an equal footing by computing the appreciation adjustment as was done above in Estate *B*.

58. See ESTATE AND GIFT TAX REPORT, *supra* note 4, at 41. One question to be considered is how to compute the appreciation adjustment if both a mortgage and a marital deduction are involved. While the issue was not specifically discussed in either the committee reports or in the Code itself, there appears to be authority for (1) making the initial mortgage adjustment of section 1023(g)(4) for determining the fair market value of property treated as included in the gross estate prior to the marital deduction adjustment of section 1023(f)(4), and (2) then referring to the mortgage adjustment rule to establish the fair market value of the asset to be used in section 1023(f)(2) to determine net appreciation. The following example will clarify this confusing statement.

Assume an estate with one asset, real estate, which has a fair market value of \$1,000,000, a recourse mortgage liability of \$500,000 and a fresh-start basis of \$50,000. Assume further that the property is devised to the decedent's spouse and that the marital deduction available is \$250,000. The estate tax on such an estate would be computed as follows:

Gross Estate	\$1,000,000
Less: mortgage	\$500,000
marital deduction	<u>\$250,000</u>
Deductions	\$ 750,000
Taxable Estate	<u>\$ 250,000</u>
Tax	\$ 70,800
Less: unified credit (1977)	\$ 30,000
Estate Tax	<u><u>\$ 40,800</u></u>

For purposes of the appreciation adjustment as provided by section 1023(c), it would appear that the first step is to apply the section 1023(g)(4) mortgage adjustment and to assign the value of \$500,000 as the "fair market value of . . . property to be treated as included in the gross estate." That this adjustment should be the initial

The final computation which must be made in order to calculate the appreciation adjustment is a determination of the "net appreciation" in value of appreciated carryover basis property subject to tax. "Net appreciation" is defined by the pertinent part of section 1023(f)(2) as follows:

one is suggested by the committee reports and the Code itself. First, the committee reports state that under this adjustment, "the fair market value of the real estate for purposes of increasing the basis of the property by Federal and State estate taxes is only [\$500,000]." ESTATE AND GIFT TAX REPORT, *supra* note 4, at 41 (emphasis added). It should be noted that the committee report does not state that the "fair market value subject to tax" is only \$500,000. Thus, when section 1023(c)(2) refers to the "fair market value of all property which is subject to the tax," it would appear that the "fair market value of all property" language, without more, would be referring to the \$500,000 in this case after the section 1023(g)(4) adjustment.

With \$500,000 as the fair market value of property being treated as included in the gross estate, the next step would appear to be the application of the marital deduction adjustment, section 1023(f)(4), to determine the "fair market value of all property subject to the tax." As has been discussed in text at notes 53-55 *supra*, this is accomplished by reducing the amount of the property treated as included in the gross estate (\$500,000) by the amount of the marital deduction (\$250,000). 1976 Act § 1023(f)(4). As such, it would appear that the amount "subject to tax" in this example is \$250,000.

The next step is the computation of the net appreciation *in the value of carryover basis property subject to tax*. 1976 Act § 1023(c)(1). In determining this amount a close look at the definition of "net appreciation" will be helpful.

Under section 1023(f)(2), "net appreciation" is "the amount by which the fair market value of [carryover basis property subject to tax] exceeds the adjusted basis of such property immediately before the death of the decedent (as determined after [the fresh-start adjustment])." As has already been established, the "fair market value of . . . property to be treated as included in the gross estate" is \$500,000. Further, the amount of that property "subject to tax" is \$250,000. As such, it would appear that the "net appreciation" would be determined as follows. Inasmuch as only part of the appreciated property is subject to tax, only part of the appreciation should be included in the numerator. Since only \$250,000 of the \$500,000 treated as the property included in the gross estate is "subject to tax," only 50% of the appreciation should be included in the "net appreciation" amount.

50% of fair market value	
(\$500,000)	= \$250,000
50% of basis (\$50,000)	= \$ 25,000
"net appreciation"	= <u>\$225,000</u>

On the basis of the foregoing, the appreciation adjustment would be determined as follows:

Estate Tax	\$ 40,800
Net Appreciation	\$225,000
Amount subject to tax	\$250,000
\$40,800 x $\frac{\$225,000}{\$250,000}$	= appreciation adjustment
appreciation adjustment	= \$36,720

On the basis of the appreciation adjustment alone, the new basis of the realty would equal \$86,720 (\$50,000 fresh-start basis plus \$36,720 appreciation adjustment).

For purposes of [section 1023], the net appreciation in value of any property is the amount by which the fair market value of such property exceeds the adjusted basis of such property immediately before the death of the decedent (as determined after any [fresh-start adjustment]).

As such, it would appear at first glance that the net appreciation is merely the fair market value of any property less the basis of that property. Unfortunately, the tax laws are not so simple.

It should be recalled that the net appreciation sought for purposes of the appreciation adjustment formula is the net appreciation of *appreciated carryover basis property which is subject to tax*.⁵⁹ This is, of course, perfectly logical. As was discussed above, the denominator of the Treasury's appreciation adjustment formula is the fair market value of all property "subject to tax." Thus, it follows that the numerator should likewise be concerned only with appreciation of property "subject to tax." A simple example should clarify this point. Assume that the amount of the property treated as included in the gross estate is \$500,000 and that a marital deduction of \$250,000 results in \$250,000 being "subject to tax."⁶⁰ Assume further that the estate consists of one appreciated asset with a fair market value of \$500,000 and a basis of \$250,000. Inasmuch as only one-half of the appreciated property is "subject to tax," that part of the appreciation is included in the numerator. Thus, although the property had appreciated in the amount of \$250,000, only \$125,000 of that appreciation constitutes "net appreciation" of appreciated carryover basis property which is subject to tax for purposes of section 1023(c)(1).⁶¹

After struggling through all the computations and subcomputations of the appreciation adjustment, one can hardly question that the provision is a complex one. In order to better explain the computation of the appreciation adjustment, assume the following hypothetical paraphrased from the committee reports.⁶² A decedent dies in 1977 with personal effects having a fair market value of \$10,000 and an adjusted basis of \$50,000 and stock having a fair market value of \$390,000 and a basis of \$39,000. Assume that the entire \$400,000 estate is left to the spouse, and that the estate claims the \$250,000 marital deduction authorized by the 1976 Tax Reform Act.⁶³ Assuming for simplicity that there are neither funeral nor administration expenses, and that no adjusted taxable gifts will be brought back

59. 1976 Act § 1023(c).

60. *See id.* § 1023(f)(4).

61. ESTATE AND GIFT TAX REPORT, *supra* note 4, at 42-43.

62. *Id.*

63. 1976 Act § 2056(c)(1)(A)(i).

into the gross estate by section 2001(b)(1)(B), the decedent's taxable estate is \$150,000. Under the 1976 Act section 2001(c), a taxable estate of \$150,000 produces a \$38,800 tentative tax, which results in an \$8,800 tax after the \$30,000 unified credit applicable to the estates of decedents dying in 1977.⁶⁴ Assuming a state death tax credit of \$400,⁶⁵ the gross estate tax is \$8,400.⁶⁶ Assume further that the executor makes the election provided in section 1023(b)(3) to exclude all of the personal assets from "carryover basis property." As a result of such election, these assets will receive a fair market value basis pursuant to section 1014(b).⁶⁷

Inasmuch as the estate will be granted a \$250,000 marital deduction, for section 1023(c) purposes \$250,000 of the \$400,000 gross estate is deemed not "subject to tax."⁶⁸ Thus, the denominator of the appreciation fraction is \$150,000.

As is set forth in the statute, the numerator of the appreciation fraction is to be the "net appreciation in value" of "appreciated carryover basis property . . . which is subject to tax."⁶⁹ Inasmuch as only a part of the appreciated property is subject to tax, only a part of the appreciation is included in the numerator. Since \$150,000 of the \$400,000 (or 37.5%) of the gross estate is subject to tax, a similar percentage of the stock's fair market value of \$390,000 ($37.5\% \times \$390,000 = \$146,250$) and of the stock's basis of \$39,000 ($37.5\% \times \$39,000 = \$14,625$) must be computed in order to determine the net appreciation in value of appreciated carryover basis property which is subject to tax. Thus, the fair market value of the portion of the carryover basis property subject to tax is \$146,250, and the basis of that portion is \$14,625. As such, the net appreciation numerator referred to in section 1023(c)(1) is \$146,250 less \$14,625, or \$131,625.

Applying the figures to the formula, the net appreciation of \$131,625 is divided by the \$150,000 amount subject to tax, which yields the factor .8775. This factor is then multiplied by the amount of estate taxes paid, \$8,400, which yields an appreciation adjustment of \$7,371. This amount is added to the \$39,000 basis of all carryover

64. *Id.* § 2010(b).

65. *Id.* § 2011(b).

66. The example set forth in the committee reports assumes state death taxes paid by the surviving spouse in the amount of \$400, an amount equal to the maximum state death tax credit allowed under section 2011(b). While the taxable estate in the example is \$150,000, for state tax credit purposes under section 2011(b) the "adjusted taxable estate" is \$90,000 (\$150,000 less \$60,000). 1976 Act § 2011(b).

67. I.R.C. § 1014(b).

68. 1976 Act § 1023(f)(4)(A).

69. *Id.* § 1023(c) (emphasis added).

basis property, for a total basis of \$46,371 after the appreciation adjustment.⁷⁰

C. Minimum Basis Adjustment

If after the appreciation adjustment and the fresh-start adjustment discussed above, the total adjusted basis of all carryover basis property⁷¹ is less than \$60,000, the total basis of all such property is increased by the excess of \$60,000 over such aggregate adjusted basis.⁷² For example, if the adjusted basis of all carryover basis property after the fresh-start and the appreciation adjustments equals only \$50,000, an increase to \$60,000 would be appropriate.

As in the case of the appreciation adjustment discussed above, it is important to take into consideration the fact that the minimum basis adjustment applies only to carryover basis property.⁷³ Thus, if the estate includes insurance and other non-carryover basis property of \$80,000 with a total of only \$50,000 "carryover basis property,"⁷⁴ the minimum basis adjustment is still available. Should the executor elect to treat \$10,000 of personal property or household goods as non-carryover basis property under section 1023(b)(3),⁷⁵ such property up to \$10,000 also would be excluded from "carryover basis property" in determining whether a minimum basis adjustment is appropriate.⁷⁶ If the fair market value of the personal property and the household effects exceeds \$10,000, the excess would be considered "carryover basis property." However, for purposes of the minimum basis adjustment, the adjusted basis of such carryover basis property would be limited to the lesser of the adjusted basis or the fair market value at the decedent's death.⁷⁷

Assuming a minimum basis adjustment is appropriate, how is it to be allocated among the estate assets? As provided in section 1023(d), the basis of each appreciated carryover basis asset (after fresh-start and appreciation adjustments, if any) is increased

70. ESTATE AND GIFT TAX REPORT, *supra* note 4, at 42-43.

71. The 1976 Act, § 1023(d)(1), and the committee reports, ESTATE AND GIFT TAX REPORT, *supra* note 4, at 41, both indicate that the aggregate bases of "all carryover basis property" must be used for the minimum basis computation. At this point, there is no concern as to whether the carryover basis property has appreciated or depreciated.

72. 1976 Act § 1023(d); ESTATE AND GIFT TAX REPORT, *supra* note 4, at 41-42. It should be noted that the minimum basis adjustment is not available to any carryover basis property acquired from a decedent who was a nonresident alien at the time of his death. 1976 Act § 1023(d)(3); ESTATE AND GIFT TAX REPORT, *supra* note 4, at 41-42.

73. See 1976 Act § 1023(d)(1).

74. See 1976 Act § 1023(b).

75. See text at notes 14-25 *supra*.

76. ESTATE AND GIFT TAX REPORT, *supra* note 4, at 41.

77. 1976 Act § 1023(d)(2); ESTATE AND GIFT TAX REPORT, *supra* note 4, at 41.

by an amount which bears the same ratio to the amount of such excess as—

- (A) the net appreciation in value of such property, bears to
- (B) the net appreciation in value of all such property.⁷⁸

For a simple example, assume that the adjusted basis of all carryover basis property (after the fresh-start and appreciation adjustments) was \$50,000 and that the "excess" referred to above was \$10,000. If appreciated carryover basis property *A* had "net appreciation" of \$2,000 as compared to \$20,000 "net appreciation" of all appreciated carryover basis property, \$1,000 of the \$10,000 "excess" basis would be attributable to property *A*. As in the case of the appreciation adjustment, however, the minimum basis adjustment may not increase the adjusted basis of any carryover basis property in excess of the property's fair market value.⁷⁹

D. State Succession Tax Adjustment

The final adjustment increases the basis of appreciated carryover basis property by any state death taxes paid by a distributee of carryover basis property which are attributable to any remaining appreciation in such property.⁸⁰ Inasmuch as Florida does not have any such state succession tax payable by a beneficiary,^{80.1} this adjustment is of limited concern to Florida practitioners. Its principles will be reviewed, however, for academic purposes.

In making this final adjustment, a number of rules must be applied. First, the basis of the carryover basis property will be subject to the state succession tax adjustment only if the adjustments of sections 1023(c), (d), and (h), if any, have already been applied to the property.⁸¹ Second, as in the case of the appreciation adjustment, the state succession tax adjustment is made only with respect to property which is "subject to tax" as that phrase is explained in section 1023(f)(4)(B).⁸² Third, the adjustment is limited to the appreciation element of the carryover basis property.⁸³ Finally, the mortgage adjustment

78. 1976 Act § 1023(d)(1).

79. *Id.* § 1023(f)(1).

80. *Id.* § 1023(e).

80.1 Florida's estate tax is contained in chapter 198, Florida Statutes, and its imposition falls on the estate, not on the beneficiaries. See FLA. STAT. § 198.02 (1975); Traum Lecture, *supra* note 42.

81. *Id.* § 1023(e)(2).

82. *Id.* § 1023(e)(2)(B); ESTATE AND GIFT TAX REPORT, *supra* note 4, at 42.

83. 1976 Act § 1023(e)(2)(A).

rule of section 1023(g)(4) also applies to the computation of the state succession tax adjustment.⁸⁴

For a simple application of this rule⁸⁵ assume that the basis for carryover basis property is \$60,000 after the fresh-start, appreciation, and minimum basis adjustments. Assume also that the fair market value of the one carryover basis asset in the estate is \$390,000, and that the fair market value of all property in the gross estate is \$400,000. Assume further a state succession tax of \$400. In this example, the appreciation in the carryover basis asset is clearly \$390,000 less \$60,000, or \$330,000. If the state succession tax is based on the entire amount of the property passing to the beneficiary, the "fair market value of all property acquired by [the beneficiary] which is subject to taxes" is \$400,000, resulting in a fraction of \$330,000/\$400,000. If the state succession taxes are \$400, this results in a state succession tax adjustment equal to \$330. Such an adjustment would increase the carryover basis from \$60,000 to \$60,330.⁸⁶

IV. PECUNIARY BEQUESTS

In addition to requiring detailed computations to determine the basis of an asset acquired from a decedent, the carryover basis rules created the potential for inequity in light of the two basic marital deduction formula clauses and the *Kenan* rule.⁸⁷ To alleviate this problem, Congress included in the Tax Reform Act section 1040 which limits the amount of gain recognized when carryover basis property is used to satisfy a pecuniary bequest. Some digression is required to understand the potential inequity which has been avoided by section 1040.

Two basic marital deduction formula clauses are employed in estate planning to secure the maximum allowable marital deduction

84. *Id.* § 1023(g)(4); ESTATE AND GIFT TAX REPORT, *supra* note 4, at 42. See generally text at notes 56-58 *supra*.

85. A formula can be stated:

"net appreciation" in
value of the
carryover basis
asset received
by the beneficiary

fair market value of
all property acquired
by such person which
is subject to taxes

$$\begin{array}{rcl} \text{X total state} & & = \text{state succession} \\ \text{succession} & & \text{tax increase} \\ \text{tax paid} & & \text{to basis} \end{array}$$

86. ESTATE AND GIFT TAX REPORT, *supra* note 4, at 42-43.

87. *Kenan v. Commissioner*, 114 F.2d 217 (2d Cir. 1940), discussed in detail in note 91 *infra*.

without overqualifying the surviving spouse's gross estate; the "fractional share formula" and the "pecuniary formula."⁸⁸ Under the "fractional share formula," the surviving spouse is treated as receiving "a fraction of each asset" in the decedent's estate, and there is no taxable transaction when the spouse receives his or her share of the assets.⁸⁹ By contrast, under the "pecuniary formula," the surviving spouse receives "an amount" equal to a certain percentage of the decedent's estate.⁹⁰ Satisfaction of the right to receive such "an amount" is treated as a taxable transaction under *Kenan*.⁹¹

Prior to 1977, this divergent tax treatment of a satisfaction of the two different types of formula marital deduction clauses did not give rise to any inequitable results. Although a *Kenan* gain was possible in the satisfaction of a pecuniary formula bequest, any such gain was usually very nominal due to the fact that the estate took a step-up in basis to the fair market value at the decedent's date of death.⁹²

With the enactment of the carryover basis rules, this practical equality in tax treatment between the two clauses would have come to an end absent section 1040. For example, if the estate of a decedent received property with a fair market value of \$200, but with a carryover basis (as adjusted) of \$100, use of this appreciated property to satisfy a pecuniary bequest of \$200 would result in a \$100 gain to the estate.⁹³ No such gain would occur in the case of the fractional share formula (assuming that the estate distributes to the spouse his or her share of each asset), due to the lack of a taxable transaction.⁹⁴

To remedy this problem, Congress enacted section 1040 which provides in pertinent part that

[i]f the executor of the estate of any decedent satisfies the right of any person to receive a pecuniary bequest with appreciated carry-over basis property . . . , then gain on such exchange shall be

88. For a detailed discussion of the marital deduction and the various formula and non-formula clauses to provide for it, see A. CASNER, *ESTATE PLANNING* 783-874 (3d ed. 1961 & Supp. 1974).

89. See *ESTATE AND GIFT TAX REPORT*, *supra* note 4, at 44.

90. *Id.* at 44-45.

91. In *Kenan*, a sum certain was due to be payable to one Louise Wise. The amount could have been satisfied by the transfer of marketable securities of an equivalent fair market value. The amount was paid partly in cash and partly in securities. In *Kenan*, Judge Augustus Hand ruled that the satisfaction of the right to receive the "amount" constituted a taxable exchange—the satisfaction was treated as though the trustee distributed cash to the beneficiary who then purchased the property at its fair market value. 1 S. SURREY, W. WARREN, P. MCDANIEL & H. AULT, *FEDERAL INCOME TAXATION*, 974-78 (1972).

92. *ESTATE AND GIFT TAX REPORT*, *supra* note 4, at 44-45.

93. *Id.*

94. *Id.*

recognized to the estate only to the extent that, on the date of such exchange, the fair market value of such property exceeds the value of such property [used for purposes of the estate tax of Chapter 11].⁹⁵

A similar rule is provided for distributions of carryover basis property from trusts.⁹⁶ Lastly, where section 1040 is employed, the basis of any asset distributed to a beneficiary pursuant to its provisions is the carryover basis increased by the amount of gain recognized to the estate or trust.⁹⁷

V. EXECUTOR'S DUTY TO FURNISH BASIS INFORMATION

Sections 6039A and 6694, enacted as part of the estate and gift tax package of the 1976 Tax Reform Act, require the filing of informational returns concerning the bases of assets and provide penalties for the failure to so file. Specifically, section 6039A requires every executor to furnish (1) to persons acquiring property from a decedent, a statement as to the adjusted basis of each item of property so acquired,⁹⁸ and (2) to the Secretary of the Treasury, such information as the Secretary may by regulation prescribe.⁹⁹ At first glance, these provisions might appear to require merely the filling out of yet another form; however, the complexity involved in the computations of a carryover basis (especially as related to the several adjustments to basis) is enough to increase significantly the duties of an attorney representing an estate. The truth of this assertion becomes clear when it is realized that the reporting requirements of section 6039A must be met by

95. 1976 Act § 1040(a).

96. *Id.* § 1040(b).

97. *Id.* § 1040(c). It should be noted that section 1040(c) which requires the pecuniary legatee to take the appreciated property at a carryover basis is a substantial departure from prior law. As was indicated in text at note 92 *supra*, prior to the Tax Reform Act of 1976 the estate received the property from the decedent with a stepped-up basis. The legatee likewise received the property at its fair market value. Under the new carryover basis rules, the estate still has no gain on the satisfaction of a pecuniary legacy in kind, but the legatee now finds himself with a carryover basis. If the legatee intends to hold the property he might not object to the carryover basis. However, if the legatee wants to dispose of the asset by sale, he is likely to be very dissatisfied receiving property with a low carryover basis instead of cash. See Stansbury & Blazek, *supra* note 10, at 16-17.

98. 1976 Act § 6039A(b). The committee reports note that the adjusted basis provided to each recipient of assets will usually be the carryover basis of the property as adjusted by the (1) fresh-start adjustment, (2) the "appreciation adjustment" and (3) the minimum basis adjustment, but prior to the state succession tax adjustment. ESTATE AND GIFT TAX REPORT, *supra* note 4, at 45-46. In some cases, however, that basis will be the fair market value of the property at the decedent's date of death. See 1976 Act § 1023(b)(3).

99. 1976 Act § 6039A(a).

"every executor," not only executors of estates required to pay an estate tax or file a 706 return.¹⁰⁰

Moreover, section 6694 imposes civil pecuniary penalties for failure to comply with section 6039A.¹⁰¹ Basically, section 6694 provides penalties of (1) \$50 for each failure to follow section 6039A (but not to exceed \$2,500) with respect to the beneficiary information return,¹⁰² and (2) \$100 for each failure (but not in excess of \$5,000) to furnish to the IRS the information required.¹⁰³ The penalty provisions may be avoided by a showing that the failure was due to "reasonable cause and not willful neglect."¹⁰⁴

VI. ESTATE PLANNING CONSIDERATIONS

A. Life Insurance Payable to Estate

It should be clear that the enactment of the carryover basis rules will have a dramatic effect upon estate planning and will require attorneys to develop new methods and strategies to cope with problems caused by the new basis rules. For example, the new rules suggest that it now may be wise to designate an insured's estate as the beneficiary of at least some life insurance proceeds.¹⁰⁵ An analysis of the pre-1977 and post-1976 basis rules should make this clear.

One of the principal obligations of an executor after collecting the estate assets is to determine the amount of liquidity needed to pay estate taxes, administration expenses and funeral expenses, and if necessary, to sell assets to meet those expenses.¹⁰⁶ Under pre-1977 law, the executor did not ordinarily have to consider the basis of the various assets in determining which should be sold.¹⁰⁷ Inasmuch as section 1014 provided a step-up to the date of death fair market value, an asset usually could be sold without the executor having to concern himself with the amount of gain to be recognized on the sale. Usually such gain was nonexistent or nominal in amount. By contrast, since such assets now may have a carryover basis, any sale by the executor to raise funds for administration expenses and estate taxes will have the

100. *Id.*

101. *Id.* § 6694.

102. *Id.* § 6694(b).

103. *Id.* § 6694(a).

104. *Id.* § 6694(a), (b).

105. Stansbury & Blazek, *supra* note 10, at 16, 18; Stansbury & Blazek, *Carryover Basis*, in 2 AMERICAN LAW INSTITUTE—AMERICAN BAR ASSOCIATION, TAX REFORM ACT OF 1976, at 44 (1976) [hereinafter cited as Stansbury & Blazek, ALI-ABA].

106. Stansbury & Blazek, *supra* note 10, at 16; French, *Functions of Lawyers and Personal Representatives*, in THE FLORIDA BAR, FLORIDA PROBATE PRACTICE § 4.9 (1968).

107. Stansbury & Blazek, *supra* note 10, at 16.

potential for creating capital gains which will create income taxes for the estate.¹⁰⁸ To remedy this problem, it is recommended that the insured designate his estate as the beneficiary of some of his insurance policies. This would assure sufficient liquidity, thereby avoiding sales of assets which might produce taxable income.¹⁰⁹

B. Effect on Buy-Sell Agreements

In the area of estate planning for closely-held businesses, it appears that the carryover basis rules may discourage the use of stock redemption agreements as compared with cross purchase plans.¹¹⁰ Further, as a result of the loss of the step-up in basis at death, the new rules may discourage the use of buy-sell agreements of both varieties, or at least require additional planning for liquidity at death. A basic understanding of the aspects of cross purchase plans and stock redemption plans is required before the effect of the new carryover basis rules can be appreciated.

Stock redemption plans and cross purchase plans are forms of business purchase agreements which provide for an orderly method of terminating a person's business interest in the event of death.¹¹¹ The two types of plans employ different means to achieve this objective.

Under a cross purchase plan, upon the death of a shareholder his or her estate is obligated to sell, and the surviving shareholder is obligated to buy, the decedent's shares. This type of plan is often funded by life insurance, with each shareholder owning insurance on the life of the other. When the surviving shareholder receives the insurance proceeds and pays them to the decedent's estate, the survivor gets a cost basis for the shares purchased.¹¹² Assume Able and Baker each own fifty shares of *A&B Co.*, and that each has a basis of \$10,000 in his fifty shares. Assume further that the cross purchase plan provides that the fifty shares of the decedent are to be sold to the survivor for \$50,000. Upon the death of the first (Able), the survivor (Baker) pays

108. *Id.*

109. *Id.* at 16, 18.

110. See *ADVANCED UNDERWRITER*, Nov. 1976, at 12 (published by Connecticut Mutual Life Ins. Co.).

111. Litman, *Buy-Sell Agreements for a Closely Held Corporation*, 52 *FLA. B.J.* 555 (1976). Some of the other important purposes of business purchase agreements include (1) providing a decedent's estate with sufficient funds to pay estate taxes and administration expenses when there is no ready market for the decedent's closely-held stock, (2) assuring continuity in the management of the business, and (3) fixing the estate tax value of the stock.

112. *Id.* at 557. See generally Nichols, *Business Purchase Agreements*, in *THE FLORIDA BAR, ORGANIZING AND ADVISING SMALL FLORIDA BUSINESSES*, ch. 10 (1969).

\$50,000 for Able's fifty shares, and gets a basis in the entire business equal to \$60,000 (\$50,000 plus his original cost basis of \$10,000). By contrast, under the corporate stock redemption plan the corporation is obligated to purchase the decedent's shares. If insurance is used to fund the redemption agreement, the corporation is the owner. On the death of the first decedent, his estate sells the fifty shares to the corporation; the survivor then owns one hundred percent of the business merely because his fifty shares are now the only shares outstanding. In this situation the survivor's basis remains at \$10,000, the original cost of his fifty shares.¹¹³

Thus, if the survivor (Baker) decides to sell the business for \$100,000 during his life, the cross purchase basis of \$60,000 would result in less gain realized ($\$100,000 - \$60,000 = \$40,000$) than would the stock redemption plan basis of \$10,000 ($\$100,000 - \$10,000 = \$90,000$). However, prior to 1977, if the survivor (Baker) held the business until *his* death, his estate would get a step-up in basis to the fair market value (\$100,000),¹¹⁴ and his estate could then sell without gain realization. By contrast, under the carryover basis rules, Baker's estate will no longer get such a step-up in basis, and gain to the estate will be measured as the difference between the amount realized on sale and the carryover basis as adjusted. As such, it is clear that Baker's estate would be liable for less income tax if Baker had acquired Able's fifty percent interest by cross purchase.¹¹⁵

In addition, buy-sell agreements under the carryover basis rules are not as useful for tax planning as they were under the step-up basis rules of section 1014. Prior to 1977, one of the important factors encouraging the use of either plan was that the basis of the first decedent's shares was stepped up to fair market value at the death of the decedent.¹¹⁶ Thus, any subsequent sale or redemption of the stock produced little or no gain realized. For example, consider the case of Able and Baker, each of whom has a basis of \$10,000 in his fifty shares. Under the old rules, the estate of the first decedent would get to step-up the basis of the shares to the fair market value at the date of death (assume that to be \$50,000).¹¹⁷ Instead, under the new carryover basis rules, the \$10,000 original basis, with some adjustments, is carried over. Sale of the fifty shares by the estate now will produce a considerable gain (\$50,000 less [\$10,000 plus adjustments]). Thus, the estates of clients having business buy-sell agreements might face

113. Litman, *supra* note 111, at 557.

114. I.R.C. § 1014(a).

115. ADVANCED UNDERWRITER, *supra* note 110, at 12.

116. I.R.C. § 1014; *see* text at notes 1-5 *supra*.

117. *See* note 5 *supra*.

liquidity problems if practitioners fail to give sufficient attention to the possibility of a sizable capital gains tax on a sale of the decedent's business interest.¹¹⁸

C. Other Estate Planning And Drafting Considerations

A number of additional estate planning matters relating to the carryover basis rules should be considered. First, for the immediate future the benefits of a section 1014 step-up in basis are partially preserved in the section 1023(h) fresh-start adjustment.¹¹⁹ As such, it is probably still better for persons to make inter vivos gifts of high basis assets; it is preferable for a decedent to die holding low basis, highly appreciated assets if the appreciation has occurred over a substantial period of time.¹²⁰ However, the greater the time between December 31, 1976, and a decedent's death, the less significant the fresh-start adjustment becomes.

Second, the estate planner should advise his clients of the importance of establishing their adjusted bases for all assets held where the bases are not otherwise apparent.¹²¹ Marketable securities, which use the December 31, 1976, value as the carryover basis, should pose no problem. For other significant assets, however, detailed records should be compiled.¹²²

Finally, in distributing the assets the executor must consider not only the value of the property but also its basis and how that basis affects all beneficiaries entitled to the decedent's property.¹²³ For example, if both beneficiaries, Alex and Brad, were entitled to receive an amount equal to \$500 and if property with a value of \$500 were distributed to each, most taxpayers would favor the asset with the higher carryover basis.¹²⁴ Thus, if Brad receives property with a basis of \$100

118. Designation of the insured's estate as the beneficiary of some insurance policies would appear to help alleviate this liquidity problem. See text at notes 105-09 *supra*; Barkin Lecture, *supra* note 31.

119. See text at notes 26-43 *supra*.

120. See Stansbury & Blazek, *supra* note 10, at 19; Barkin Lecture, *supra* note 31.

121. Stansbury & Blazek, ALI-ABA *supra* note 105, at 44; Barkin Lecture, *supra* note 31.

122. In all likelihood it will be the executor, or his attorney, who compiles the adjusted basis records. Thus, the executor is faced with the task of compiling four different values for each asset: (1) the cost or adjusted basis, (2) the December 31, 1976, value, (3) the date of death value, and (4) the alternate valuation date value. Barkin Lecture *supra* note 31; Stansbury & Blazek, ALI-ABA, *supra* note 105, at 45.

123. See Stansbury & Blazek, *supra* note 10, at 16-19 for an excellent discussion of estate planning and this aspect of the new carryover basis rules. See also Stansbury & Blazek, ALI-ABA, *supra* note 105, at 44-45.

124. In this situation the beneficiaries' bases would be determined by section 1040(c). See note 97 *supra*.

while Alex receives property with a \$450 basis, it is quite clear that the two beneficiaries have not been treated equally. As such, it would appear prudent to avoid provisions which would allow executors to make such unequal in-kind distributions without taking the basis of the property distributed into consideration.

VII. CONCLUSION

The new carryover basis rules of section 1023 probably will have a more profound effect on estate planning than any other estate and gift tax amendment since the introduction of the marital deduction in 1948.¹²⁵ This article obviously presents merely the top of an iceberg. Each day as executors grapple with the provisions of section 1023 and especially with its required adjustments, new law will be developed and tax practitioners will create estate plans to deal with its impact. It thus behooves the estate planner to develop and to maintain a working knowledge of the intricacies of the new legislation.

125. When enacted, the Technical Corrections Act of 1977 (H.R. 6715, *reprinted in* [1977] 6 *FED. TAXES* (P-H) ¶ 59,415) will change some of the carryover basis provisions of the 1976 act.