

# DETERMINING AN ASSET’S TAX BASIS IN THE ABSENCE OF A MEANINGFUL TRANSFER TAX REGIME

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*Until recently, in those circumstances where there was a valuation range with respect to a particular asset, executors faced a choice: among estates subject to the estate tax, declaring a high value would increase the estate tax liability; however, due to the Internal Revenue Code’s “basis equal to fair market value” rule applicable at death, declaring a low value would expose heirs to a greater capital gains tax on subsequent asset disposition. Because the estate tax rates were higher and that tax was immediate (as opposed to deferred until a later sale by the heir), executors typically minimized asset values, with the corresponding effect of tax basis diminishment. This commonplace strategy thus negated the possibility that taxpayers might exploit the basis equal to fair market rule.*

*But this is often no longer the case. Through a series of exemption level increases, tax rate reductions, and other reforms, Congress has gutted the nation’s transfer tax system. What remains is a teetering transfer tax system that applies only to a handful of the wealthiest taxpayers. For the rest, the transfer tax system provides no disincentive to executors from assigning the highest defensible valuations to a decedent’s assets, opening the opportunity to capitalize upon the basis equal to fair market value rule. Unfortunately, the I.R.S. lacks the tools and resources to combat this practice. To preserve the integrity of the capital gains tax and the revenue that it produces, Congress must therefore intercede.*

## TABLE OF CONTENTS

I.	INTRODUCTION.....	.....
II.	THE PRIOR TAX PARADIGM.....	.....
	A.	The Nation’s Formerly Robust Transfer Tax Regime.....
	B.	Disappearing Asset Value.....
	C.	The Basis Equal to Fair Market Value Rule.....
	D.	The Estate Planning Bar’s Role.....
III.	THE NEW TAX PARADIGM.....	.....
	A.	The Gutting of the Transfer Tax System.....
	B.	Tax Burden Levied on Capital Income.....
IV.	THE AFTERMATH: TAX BASIS MAXIMIZATION.....	.....
	A.	Taxpayer Objective: Exploitation of the Basis Equal to Fair Market Value Rule.....
	B.	Asset Basis Maximization Methodologies.....
	C.	IRS’s Inability to Police the Tax Basis Problem.....
	D.	Need for Congressional Reform.....
V.	CONCLUSION.....	.....

## I. INTRODUCTION

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For close to a century, when the federal transfer tax system (comprised of the gift, estate, and generation-skipping transfer taxes) broadly applied to estates of decedents with any significant wealth, an important goal of estate planners was to minimize value of a decedent's assets reported for estate tax purposes.<sup>1</sup> And for good reason: from 1941-1976, the top marginal estate tax rate was 77% (applying to taxable estates in excess of \$10,000,000), and, as recently as 2001, the top rate was 55% (applying to taxable estates in excess of \$3,000,000).<sup>2</sup>

But over the course of the last two decades, Congress has gutted the nation's transfer tax system. Beginning with the passage of the Economic Growth and Tax Relief Reconciliation Act of 2001<sup>3</sup> and ending in 2017 with the Tax Cuts and Jobs Act,<sup>4</sup> the amount that taxpayers can transfer free of transfer tax has risen approximately twenty-fold, from \$675,000 to \$11,180,000.<sup>5</sup> In addition, over the course of the same time period, the top transfer tax rate has been reduced from 55% to 40%.<sup>6</sup> The combination of a huge transfer tax exemption and a lower top tax rate, together with the fact that the vast majority of state legislatures have repealed their estate taxes,<sup>7</sup> has left the estate tax essentially a shell of its former self – applicable to less than .01% of all decedent taxpayers (or one in every 10,000 decedents).<sup>8</sup>

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<sup>1</sup> See, e.g., James R. Repetti, *Minority Discounts: The Alchemy in Estate and Gift Taxation*, 50 TAX L. REV. 415, 416 (1995) (“A common tool of estate planning involves the purposeful diminution in value of family property in order to reduce estate and gift taxes.”); William S. Blatt, *Minority Discounts, Fair Market Value, and the Culture of Estate Taxation*, 52 TAX L. REV. 225, 225 (1997) (“The allowance of minority discounts encourages transactions designed to reduce transfer taxes.”); Joseph M. Dodge, *Redoing the Estate and Gift Taxes Along Easy-to-Value Lines*, 43 TAX L. REV. 241, 244 (1988) (“[V]irtually all of the transfer tax loopholes involve undervaluation of gratuitous transfers with the blessing of existing law.”); Mary Louise Fellows & William H. Painter, *Valuing Close Corporations for Federal Wealth Transfer Taxes: A Statutory Solution to the Disappearing Wealth Syndrome*, 30 STAN. L. REV. 895 (1978) (“Disappearing wealth occurs in two situations. First, if a controlling shareholder makes one or more inter vivos gifts of minority blocks so that he divests himself of control . . . [S]econd, the value incident to de facto control over a corporation is not subject to the transfer taxes . . .”).

<sup>2</sup> Darien B. Jacobson, Brian G. Raub & Barry W. Johnson, *The Estate Tax: Ninety Years and Counting*, I.R.S. STATISTICS OF INCOME BULLETIN, Summer 2007, at 122.

<sup>3</sup> Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38 (2001).

<sup>4</sup> Tax Cuts and Jobs Act, Pub. L. No. 115-97, 131 Stat. 2054 (2017).

<sup>5</sup> *Id.* at § 11061(a). In 2001, the federal estate tax exemption was \$675,000; in 2018, this same dollar figure would have a purchasing power equivalent to about \$955,000. See Federal Reserve Bank of Minneapolis, Consumer Price Index, 1913-2018, <https://www.minneapolisfed.org/community/financial-and-economic-education/cpi-calculator-information/consumer-price-index-and-inflation-rates-1913> [<https://perma.cc/4MHU-4CSN>]. That being the case, under inflation-adjusted dollar figures, the increase in the exemption amount is approximately twelve-fold.

<sup>6</sup> I.R.C. § 2001(c).

<sup>7</sup> See, e.g., Ashlea Ebeling, *Where Not to Die in 2018*, FORBES (Dec. 21, 2017, 3:00 PM) <https://www.forbes.com/sites/ashleaebeling/2017/12/21/where-not-to-die-in-2018/#16c43bd85b1b> [<https://perma.cc/N8FV-YZPL>]. See generally Jeffrey A. Cooper, *Interstate Competition and State Death Taxes: A Modern Crisis in Historical Perspective*, 33 PEPP. L. REV. 835, 881 (2006); Jeffrey A. Cooper, John R. Ivimey & Donna D. Vincenti, *State Taxes After EGTRRA: A Long Day's Journey*, 17 QUINNIPIAC PROB. L.J. 90, 92 (2003) (“In an effort to reduce the fiscal impact of federal tax cuts, the federal government effectively repealed the entire death tax system of over 30 states. Ending nearly 80 years of revenue sharing, Congress and the President effectively told the states to fend for themselves on the issue of estate taxation, and fend for themselves they have [by eliminating their estate taxes].”).

<sup>8</sup> Sasha A. Klein & Mark R. Parthemer, *The New Tax Law: It's Déjà vu All Over Again*, 32 PROB. PROP. 40, 43 (2018) (“[Raising the basic transfer tax exclusion amount from \$5 million to \$10 million] will result in a substantial

The foregoing transfer tax reforms have been a true valuation game-changer. Because in most instances the Internal Revenue Code (“Code”) no longer imposes an estate tax, the incentive to minimize estate asset values no longer exists. Due to the basis equal to fair market value rule applicable at death,<sup>9</sup> it is now common to maximize asset values to defeat or lighten capital gain tax burdens.<sup>10</sup> Put somewhat differently, executors, personal representatives, and administrators are apt to use the highest justifiable date of death asset values in order to minimize or eliminate the future income tax burdens of a decedent’s heirs.<sup>11</sup> Furthermore, except in extreme cases, this new tactic of augmenting a decedent’s tax basis in the assets owned at death will likely be accomplished without significant interference from the I.R.S., which lacks the resources to monitor inflated valuation determinations.<sup>12</sup>

This analysis tracks how Congressional actions have unraveled the dynamic between the transfer and income tax systems that historically kept the date of death valuation process in check. Section II overviews the prior tax paradigm and how taxpayers then conducted their testamentary affairs. Section III describes the new tax paradigm and taxpayers’ and the estate planning bar’s predominant concerns. Next, Section IV summarizes taxpayers’ newly-minted tax-minimization strategies and what, if anything, the I.R.S. and Congress can do to combat these ploys. Finally, Section V concludes.

## II. THE PRIOR TAX PARADIGM

Over the course of the past century, the income tax and transfer tax regimes have coexisted. While the two tax systems were not intertwined,<sup>13</sup> Congress instituted several measures designed

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further reduction in taxable estates, estimated to decline from .02% to .01% of taxpayers (or one in every 10,000 decedents).”).

For a small number of decedents, the transfer-tax system thus continues to apply, and the old choice between reducing the estate tax at the cost of increasing the capital gains taxes faced by heirs will operate in much the same way as it always has. Admittedly, this small number of decedents holds considerable wealth. For the most recent year for which data are available (decedents dying in 2013), while the nationwide number of estates having assets of more than \$20 million numbered only 1,228, the aggregate value of the assets owned by these estates were in excess of \$82 billion, constituting a bit more than half of all assets reported on estate tax returns for that year. I.R.S. Statistics of Income Division, *SOI Tax Stats Estate Tax Statistics Year of Death Table 1*, I.R.S. (2017), <https://www.irs.gov/statistics/soi-tax-stats-estate-tax-statistics-year-of-death-table-1> [<https://perma.cc/A9UH-XUSJ>].

<sup>9</sup> I.R.C. § 1014(a).

<sup>10</sup> I.R.C. § 1(h). See also Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, §1402, 124 Stat. 1029, 1060-61 (taxpayers whose incomes exceed specified thresholds incur an additional 3.8% tax on capital income, including capital gains).

<sup>11</sup> See Section IV.B, *infra*.

<sup>12</sup> See NAT’L TAXPAYER ADVOCATE, ANNUAL REPORT TO CONGRESS vii (2017) (“Funding cuts have rendered the IRS unable to provide acceptable levels of taxpayer service, unable to upgrade its technology to improve its efficiency and effectiveness, and unable to maintain compliance programs that both promote compliance and protect taxpayer rights.”); CHUCK MARR & CECILE MURRAY, CTR. ON BUDGET AND POLICY PRIORITIES, *IRS FUNDING CUTS COMPROMISE TAXPAYER SERVICE AND WEAKEN ENFORCEMENT 1* (2016) (“The Internal Revenue Service (IRS) budget has been cut by 17 percent since 2010, after adjusting for inflation, forcing the IRS to reduce its workforce, severely scale back employee training, and delay much-needed upgrades to information technology systems.”).

<sup>13</sup> See, e.g., *Farid-Es-Sultaneh v. Comm’r*, 160 F.2d 812, 814-15 (2d Cir. 1947) (“[T]he income tax provisions are not to be construed as though they were in *pari materia* with either the estate tax law or the gift tax statutes.”).

to ensure that each was in sync with the other.<sup>14</sup> This symbiotic relationship extended to the area of asset valuations: the “bite” of the estate tax regime was somewhat lessened by the application of the basis equal to fair market rule applicable upon death to a decedent’s assets.

The next four Subsections explore the depth of this interrelationship, examining (A) the nation’s formerly robust transfer tax regime, (B) taxpayers’ valuation minimization strategies, (C) the basis equal to fair market value rule, and (D) the estate bar’s role in this process.

#### A. *The Nation’s Formerly Robust Transfer Tax Regime*

The exact catalyst for creation of the nation’s transfer tax system is unclear. Certainly, it was a means of meeting the country’s need for revenue;<sup>15</sup> another important function it served was to curtail inherited wealth and the power associated therewith.<sup>16</sup> Whatever the reasons, Congress enacted the nation’s modern estate tax in 1916<sup>17</sup> and it has been an almost continuous feature of the Code ever since.<sup>18</sup>

At inception, the estate tax regime was simple. With a relatively high exemption (i.e., \$50,000),<sup>19</sup> and a top rate of 10%, it applied to very few decedent taxpayers’ estates and did not burden those estates tremendously. Furthermore, since there was initially no tax on inter vivos gifts, estate taxes could be easily avoided to the extent that living taxpayers were willing to part with all or some of their estates prior to their deaths.

Recognizing that the inter vivos gift option threatened the integrity of the estate tax, Congress, in 1924, enacted a gift tax to complement the estate tax.<sup>20</sup> A few years later, it lowered the transfer tax exemption amount to \$40,000 and subsequently raised the highest estate tax rate to 77%.<sup>21</sup> Admittedly, the road to a robust transfer tax system had a few bumps, including a puzzling repeal

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<sup>14</sup> See, e.g., I.R.C. § 691(c) (permitting an income tax deduction for any estate taxes paid in connection with income with respect to decedent items included in the taxpayer’s estate (e.g., retirement plan proceeds)); I.R.C. § 2053(a) (permitting an estate tax deduction for state income taxes a decedent taxpayer may owe at the time of death).

<sup>15</sup> See, e.g., Joel C. Dobris, *A Brief for the Abolition of All Transfer Taxes*, 35 SYRACUSE L. REV. 1215, 1216-17 (1984) (stating that the first federal estate tax was enacted in 1916 as a war tax); Louis Eisenstein, *The Rise and Decline of the Estate Tax*, 11 TAX L. REV. 223, 230 (1956) (reciting the Ways and Means Committee’s view that death taxation would be a large source of revenue).

<sup>16</sup> See, e.g., Paul L. Caron & James R. Repetti, *Occupy the Tax Code: Using the Estate Tax to Reduce Inequality and Spur Economic Growth*, 40 PEPP. L. REV. 1255, 1277 (2013) (explaining how the federal wealth transfer tax reduces wealth transfers from the largest estates to their heirs).

<sup>17</sup> Revenue Act of 1916, Pub. L. No. 64-271, 39 Stat. 756 (1916).

<sup>18</sup> In 2010, the estate tax was made optional. See Tax Relief, Unemployment Insurance Reauthorizations, and Job Creation Act of 2010, Pub. L. No. 111-312, 124 Stat. 3301 (2010). As a result, in that year, few estates paid such a tax. See, e.g., Robert Gordon, David Joulfaian & James Poterba, *Revenue and Incentive Effects of Basis Step-Up at Death: Lessons from the 2010 “Voluntary” Estate Tax Regime*, 106 AM. ECON. REV. 662, 663 (2016).

<sup>19</sup> Revenue Act of 1916, *supra* note 17, at § 201. The \$50,000 exemption in 1916 would have a current, inflation-adjusted value of about \$1,150,000. See Federal Reserve Bank of Minneapolis, Consumer Price Index, 1913-2018, <https://www.minneapolisfed.org/community/financial-and-economic-education/cpi-calculator-information/consumer-price-index-and-inflation-rates-1913> [https://perma.cc/4MHU-4CSN].

<sup>20</sup> Revenue Act of 1924, Pub. L. No. 68-176, §§ 319-324, 43 Stat. 253, 313-16.

<sup>21</sup> Jacobson, *supra* note 2.

of the new gift tax in 1926,<sup>22</sup> followed by its restoration in 1932.<sup>23</sup> Indeed, by the end of World War II, the nation's transfer tax had matured to the point of reaching most estates that contained significant wealth, rendering it a serious source of federal revenues.<sup>24</sup>

During the decades following World War II, the nation's transfer tax system continued to mature and stabilize.<sup>25</sup> In part, its success was propelled by the fact that, during the approximately six decades that followed (1940-2000), the exemption amount and transfer tax rates remained relatively constant.<sup>26</sup> Furthermore, in 1976, to further augment the integrity of the nation's estate and gift taxes, Congress introduced the generation-skipping transfer tax.<sup>27</sup> This tax was designed to curtail taxpayers (commonly, grandparents) from gifting or bequeathing their assets and estates to others (commonly, grandchildren or great-grandchildren) who were two or more generations younger than themselves, thereby eliminating one generational level of transfer tax exposure.<sup>28</sup>

While imperfect, the nation's three-pronged transfer tax system, composed of the estate, gift, and generation-skipping transfer taxes, has not only richly contributed to the nation's revenue base,<sup>29</sup> but has also somewhat reduced the flow of inherited wealth and inhibited the creation and perpetuation of dynasties. By way of example, in 1976, the transfer tax regime was hitting its full stride. That year, it produced nearly 2.6% of overall federal revenue, and reached nearly eight percent of all decedents' estates.<sup>30</sup> For several more decades, at least in terms of revenue collection, until 2001, this state of affairs regarding the status of the transfer tax regime was to remain largely intact.<sup>31</sup>

### B. *Disappearing Asset Values*

How the transfer tax system shapes taxpayers' testamentary affairs is evident in the sphere of asset valuation. For the past century, taxpayers have gone to great lengths to minimize their transfer tax burdens, chiefly by reporting the lowest defensible values associated with a decedent's assets.<sup>32</sup>

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<sup>22</sup> Revenue Act of 1926, Pub. L. No. 69-20, § 324, 44 Stat. 9, 86.

<sup>23</sup> Revenue Act of 1932, Pub. L. No. 72-154, §§ 501-532, 47 Stat. 169, 245-59.

<sup>24</sup> Jacobson, *supra* note 2, at 125.

<sup>25</sup> See, e.g., Eddie Metrejean & Cheryl Metrejean, *Death Taxes in the United States: A Brief History*, 7 J. Bus. & Econ. Res. 33, 36 (2009) ("The estate tax enacted in 1916 set the standard for what the estate tax would be for the next 50 years. Other than rate and exemption changes and several other minor changes, the estate tax remained largely unchanged until 1976.").

<sup>26</sup> Jacobson, *supra* note 2. The 77% top rate consistently applied from 1941 until 1976.

<sup>27</sup> Tax Reform Act of 1976, Pub. L. No. 94-455, § 2006(a), 90 Stat. 1520, 1879. The Tax Reform Act of 1986 retroactively repealed the 1976 generation-skipping transfer tax and replaced it with Chapter 13 of the Code. Tax Reform Act of 1986, §§ 1431-1433, Pub. L. No. 99-514, 100 Stat. 2712, 2717.

<sup>28</sup> See, e.g., Howard E. Abrams, *Rethinking Generation-Skipping Transfers*, 40 Sw. L.J. 1145, 1145 (1987) ("The very wealthy, though, use cascading life estates and special powers of appointment to approximate outright transfers while avoiding the periodic imposition of transfer tax.").

<sup>29</sup> Jacobson, *supra* note 2, at 125.

<sup>30</sup> *Id.*

<sup>31</sup> *Id.*

<sup>32</sup> See generally James R. Repetti, *Minority Discounts: The Alchemy in Estate and Gift Taxation*, 50 TAX L. REV. 415 (1995) (describing the techniques taxpayers employ to temporarily diminish asset values); George Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance*, 77 COLUM. L. REV. 161, 195 (1977) ("[A]n extraordinarily productive technique for reducing taxes on these transfers is to exploit valuation uncertainties.

In the transfer tax system, asset valuations have thus always been contentious, sparking much litigation involving recurring taxpayer valuation ploys.<sup>33</sup> Ultimately, Congress chose to respond by enacting Chapter 14 of the Code, which is entitled “Special Valuation Rules.”<sup>34</sup> Despite its brevity, this chapter sought to deter a broad range of taxpayer valuation minimization schemes.<sup>35</sup>

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Aggressive tax lawyers have developed a package of valuation stratagems which cuts deeply into the estate and gift tax base.”).

<sup>33</sup> In particular, the following four ploys were widely used:

- Recapitalizing family-owned businesses with two-tiered capital structures. Older family members would receive preferred stock with rich dividend and liquidation rights, while younger members would get, by gift, common stock with little current value, but substantial growth potential. *See, e.g.*, H.R. Rep. No. 391, pt. 2, *reprinted in* 1987 U.S.C.C.A.N. 2313-378, 657-60 (detailing how corporate and partnership arrangements were enabling taxpayers to defeat their transfer tax obligations); H.R. Rep. No. 795, at 422 (1988) (explaining how taxpayers orchestrated their business affairs to minimize their transfer tax exposure). *See generally* Byrle M. Abbin, *Taking the Temperature of Asset Value Freeze Approaches: What’s Hot, What’s Not*, 66 TAXES 3 (1988);
- utilizing a grantor retained income trust (or GRIT) that was designed to bloat the value of a retained interest in the transferor’s hands in order to diminish the value of the transferred trust remainder interest passing to transferees. *See, e.g.*, JOHN R. PRICE, CONTEMPORARY ESTATE PLANNING § 9.43 (1992); BORIS I. BITTKER & LAWRENCE LOKKEN, 5 FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶136.4.1; STEPHENS ET AL., FEDERAL ESTATE AND GIFT TAXATION ¶ 4.08 [9] [e] (6th ed. 1991); *see also* STAFF OF JOINT COMM. ON TAX’N, 101ST CONG., FEDERAL TRANSFER TAX CONSEQUENCES OF ESTATE FREEZES 12 (Comm. Print 1990); Richard A. Oshins, *GRITs, Splits and Tidbits*, 126 TR. & EST. 28, 28 (1987);
- adding certain rights and restrictions to business agreements involving family-owned businesses with the intent of constraining asset value of those family members in the older generation. *See, e.g.*, Brent B. Nicholson, *Holman v. Commissioner: A Death Knell for the Tax Value of Transfer Restrictions in Family Limited Partnerships?*, 2 WM. & MARY BUS. L. REV. 291 (2011) (explaining how taxpayers, to minimize the value of business assets, sought to exploit transfer restrictions)); and
- instituting voting or liquidation rights in the hands of senior family member’s hands that were purposefully designed to lapse upon death (or other event), augmenting thereby the value of the interests held by junior family members. *See, e.g.*, Jerald David August, *Planning for Lapsing Rights and Restrictions – The Impact of Section 2704 on Valuation*, 82 J. TAX’N 342 (1995) (explaining how taxpayers manipulated voting and liquidation rights); Estate of Harrison v. Comm’r., 52 T.C.M. 1306 (1987) (holding that when the taxpayer’s right of partnership liquidation lapsed at death, the taxpayer’s representatives could, in valuing the partnership interest, rightfully ignore the value associated with this liquidation right).

<sup>34</sup> Chapter 14 of the Internal Revenue Code, entitled “Special Valuation Rules,” was enacted under the Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11602, 104 Stat. 1388. *See* H.R. 5835, 101ST CONG. § 11602 (1990).

<sup>35</sup> The four Code sections that comprise the entirety of Chapter 14 and their objectives are listed seriatim.

I.R.C. § 2701: With respect to transfers made to family members of controlled business enterprises, the Code requires that a retained senior equity interest (e.g., preferred stock) be valued at zero unless it includes a right to a “qualified payment” (i.e., a cumulative right to periodic dividends or other distributions at a fixed rate).

I.R.C. § 2702: Modeled after split-interest charitable trusts, this Code section essentially requires a retained term interest held in trust to be expressed as an annuity or unitrust interest; any other retained interest is deemed to be of zero value, making the entirety of the trust contribution fully taxable.

I.R.C. § 2703: Unless an enumerated exception applies, this Code section declares that all property valuation computations should be conducted by disregarding “(1) any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right), or (2) any restriction on the right to sell or use such property.”

But Congressional loophole-closing action was met with stiff taxpayer opposition. To mitigate their transfer tax burdens, taxpayers quickly turned to two transfer-tax avoidance tactics, namely, (a) valuation discounts and (b) the use of grantor retained annuity trusts. Consider each.

(a) Valuation Discounts. After Congress enacted Chapter 14, taxpayers began an ambitious campaign to “wrap” their assets in closely-held business arrangements (i.e., partnerships, limited liability companies, and corporations) and then transfer their asset ownerships in ways that, for transfer tax reporting purposes, allow reporting of significant minority and marketability valuation discounts, ranging as high as 70%.<sup>36</sup>

A simple example illustrates how taxpayers (with the assistance of their advisors) chose to orchestrate their personal affairs. Assume Taxpayer J owns \$10 million of Apple stock. She forms a limited liability company, funding it with all of her Apple stock. A week later she transfers a 49% minority interest in the limited liability company to her daughter. Rather than report the value of the gifted interest to be \$4.9 million (i.e., \$10 million x .49), after taking a 30% marketability and minority interest discounts, she may report the value of the gifted interest to be \$3.43 million (\$4.9 million – (\$4.9 million x .3)).

Over the course of the last two decades, Taxpayer J and many similarly-situated taxpayers have utilized valuation discounts to diminish the value of the assets they gift and bequeath, meeting with significant judicial success.<sup>37</sup> Indeed, a few years after the passage of Chapter 14, even the I.R.S. conceded that some valuation discounts are appropriate in certain circumstances.<sup>38</sup> And despite many academics and politicians decrying the use of this valuation strategy,<sup>39</sup> taxpayers have continued to take aggressive valuation discounts for gift, estate, and generation-skipping transfer tax reporting purposes.

(b) Grantor Retained Annuity Trusts (GRATs). With Chapter 14’s enactment, congressional members thought they had eliminated the ability of taxpayers to make transfers into trust that would enable them to circumvent their transfer tax obligations. They were wrong. Creative tax advisors devised a transfer tax strategy that turned newly enacted Code section 2702 upside down:

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I.R.C. § 2704: In the context of a family-owned business, this Code section states that the lapse of a voting or liquidation right can give rise to a taxable gift or inclusion in the holder’s estate, whichever is applicable.

<sup>36</sup> *Martin v. Comm’r*, 149 T.C. 12 (1985). The practice of valuation discounts has been widespread. *See, e.g.*, Ronald H. Jensen, *The Magic of Disappearing Wealth Revisited: Using Family Limited Partnerships to Reduce Estate and Gift Tax*, 1 PITT. TAX REV. 155 (2004); Justin P. Ransome & Vinu Santchit, *Valuation Discounts for Estate and Gift Taxes*, J. OF ACCOUNTANCY (2009), <https://www.journalofaccountancy.com/issues/2009/jul/20091463.html> [<https://perma.cc/JRV7-4B96>].

<sup>37</sup> *See, e.g.*, Wendy C. Gerzog, *Kelley: A Green Light for FLPs*, 109 TAX NOTES 1467 (2005); Wendy C. Gerzog, *Return to Senda: Order Determinative for FLP Discounts*, 110 TAX NOTES 791 (2006); Espen Robak, *Recent Cases Suggest How to Maximize the Marketability Discount*, 31 EST. PLAN. 605 (2004).

<sup>38</sup> *See Rev. Rul. 93-12*, 1993-1 C.B. 202 (“[M]inority discount will not be disallowed solely because a transferred interest, when aggregated with the interests held by family members, would be a part of a controlling interest.”).

<sup>39</sup> *See, e.g.*, TREASURY DEP’T, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH 386-87 (1984) (expounding a proposal to curtail minority discounts); George Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance*, 77 COLUM. L. REV. 161, 195-204 (1977) (pointing out how taxpayers make wealth artificially disappear).

taxpayers would transfer assets into trust, retain a large annuity amount, and report the fair market value of the gifted remainder interest to be zero.<sup>40</sup> If the contributed trust assets produced yields or appreciated in value in excess of the applicable federal interest rate, wealth would inure free of transfer tax to the trust remainder beneficiaries; if the contributed trust assets failed to produce yields or appreciate value in excess of the applicable federal rate, there was no downside risk to the taxpayer (who, in making the trust contribution and reporting a \$0 gift, had not used any portion of his lifetime exemption amount).

To illustrate, suppose Taxpayer K is the sole owner of stock in a closely-held business, worth \$10 million. Suppose further that Taxpayer K establishes a GRAT with a three-year term in a month when the applicable federal interest rate is 4.6%, and transfers her stock to the GRAT. Assuming Taxpayer K retains a 36.45% annuity interest (i.e., each year, for the next three years, the trust must pay a \$3,645,000 annuity to Taxpayer K), then the fair market value of the remainder interest would be zero. However, at the end of the trust term, assuming the business was able to produce income or increase in value in excess of the applicable federal rate, any trust assets remaining at the end of the three-year term would pass tax free to the trust's designated beneficiaries.

As long as the transfer tax regime has remained vibrant, taxpayers have employed both predictable and ingenious methods to diminish the value of those assets they intend to gift and bequeath. And their efforts have generally met with judicial success and begrudging administrative acquiescence by the I.R.S.<sup>41</sup>

### *C. The Basis Equal to Fair Market Value Rule*

In the income tax sphere, the Code instructs that, at death, the tax bases of a decedent's assets should equal their fair market value.<sup>42</sup> Although this rule's origins are not entirely clear,<sup>43</sup> it has been one of the Code's cornerstones for nearly a century.

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<sup>40</sup> Jerome J. Caulfield, *The Quest for the Zeroed-Out GRAT: Walton Says It Can Be Done*, 28 EST. PLAN. 251 (2001); Carlyn S. McCaffrey, Lloyd Leva Plaine & Pam H. Schneider, *The Aftermath of Walton: The Rehabilitation of the Fixed-Term, Zeroed-Out GRAT*, 95 J. TAX'N 325 (2001).

<sup>41</sup> Two concessions should be noted. First, absent a ready marketplace, such as a stock exchange, there is usually a range of possible values that can be assigned to any asset. The valuation standard is "the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and both having reasonable knowledge of the relevant facts." Treas. Reg. § 25.2512-1(a). Particularly in the case of real estate or the stock in a closely-held business, the range of possible valuations may be great indeed. The second concession is that not all assets, such as publicly-traded stock, are difficult to value. However, remember that even the easy-to-value assets may be wrapped in entity structures, which entitle their owners to exploit valuation discounts. *See, e.g.*, *McCord v. Comm'r*, 120 T.C. 358 (2003) (stating that valuation discounts are permitted for ownership interest in family limited partnership which owned stock, bonds, real estate, oil and gas investments, and other closely-held business interests); *Lappo v. Comm'r*, 86 T.C.M. (CCH) 333 (2003) (applying the valuation discount to a family limited partnership that owned marketable securities and real property); *Peracchio v. Comm'r*, 86 T.C.M. (CCH) 412 (2003) (applying the valuation discount to a family limited partnership that owned cash and marketable securities).

<sup>42</sup> I.R.C. § 1014(a).

<sup>43</sup> *See* LAWRENCE ZELENAK, FIGURING OUT THE TAX: CONGRESS, TREASURY, AND THE DESIGN OF THE EARLY MODERN INCOME TAX 83-109 (2018) (explaining Code section 1014's obscure origins).

While there are several reasons Congress has chosen to retain this rule, the one most commonly cited is that of administrative convenience. That is, it is sometimes difficult or impossible to identify the tax basis that decedents may have in some of their assets acquired years or decades earlier.<sup>44</sup> The basis equal to fair market value rule at death obviates the need for taxpayers' heirs to ascertain this information.

In light of the administrative convenience associated with the basis equal to fair market value rule, efforts to repeal it have been met with stiff resistance. Congress has tried twice. The first time was in 1976,<sup>45</sup> but the public outcry against repeal was so loud that Congress quickly suspended it,<sup>46</sup> and ultimately rescinded it.<sup>47</sup> The second time was in 2001 when Congress instituted a one-year carryover tax basis rule;<sup>48</sup> again, Congress lacked the will to make this stick, opting instead to make its application elective.<sup>49</sup> The basis equal to fair market rule thus remains unscathed, despite significant misgivings regarding its inequity and the fact that technological advances that have made tremendous strides towards facilitating the tax basis identification of a decedent's assets.<sup>50</sup>

And while the debate on whether Congress should retain the basis equal to fair market value rule continues to rage, the revenue losses associated with this rule's retention grow. Each year, the Treasury Department provides cost estimates associated with those Code provisions that deviate from the Haig-Simons definition of income.<sup>51</sup> These estimates are known as the tax expenditure budget.<sup>52</sup> In 2018 alone, the estimated cost associated with maintaining the basis equal to fair market value rule was a staggering \$54 billion.<sup>53</sup>

But this tax expenditure is about to climb significantly. For nearly a century, the exploitation of the basis equal to fair market value rule has always been kept in check by the nation's modest transfer tax regime, a key feature of which led taxpayers to prize lower asset valuations. In the absence of even a modest transfer tax regime, however, taxpayers can capitalize upon the basis equal to fair market value rule with intense vigor.

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<sup>44</sup> See *id.* at 110-32 (explaining why, for the past century, Congress has chosen to retain Code section 1014).

<sup>45</sup> Tax Reform Act of 1976, Pub. L. No. 94-455, § 2005, 90 Stat. 1520, 1872.

<sup>46</sup> Revenue Act of 1978, Pub. L. No. 95-600, § 515, 92 Stat. 2763, 2884.

<sup>47</sup> Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-223, § 401(a), 94 Stat. 229, 299.

<sup>48</sup> Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 501, 115 Stat. 38, 68-69 (though enacted in 2001, according to its terms, this rule was not to go into effect until 2010).

<sup>49</sup> Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, § 301(c), 124 Stat. 3296.

<sup>50</sup> See Richard Schmalbeck, Jay A. Soled & Kathleen DeLaney Thomas, *Advocating a Carryover Tax Basis Regime*, 93 NOTRE DAME L. REV. 109, 128-32 (2017) (detailing technological advances that facilitate tax basis identification).

<sup>51</sup> See U.S. DEP'T OF THE TREASURY, TAX EXPENDITURES (2017) 2, <https://www.treasury.gov/resource-center/tax-policy/Documents/Tax-Expenditures-FY2019.pdf> [<https://perma.cc/39XP-Y9WH>] ("The normal tax baseline is patterned on a practical variant of a comprehensive income tax, which defines income as the sum of consumption and the change in net wealth in a given period of time.")

<sup>52</sup> See Steven A. Dean, *The Tax Expenditure Budget Is a Zombie Accountant*, 46 U.C. DAVIS L. REV. 265, 267 (2012) ("[T]he tax expenditure budget computes the dollar cost of a wide range of tax breaks.")

<sup>53</sup> OFFICE OF MGMT. & BUDGET, FISCAL YEAR 2018: ANALYTICAL PERSPECTIVES OF THE U.S. GOVERNMENT, 131 tbl.13-1, item 72, <https://www.whitehouse.gov/sites/whitehouse.gov/files/omb/budget/fy2018/spec.pdf> [<https://perma.cc/BJ96-JT4K>].

#### D. The Estate Planning Bar's Role

While many factors motivate taxpayers to hire estate planning professionals, chief among them has historically been transfer tax minimization.<sup>54</sup> Estate planners would routinely pitch their services, claiming that a few billable hours of their time could produce remarkable transfer tax savings.

To illustrate this point, consider a hypothetical example based on the rules and rates applicable in the early and mid-1990s, when the lifetime exemption amount was \$600,000 and the lifetime exemption amount was not portable – i.e., automatically transferable – between spouses as is the case today.<sup>55</sup> Suppose a married couple had a combined net worth of \$1.2 million, with \$600,000 of assets separately titled in each spouse's name. They retain the services of an estate-planning attorney, who recommends that each spouse execute a last will and testament directing the \$600,000 of assets owned each spouse to pass into a testamentary trust for the lifetime benefit of the surviving spouse. This testamentary trust served a dual purpose: it absorbed the use of the first decedent spouse's lifetime exemption amount and, in addition, the assets owned by this trust would not subsequently be included in the surviving spouse's gross estate. (In the vernacular of the estate-planning bar, testamentary trusts of this sort were commonly referred to as “by-pass trusts”).<sup>56</sup> In this example, the use of such a trust would reduce the potential estate tax faced by the couple from \$192,500 to zero.<sup>57</sup>

The estate planning bar can hardly be faulted for the Swiss-cheese structure of the wealth-transfer tax system that created such easy opportunities for professionals to reduce potential tax bills. But regardless of fault, estate planners over the years developed an impressive arsenal of transfer-tax saving techniques, generating acronyms the likes of which are unparalleled in virtually any other area of the law. A small such sampling include the following commonly used estate planning techniques: GRITs, GRATs, GRUTs, CRATs, CRUTs, CLATs, CLUTs, QTIPs, and QPRTs.<sup>58</sup>

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<sup>54</sup> See Howard M. Zaritsky, *Say Goodbye to the Estate Tax – For at Least a Decade*, 44 EST. PLAN. 47, 48 (2017) (“The repeal of the estate tax will dramatically alter present estate planning, which for large estates tends to focus on the minimization of estate and GST taxes.”).

<sup>55</sup> I.R.C. § 2010(c)(4).

<sup>56</sup> See, e.g., Stewart J. Beyerle, *Bypass Trusts Can Maximize Unified Credit*, 18 EST. PLAN. 212, 212 (1991) (“A bypass trust shelters assets from the estate tax assessed on the death of both spouses, while still permitting the surviving spouse to have access to these assets. This is why it is often called a ‘credit shelter’ trust.”).

<sup>57</sup> Absent legal advice, the hypothetical couple would probably have bequeathed their respective estates to each other, with testamentary bequests to the children if there was no surviving spouse. But this would mean that the surviving spouse would eventually leave an estate of \$1.2 million (more or less, depending on subsequent fluctuations in asset values) to their children. At the time, such a disposition would have subjected the surviving spouse's estate to an estate tax liability of \$192,500.

<sup>58</sup> See, e.g., Wendy C. Gerzog, *The Times They Are Not A-Changin': Reforming the Charitable Split-Interest Rules (Again)*, 85 CHI.-KENT L. REV. 849, 853 (2010) (“A CRT must be created either as a charitable remainder annuity trust (CRAT) or a charitable remainder unitrust (CRUT). A CLT must be in the form of either a charitable lead annuity trust (CLAT) or a charitable lead unitrust (CLUT).”); David W. Olsen, *So... What's for Breakfast: GRITs, GRATs, or GRUTs?*, 7 J. SUFFOLK ACAD. L. 49 (1990/1991) (“GRITs, GRATs and GRUTs, in one form or another, have been tools used by estate planners for years.”); Bruce L. Stout, *A QTIP Election Can Lend Flexibility to an Estate Plan*, 52 TAX'N FOR ACCT. 294 (1994), Westlaw (“The use of a QTIP election is very much the best of both worlds--

The government bears the revenue loss associated with this creativity. But instead of fixing the transfer tax rules to reduce avoidance opportunities, Congress has instead chosen to largely take the transfer tax off the table for all but the very wealthiest of estates. Even this, however, did not extinguish the creativity of the estate planning bar; instead, as explained below, its members have developed a whole set of new techniques to capitalize on the basis equal to fair market value rule.

### III. THE NEW TAX PARADIGM

The last two decades have witnessed a concerted effort to repeal the wealth-transfer taxes. This has been a particular point of emphasis among Republicans,<sup>59</sup> but they have not been entirely alone.<sup>60</sup> While efforts to repeal the transfer tax system completely have thus far proven unsuccessful, Congress has made significant strides to ensure that families could maintain sizable amounts of wealth free of transfer tax levies. Many state legislatures have also joined the wealth preservation bandwagon, perhaps best exemplified by their near-universal elimination of the Rule Against Perpetuities.<sup>61</sup>

The passage of the Tax Cut and Jobs Act reflects the deep disdain which the 2017 Congress harbored towards the nation's transfer tax system. Now, only those families that need a ten-figure calculator to compute their net worth fall within its clutches.<sup>62</sup>

#### A. *The Gutting of the Transfer Tax System*

As previously pointed out, over the course of the last two decades, the transfer tax system has

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the testator has the ability to determine and control the ultimate disposition of his estate while retaining the opportunity to benefit from the unlimited marital deduction.”); Jeremy T. Ware, *Using QPRTS to Maximum Advantage for Wealthy Clients*, 32 EST. PLAN. 34, 34 (2005) (“The qualified personal residence trust, or ‘QPRT,’ is one of the tried-and-true workhorses of estate planning. It provides a tax-favored and IRS-blessed means of transferring a personal residence to the objects of a donor's bounty.”).

<sup>59</sup> See Zaritsky, *supra* note 54, at 47 (“Repeal of the estate tax has been part of every Republican tax reform plan in recent years.”); Grayson M.P. McCouch, *The Empty Promise of Estate Tax Repeal*, 28 VA. TAX REV. 369, 373 (2008) (“Estate tax repeal figured as a prominent issue in the 2000 presidential campaign, especially after candidate George W. Bush endorsed repeal as part of his tax-cutting agenda, along with income tax rate cuts, an expanded child credit, and reduction of the marriage tax penalty.”).

<sup>60</sup> While the Republicans have repeatedly voted for estate tax repeal, *see generally* Edward J. McCaffery & Linda R. Cohen, *Shakedown at Gucci Gulch: The New Logic of Collective Action*, 84 N.C. L. REV. 1159, 1165 (2006), in 2012 former President Obama approved increasing the applicable exclusion amount from \$3.5 million to \$5 million. Terence S. Nunan, *Basis Harvesting*, 25 PROB. & PROP. 54, 55 (2011) (“The Tax Act, with its \$5 million estate tax exclusion, was a compromise between the Obama Administration and Republican legislators, the latter favoring total repeal of the estate tax.”).

<sup>61</sup> Robert H. Sitkoff & Max M. Schanzenbach, *Jurisdictional Competition for Trust Funds: An Empirical Analysis of Perpetuities and Taxes*, 115 YALE L.J. 356 (2005); Stewart E. Sterk, *Jurisdictional Competition to Abolish the Rule Against Perpetuities: R.I.P. for the RAP*, 24 CARDOZO L. REV. 2097 (2003); Joel C. Dobris, *The Death of the Rule Against Perpetuities, or the RAP Has No Friends—An Essay*, 35 REAL PROP. PROB. & TR. J. 601, 603-04 (2002). Traditionally, under this rule, property rights generally had to vest within a life in being plus twenty-one years. *See generally* Frederick R. Schneider, *A Rule Against Perpetuities for the Twenty-First Century*, 41 REAL PROP. & TR. J. 743 (2007). Without the application of this rule, property can theoretically remain in trust indefinitely.

<sup>62</sup> *See supra* note 5.

been a repeated target of political attacks.<sup>63</sup> These attacks have resulted in the passage of multiple legislative initiatives that, at the federal level, have gutted the transfer tax system;<sup>64</sup> furthermore, in the wake of these federal initiatives, many state legislatures have followed suit, repealing or, at the very least, mitigating the estate tax burdens of those domiciled within their borders.<sup>65</sup>

Consider first the legislative trend at the federal level. Three key pieces of legislation tell the majority of the transfer tax saga. Each either significantly raised the lifetime exemption amount or lowered the top marginal tax rate (and, in one instance, it did both). The chart immediately below spells this out:

	Exemption Amount		Tax Rate	
	Before	After	Before	After
1. Economic Growth and Tax Relief Reconciliation Act of 2001 <sup>66</sup>	\$675,000	\$3,500,000	55%	35%
2. American Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 <sup>67</sup>	\$3,500,000	\$5,000,000	35%	35%
3. Tax Cut and Jobs Act <sup>68</sup>	\$5,490,000	\$11,180,000	40%	40%

Next, consider the legislative trend at the state level. By way of background, to attract citizens to establish domicile within their borders, many state legislatures have long eschewed estate tax imposition.<sup>69</sup> To help states augment their coffers, in 1926 Congress enacted legislation to the effect that the federal estate tax would, within limits, offer a credit for state estate taxes paid.<sup>70</sup> With no additional financial cost to their citizens, every state enacted an estate tax to absorb the federal government's largesse. This revenue sharing arrangement persisted for over six decades; however, it came to a quick end when Congress enacted the Economic Growth Tax Relief Act of 2001 that repealed the state estate tax credit,<sup>71</sup> replacing it instead with a deduction.<sup>72</sup> The repeal of the state estate tax credit launched a wave: to safeguard against taxpayer flight, the majority of

<sup>63</sup> See *supra* notes 59-62.

<sup>64</sup> See *supra* notes 3-4 and accompanying text.

<sup>65</sup> See *supra* note 7.

<sup>66</sup> See *supra* note 3. Note that the \$3,500,000 exemption did not take effect immediately upon passage of this bill, but rather was deferred until 2009.

<sup>67</sup> Pub. L. 111-132, 124 Stat. 3296. This Act was also the first to incorporate an indexing provision into the exemption amount, so that it thereafter is adjusted annually to reflect inflation.

<sup>68</sup> See *supra* note 4.

<sup>69</sup> Claire Arritola, *Repealing the Federal Credit for State Estate Taxes Was Bad Policy*, STATE TAX NOTES (2014), <http://www.taxanalysts.org/content/repealing-federal-credit-state-estate-taxes-was-bad-policy> [https://perma.cc/WV59-NYFC]. ("Some states already had wealth transfer taxes in place, but other states, such as Florida, did not. States looking to attract the wealthy took steps such as placing prohibitions on estate taxes in their state constitution.")

<sup>70</sup> See Revenue Act of 1926, Pub. L. No. 69-20, § 301(b), 44 Stat. 9, 70.

<sup>71</sup> Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38 (2001).

<sup>72</sup> I.R.C. § 2058(a).

state legislatures repealed their estate taxes.<sup>73</sup> Some states still impose an estate tax, but their numbers continue to dwindle. Indeed, in 2017 only 17 states remain that still impose an estate and/or inheritance tax.<sup>74</sup>

The implications associated with the federal and state trends are dire for the transfer tax system. The federal transfer tax system now exempts \$11,180,000 from transfer tax. (Married couples can transfer twice this amount or \$22,360,000.) This dollar amount is adjusted annually for inflation.<sup>75</sup> According to the I.R.S. Statistics of Income, the number of taxable estates that equaled or exceeded \$10 million in 2016 totaled 2,204.<sup>76</sup> Given the fact that the U.S. Census Bureau reports that 2,744,248 U.S. residents died in 2016,<sup>77</sup> less than a paltry .01% of the entire U.S. population would have any federal transfer tax exposure. At the state level, if the current transfer-tax repeal trend continues,<sup>78</sup> there is every reason to believe that state estate tax imposition will soon become a relic of the past.<sup>79</sup>

### *B. Tax Burden Levied on Capital Income*

While the federal and state estate tax regimes have been largely phased out or, in many cases, eliminated, the tax on capital income remains intact. At the risk of oversimplification, earned income generally falls into one of the following three baskets: (i) labor and service income; (ii) business profits; and (iii) capital gains. The first income basket – labor and service income – generally bears the greatest financial burden, subject to both income and payroll taxes.<sup>80</sup> Next, the second basket – business profits – generally bears a moderate financial burden, subject to the income tax.<sup>81</sup> Finally, the third basket – capital gains – generally bears a relatively light financial burden, subject to preferential tax rates,<sup>82</sup> deferral opportunities,<sup>83</sup> and exemptions.<sup>84</sup>

Many taxpayers nonetheless contend that the putative “light” tax burden capital gains endure is still too heavy. They believe that Congress should not tax capital gains at all or, alternatively, tax such gains with even more restraint. Advocates for this position point out that capital gains

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<sup>73</sup> See *supra* note 7.

<sup>74</sup> Ebeling, *supra* note 7.

<sup>75</sup> I.R.C. § 2010(c)(3)(B).

<sup>76</sup> See SOI Tax Stats – Estate Tax Statistics Filing Year Table 1 (2016), <https://www.irs.gov/statistics/soi-tax-stats-estate-tax-statistics-filing-year-table-1> [<https://perma.cc/3PTH-N736>].

<sup>77</sup> Kenneth D. Kochanek, Sherry L. Murphy, Jiaquan Xu & Elizabeth Arias, *Mortality in the United States in 2016* (2017), <https://www.cdc.gov/nchs/data/databriefs/db293.pdf> [<https://perma.cc/9PT9-48GZ>].

<sup>78</sup> See *supra* note 7.

<sup>79</sup> No state except Connecticut imposes a gift tax (Conn. Chapter 228c § 12-640). That being the case, in those states that still impose estate taxes, it is possible for taxpayers to reduce their transfer tax obligations.

<sup>80</sup> Linda Sugin, *Payroll Taxes, Mythology, and Fairness*, 51 HARV. J. ON LEGIS. 113, 115-16 (2014).

<sup>81</sup> I.R.C. § 61(a). Note that several features of the Tax Cuts and Jobs Act of 2017 will further lighten this load by reducing the corporate income tax rate (I.R.C. § 11) and allowing a generous business income deduction for non-corporate businesses (I.R.C. § 199A).

<sup>82</sup> I.R.C. § 1(h).

<sup>83</sup> I.R.C. § 1031(a).

<sup>84</sup> I.R.C. § 1202(a).

often constitute nominal rather than economic gains and, as such, should not be taxed;<sup>85</sup> likewise, capital appreciation is frequently related to income that has already been taxed at the corporate level and, that being the case, such wealth should not be taxed a second time in the hands of its shareholders.<sup>86</sup>

Putting aside the question of whether capital gains should be taxed, consider how such gains are actually taxed. At the federal level, the capital gain tax burden is composed of two components. The first is the imposition of income tax with a series of graduated tax rates that range as high as 20%.<sup>87</sup> The second is the imposition of the net investment income tax that the Code imposes on the income of those taxpayers whose adjusted gross incomes exceed certain thresholds.<sup>88</sup> The current net investment income tax rate is a flat 3.8%.<sup>89</sup>

Aside from federal income tax imposition, those states that impose income taxes also tax capital gains. But unlike their federal counterpart, no state offers a preferential tax rate for capital gains. With state income tax rates that currently range as high as 13.3%,<sup>90</sup> this is another potential tax burden to which capital gains are exposed. State taxes paid are theoretically deductible on taxpayers' federal tax returns,<sup>91</sup> which would mitigate their burden. However, due to threshold limitations,<sup>92</sup> the imposition of the alternative minimum tax,<sup>93</sup> and the option of utilizing robust (and recently augmented) standard deductions,<sup>94</sup> the availability of this deduction often proves illusory.

In light of the fact that capital gains are subject to income tax, the net investment tax, and state tax, many taxpayers consider the aggregate tax burden consequential. They therefore are apt

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<sup>85</sup> See, e.g., Charles J. Cooper, Michael A. Carvin & Vincent J. Colatrisano, *The Legal Authority of the Department of the Treasury to Promulgate a Regulation Providing for Indexation of Capital Gains*, 12 VA. TAX REV. 631, 638 (1993):

One of the express congressional justifications for the preferential treatment of capital gains has been the adverse effect of inflation on the calculation of capital gains. During periods of high or even moderate inflation, nominal gains realized upon the sale of property may not reflect a true increase in the value of the property at all. Thus, the taxpayer is taxed on the sale even though, in real terms, he has not received any income in the sense of an increase in wealth or purchasing power.

<sup>86</sup> Noel B. Cunningham & Deborah H. Schenk, *The Case for a Capital Gains Preference*, 48 TAX L. REV. 319, 331 (1993):

Under our current income tax system, corporate income is taxed twice, once at the corporate level when earned, and again at the shareholder level when distributed. This "classical system" of taxation is inconsistent with an ideal Haig-Simons income tax and has been the subject of much criticism. For decades, reformers have called for its elimination by integrating the corporate and individual income taxes.

<sup>87</sup> I.R.C. § 1(h).

<sup>88</sup> I.R.C. § 1411(b).

<sup>89</sup> I.R.C. § 1411(a).

<sup>90</sup> See, e.g., CAL. REV. & TAX. CODE §§ 17041, 17043 (West 2014) (declaring that the highest marginal income tax rate in the state of California is currently 13.3%).

<sup>91</sup> I.R.C. § 164(a).

<sup>92</sup> See I.R.C. § 164(b)(6) (providing that taxpayers may only deduct up to a maximum of \$10,000 of state or local taxes (or \$5,000 for a married taxpayer filing a separate return)).

<sup>93</sup> I.R.C. § 55 et. seq.

<sup>94</sup> I.R.C. § 63(c) (providing that in 2018, the standard deduction is \$12,000 for a single taxpayer and \$24,000 for a married couple filing a joint return).

to take one or more measures to minimize their capital gains tax exposure. Among other strategies, they purposefully harvest losses,<sup>95</sup> avail themselves of exemptions,<sup>96</sup> and strategically move to states that do not impose income taxes.<sup>97</sup>

To date, there has been one capital gain tax-saving strategy that has largely remained in abeyance, namely, capitalizing upon the basis equal to fair market value rule. The reason for that has been explained above: because the estate tax rates have historically been higher than the capital gains rates, taxpayers did not seek refuge in the basis equal to fair market value rule to inflate the values of assets owned by decedents.<sup>98</sup>

#### IV. THE AFTERMATH: TAX BASIS MAXIMIZATION

Now that Congress has diminished the impact of the transfer tax regime, taxpayers will likely turn to income tax planning. As part of their strategy, they are devising creative and innovative approaches to secure high tax bases for their assets.

In this section, subsection A details taxpayers' objectives. Subsection B discusses methodologies to maximize asset tax bases. Subsection C analyzes the challenges that the I.R.S. faces in identifying misreported tax bases and the meager enforcement weapons at its disposal even when it does identify problems. Finally, Subsection D posits Congressional options that could address the tax basis maximization syndrome.

##### A. Taxpayer Objective: Exploitation of the Basis Equal to Fair Market Value Rule

Taxpayers have no duty to pay more taxes than they owe,<sup>99</sup> and accordingly tend to structure their affairs to minimize their tax burdens. When Congress institutes laws that deviate from the Haig-Simon definition of income, taxpayers will predictably avail themselves of tax-saving opportunities. Sometimes, these deviations are purposefully encouraged by Congress to

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<sup>95</sup> Richard B. Toolson, *Higher Tax Rates Increase Importance of Choosing Tax Efficient Investments*, 92 PRAC. TAX STRATEGIES 108, 113 (2014) (“[S]omeone who invests directly in stocks has the opportunity to directly harvest capital losses. These capital losses may be used to offset, without limit, the investor's capital gains from all sources and up to \$3,000 of an individual's noncapital gain income.”).

<sup>96</sup> See, e.g., I.R.C. § 1202(a) (exempting capital gain, subject to limitations, recognized on the sale or disposition of so-called small business stock); I.R.C. § 1400Z-2 (if certain conditions are met, exempting from taxation a portion of capital gain proceeds if they are reinvested in so-called “opportunity zones”).

<sup>97</sup> See, e.g., Robert W. Wood, *California's 13.3% Tax on Capital Gains Inspires Move Then Sell Tactics*, FORBES (Aug. 31, 2017), <https://www.forbes.com/sites/robertwood/2017/08/31/californias-13-3-tax-on-capital-gains-inspires-move-then-sell-tactics/#5c3bc9502097> [<https://perma.cc/E2VN-2HF9>] (“It should be no surprise that former Californians often become residents of no-tax states like Texas. The IRS reports that between 2013 and 2014, over 250,000 California residents moved away.”).

<sup>98</sup> Once in a while, aggressive taxpayers apparently sought to “park” their assets on a temporary basis with those who were dying to exploit the basis equal to fair market value rule. However, after Congress learned of this strategy, it took measures to make its use less attractive. See Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 425(a), 95 Stat. 172. Now, when taxpayers transfer assets to those dying, in anticipation of receiving a bequest returning the gifted assets, the basis equal to fair market value rule will not apply if the transferee dies within a year of the initial transfer. I.R.C. § 1014(e). See footnote 114 *infra* and accompanying text.

<sup>99</sup> See *Helvering v. Gregory*, 69 F.2d 809, 811 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935) (“[T]here is not even a patriotic duty to increase one's taxes.”).

incentivize particular taxpayer behavior. For example, it appears that Congress has intentionally favored home ownership,<sup>100</sup> the acquisition of automobiles that are powered by electricity rather than fossil fuels;<sup>101</sup> and investment in entrepreneurial enterprises.<sup>102</sup>

Before delving into how the current Code entices taxpayers to maximize the tax basis of the assets that they own, the role of basis in the income tax regime must be clearly understood. Tax basis is one of the central concepts in the taxation of income from capital. When a taxpayer acquires an asset, its purchase price constitutes the asset's cost basis.<sup>103</sup> If the taxpayer improves the asset or takes depreciation deductions, the asset's basis is increased or decreased accordingly.<sup>104</sup> As time passes, an asset's tax basis and its fair market value are apt to diverge. Sometimes an asset's tax basis may exceed its fair market value (e.g., if a share of stock falls in value); more commonly, due to either market appreciation or to depreciation deductions that exceed natural erosion, an asset's tax basis will be less than its fair market value.

Because tax basis is the measuring stick from which gain and loss are computed, taxpayers cherish it. A higher basis is better than a lower basis, and taxpayers will quite reasonably go to great lengths to secure higher bases in their assets when opportunities arise. For example, in an endeavor to secure higher future depreciation deductions, taxpayers often find it advantageous to purchase corporate assets rather than acquire corporate stock.<sup>105</sup> Similarly, if taxpayers purchase partnership interests, rather than the partnership assets themselves, they may cause the partnership to make a section 754 election, which enables partners to command a higher tax basis in their proportionate share of partnership assets that they are deemed to own.<sup>106</sup> These tax basis augmentation strategies and others like them are routine in income tax planning.

One of the most common sources of basis augmentation is the rule, applicable at death, which re-sets an asset's tax basis to equal fair market value.<sup>107</sup> While this rule appears neutral (i.e., tax basis could be upwardly or downwardly adjusted), in the vast majority of cases, application of this rule works to the advantage of taxpayers. This is true for several reasons. First, due to inflation and economic growth, the vast majority of capital assets appreciate in value.<sup>108</sup> Second, the Code

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<sup>100</sup> See I.R.C. § 163(h)(3) (permitting an interest deduction for liabilities associated with the purchase of a qualified residence).

<sup>101</sup> See I.R.C. § 30D (providing a credit to taxpayers who place into service a new qualified plug-in electric drive motor vehicle).

<sup>102</sup> See I.R.C. § 1202(a) (exempting gains on the disposition of small business stock from taxation).

<sup>103</sup> I.R.C. § 1012(a).

<sup>104</sup> I.R.C. § 1016(a)(1) & (2).

<sup>105</sup> See, e.g., Michael L. Schler, *Basic Tax Issues in Acquisition Transactions*, 116 PENN. ST. L. REV. 879, 887-88 (2012) (“A stock purchase would result in Target continuing to amortize its existing tax basis over the remainder of the statutory lives of its assets. However, an asset purchase would result in all of Acquiring's tax basis being amortized over a new statutory life beginning on the acquisition date.”).

<sup>106</sup> See, e.g., Walter D. Schwidetzky, *Integrating Subchapters K and S – Just Do It*, 62 TAX LAW 749, 764 (2009) (“Among the times a section 754 election can be useful is when a partnership interest is purchased or inherited. If an election is made, the “inside basis” of the purchasing or inheriting partner's share of partnership assets is increased or decreased to equal the outside basis of that partner's partnership interest.”).

<sup>107</sup> I.R.C. § 1014(a).

<sup>108</sup> See, e.g., Henry Ong, *How Does Inflation Affect the Stock Market*, INQUIRER.NET (Sept. 17, 2014), <http://business.inquirer.net/178899/how-does-inflation-affect-the-stock-market> [https://perma.cc/TEV5-V4BV] (explaining how equities are a worthwhile economic investment and hedge during inflationary periods); *but cf.*

permits generous “write-offs” in the form of depreciation and amortization deductions for those assets used in trades and businesses,<sup>109</sup> which usually exceed the actual economic loss in value.<sup>110</sup> Finally, taxpayers who are elderly or in poor health can manage their portfolios to harvest losses before death, while retaining assets in which they have accumulated gains.

### B. Basis Maximization Strategies

Because most taxpayers have been relieved of the impediment of transfer taxes, they are now free to pursue several strategies that exploit the fair market value at death rule. Such techniques include, but are not limited to: (1) high-value appraisals, (2) asset retention, (3) asset gift-giving, (4) trust ploys, and (5) domicile changes.

1. High-Value Appraisals. When taxpayers need to ascertain asset values, they often rely upon specially-trained appraisers. Theoretically, the appraiser might not know whether an estate desired an appraisal at the high or low end of the defensible range because he or she would not necessarily know whether the estate would be large enough to attract a tax liability. Now, in the absence of a meaningful transfer tax regime, high asset appraisals will undoubtedly become the norm.<sup>111</sup>

Consider if a decedent owned a piece of real estate at the time of death that was originally purchased many years ago for \$100,000 and was now worth somewhere between \$800,000 and \$1 million. Suppose that the decedent’s executor retained the services of an appraiser to assess the property’s fair market value. Adhering to executor’s instructions to maximize the appraisal dollar amount, the appraiser would likely issue an appraisal report listing the property’s fair market value to be \$1 million.

Going forward, the decedent’s heir would presumably use this high value appraisal report for tax basis computational purposes (i.e., determining future depreciation deductions and computing gain/loss upon subsequent property sale, exchange, or disposition). Thus, by reporting a \$1 million date of death fair market value, the decedent’s executor is able to save the decedent’s heirs tax on \$200,000 (i.e., \$1 million (reported value) - \$800,000 (theoretical value)).

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Lawrence H. Summers, *Inflation and the Value of Corporate Equities* (Nat’l Bureau of Econ. Res., Working Paper No. 824, 1982) (arguing that inflation can diminish equity value).

<sup>109</sup> See I.R.C. § 168(k) (permitting, aside from real estate, the vast majority of purchased assets used in a trade or business to be immediately expensed).

<sup>110</sup> See, e.g., Charles T. Terry, *Normative Capital Cost Recovery for A Realization-Based Income Tax*, 5 FLA. TAX REV. 467, 480 (2002) (“[T]he present value of the series of recovery deductions available to U.S. income taxpayers with respect to many assets exceeds the present value of economic depreciation....”).

<sup>111</sup> See, e.g., James John Jurinski, *Estate Plans with Real Estate May Need Major Revisions*, 42 REAL EST. TAX’N 44, 46 (2014) (“In some situations, the planning focus will be on maximizing asset values to take advantage of the step-up rather than minimizing the value of property to minimize estate tax. The IRS may also reverse roles and urge low asset valuations and even valuation discounts.”); John J. Scroggin, *Income Tax Planning Now that Estate Taxes Are Less Significant*, 32 EST. PLAN. 33, 35 (2005) (“Instead of lowering the value of assets to reduce transfer taxes, clients may actually want to increase the value of assets to obtain a higher basis step-up. The higher basis will reduce the income taxes paid by heirs on the sale of inherited assets and will create new depreciable values for depreciable assets.”).

2. Asset Retention. Taxpayers are at liberty to make lifetime gifts or testamentary bequests of the assets that they own. There is a pro and a con associated with gift-giving: the pro is that, for transfer tax purposes, taxpayers can effectively fix the asset's value for transfer tax purposes as of the time of the gift, thereby safeguarding all future asset appreciation from additional transfer tax exposure.<sup>112</sup> The con is that, for income tax purposes, the property's recipient must take the transferor's basis in the transferred asset.<sup>113</sup>

In the absence of a transfer tax, basis considerations will drive many taxpayers to retain their assets rather than gift them. The reason is simple: Taxpayers prefer not to saddle their intended recipients with assets that have the transferor's basis; instead, they want to accord their intended beneficiaries with assets that have tax bases equal to fair market value. With highly-appreciating assets, retention in the taxpayer's hands will become the norm, not the exception.

To illustrate, consider again the example of the real estate that the taxpayer acquired for \$100,000 and is now worth between \$800,000 to \$1 million. If the taxpayer gifts such property, its recipient will have a \$100,000 tax basis in the property;<sup>114</sup> however, if the taxpayer retains the property and later bequeaths it, its recipient will have a \$1 million tax basis in the real estate.<sup>115</sup> Asset retention thus saved the asset recipient taxes on \$900,000 (i.e., \$1 million - \$100,000), epitomizing why, going forward, large-scaled asset retention will likely become standard practice.

3. Asset Gift-Giving. The previous part demonstrates why older taxpayers are clearly motivated to retain their appreciated assets, and let the fair market value basis rule eliminate taxable gains in the hands of beneficiaries. But in other circumstances, the opposite strategy may still have some uses. More specifically, younger, well-heeled, taxpayers may now have a greater incentive to give their appreciated assets to older relatives, with the expectation that the gifted assets will be returned to them in the form of subsequent bequests.<sup>116</sup> Currently, if the gift recipient lives for more than one year,<sup>117</sup> the strategy works and achieves the goal of tax elimination.<sup>118</sup>

Consider the situation of a forty-year old real estate developer who owns appreciated real estate with a \$100,000 tax basis with a \$1 million fair market value. She can gift title to this property to

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<sup>112</sup> This is commonly known as a "freeze" strategy; even though the asset may well appreciate after the gift, its value for transfer tax purposes will always be the "frozen" amount. *See, e.g.*, Douglas P. Long & Timothy J. Riffle, *Family Partnerships for Estate Freezes: The Role of Business Purpose*, 3 J. PARTNERSHIP TAX'N 46 (1986); A. Kel Long, III, *Statutory Freeze Partnerships: A Useful Estate Planning Technique*, 28 EST. PLAN. 59 (2001); Gregory J. Naples, *Recapitalizations Can Still "Freeze" an Estate Despite Recent Changes*, 41 TAX'N FOR ACCT. 70 (1988).

<sup>113</sup> I.R.C. § 1015(a).

<sup>114</sup> *Id.*

<sup>115</sup> I.R.C. § 1014(a).

<sup>116</sup> *See, e.g.*, James S. Judd, *The Evolution of Estate Planning*, 28 UTAH B.J. 14 (2015) ("With federal income tax avoidance becoming paramount to estate planning, an estate planner's client may insist on implementing an estate plan that uses the imminent death of a terminally ill parent in order to get a basis step-up in the client's assets.").

<sup>117</sup> I.R.C. § 1014(e).

<sup>118</sup> This is not a new strategy, and it is not without risks. The elderly recipient of the assets may turn out to need them for his or her own support. Or, he or she may misunderstand or forget the plan and fail to transfer the property back to the original transferee in his or her will. Or the two parties may have a falling out, with the result that the elderly relative intentionally disregards the original understanding. While some of these possibilities could be controlled by creating contractual obligations to return the assets in question at death, those very contractual obligations, if known to the I.R.S. or a court, would require recharacterization of the transaction as something other than a gift.

her elderly grandmother. Assuming the real estate developer's grandmother lives for more than one year and then bequeaths this property back to her granddaughter, her granddaughter is able to save taxes on \$900,000 (i.e., \$1 million - \$100,000).

While this strategy is old, the stakes have now changed. The strategy involves two transfers—into and out of the portfolio of the elderly relative—that would potentially be subject to a wealth-transfer tax. While this may have discouraged taxpayers in the past, as the wealth-transfer tax system fades in relevance, this strategy, even with its risks, will presumably be more appealing to a larger number of taxpayers.

4. Trust Strategies. In the trust arena, three options are available to capitalize upon the basis equal to fair market value rule.

The first is to eliminate those trusts that no longer serve a transfer-tax savings purpose and impede utilization of the basis equal to fair market value rule. There are hundreds of thousands of trusts currently in existence that taxpayers have established to help circumvent transfer tax imposition. Now that Congress has relieved nearly all estates of any transfer tax liabilities, their purpose has disappeared. Furthermore, these trusts generally hold highly appreciated assets that will not be in a position to benefit from the basis equal to fair market value rule because they are not included in the gross estate of the trust beneficiary. These trusts, in other words, are now doing more harm than good. Under these circumstances, taxpayers will want to undertake measures to terminate these trusts by having the trustee make discretionary trust distributions,<sup>119</sup> resulting in the trust assets falling into the hands of trust beneficiaries who are then able to give their heirs the benefit of the fair market value bases in their assets.

The second trust related tactic is to have taxpayers execute trust instruments that contain an asset substitution power.<sup>120</sup> This provision transforms a trust into a grantor trust that is ignored as a separate tax-paying entity for income tax purposes,<sup>121</sup> yet, for transfer tax purposes, this power's presence does not cause asset inclusion.<sup>122</sup> Ever since Congress compressed the tax rates applicable to income earned by trusts and estates, an asset substitution power has gained popularity, because it allows trust income to be subject to the grantor's lower income tax rates. But now this asset substitution power can serve another purpose: it can provide a bridge to remove highly appreciated assets from an irrevocable trust and replace such assets with cash or nonappreciated assets.<sup>123</sup> By gaining title to the appreciated trust assets, a taxpayer is positioned

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<sup>119</sup> See Judy B. Shepura, *Design Trusts that Shine in Clients' Twilight Years*, EST. PLAN. (2015) (detailing the ways that settlors can draft inter vivos and testamentary trusts that can be readily terminated if doing so makes sense from a transfer or income tax perspective).

<sup>120</sup> See Jonathan G. Blattmachr & Madeline J. Rivlin, *Searching for Basis in Estate Planning: Less Tax for Heirs*, 41 EST. PLAN. 3, 4 (2014):

A common method by which a trust is made a grantor trust is for it to either contain a substitution power under Section 675(4)(C) ... and is otherwise structured to avoid inclusion under Section 2036 or 2038... Under current law, however, in order to accomplish the strategy of giving low-basis assets to a trust and later reacquiring them to achieve a basis step up at death, the grantor must have sufficient high-basis assets or cash on hand to exchange for the appreciated trust assets.

<sup>121</sup> I.R.C. § 671.

<sup>122</sup> See generally Jay A. Soled, *Reforming the Grantor Trust Rules*, 76 NOTRE DAME L. REV. 375 (2001).

<sup>123</sup> See *supra* note 118.

to take advantage the basis equal to fair market value rule.

The third tactic involving trusts taxpayers are gravitating towards is the use of so-called Joint Exempt Step-Up Trusts (or JESTs).<sup>124</sup> The details of these trusts have been described elsewhere;<sup>125</sup> but the gist is that married taxpayers can establish a JEST to hold title to their assets. The terms of a JEST grant each spouse a general power of appointment over the trust assets; due to the presence of this power, taxpayers contend that a decedent spouse should include the entirety of the trust assets in his or her gross estate, commanding application of the basis equal to fair market rule to all, not just one-half, of the trust assets.

5. Domicile Changes. Some taxpayers are extraordinarily tax sensitive, and make even the most important of life decisions based upon tax considerations.<sup>126</sup> It is therefore not surprising that some taxpayers might make tax-driven domicile decisions. Literature on this issue abounds and states regularly compete to make their tax environments as attractive as possible to individual taxpayers and business enterprises.<sup>127</sup>

Taxpayers can manipulate their domicile to maximize the benefit of the fair market value basis rule in two ways. First, they may seek to establish domicile in those states that do not levy an estate tax,<sup>128</sup> enabling them to embrace aggressive valuation positions without the “friction” of a having to pay a state transfer tax toll charge. Second, due to a quirk in the Code applicable only in community property states, the basis equal to fair market value rule applies to all the property a couple owns, not just that property titled in the decedent’s name;<sup>129</sup> taxpayers may thus gravitate towards establishing domicile in such states.<sup>130</sup>

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<sup>124</sup> There are other trusts that estate planners are devising with the same tax basis maximization agenda in mind. Austin W. Bramwell, Brad Dillon & Leah Socash, *The New Estate Planning Lexicon: SUGRITs and Other Grantor-Retained Interest Step-Up Trusts*, 123 J. TAX’N 196 (2015).

<sup>125</sup> See Turney P. Berry & Paul S. Lee, *Retaining, Obtaining, and Sustaining Basis*, 7 EST. PLAN. & COMMUNITY PROP. L.J. 1, 28 (2014) (“Following in the line of a number of rulings, a planning technique referred to as the “Joint Exempt Step-Up Trust” (JEST) has arisen that seeks to give married couples residing in noncommunity property states some of the same step-up in basis enjoyed by couples who pass away with community property under section 1014(b)(6).”). See also Alan S. Gassman, Christopher J. Denicolo & Kacie Hohnadell, *JEST Offers Serious Estate Planning Plus for Spouses (pts. 1 & 2)*, 40 EST. PLAN. 3, 3 (Oct. 2013), 40 EST. PLAN. 14 (Nov. 2013).

<sup>126</sup> See, e.g., James Alm & Leslie A. Whittington, *Income Taxes and the Timing of Marital Decisions*, 64 J. OF PUB. ECON. 219 (1997) (discussing the bearing timing has in when couples decide to marry).

<sup>127</sup> See Karen Smith Conway & Jonathan C. Rork, *State “Death” Taxes and Elderly Migration--The Chicken or the Egg?*, 59 NAT’L TAX J. 97, 123 (2006) (finding “some evidence” that “states that experience high elderly immigration may be more likely to subsequently eliminate or reduce their incremental [estate, inheritance and gift] taxes”); Jeffrey A. Cooper, *Interstate Competition and State Death Taxes: A Modern Crisis in Historical Perspective*, 33 PEPP. L. REV. 835, 842 (2006) (“Interstate competition has impacted state death taxes since their inception.”); Cristobal Young, Charles Varner, Ithai Lurie & Richard Prisinzano, *Millionaire Migration and Taxation of the Elite: Evidence from Administrative Data*, 81 AM. SOC. REV. 421 (2016); cf. Jon Bakija & Joel Slemrod, *Do the Rich Flee from High State Taxes? Evidence from Federal Estate Tax Returns* 36 (Nat’l Bureau of Econ. Research, Working Paper No. 10645, 2004) (finding evidence “consistent with the idea that some rich individuals flee states that tax them relatively heavily, although it may reflect other modes of tax avoidance as well.”).

<sup>128</sup> See generally Cooper, *supra* note 127.

<sup>129</sup> I.R.C. § 1014(b)(6).

<sup>130</sup> See generally Paul Caron & Jay A. Soled, *The New Prominence of Tax Basis and Estate Planning*, 150 TAX NOTES 1569 (2016).

Suppose, for example, that a couple residing in New York owns investment real estate in California with a tax basis of \$1,000,000 and a fair market value of \$10,000,000. They might consider retiring in California. Unlike New York, California does not levy an estate tax and, furthermore, it is a community property state. Thus, if the husband dies domiciled in California, his estate will owe no federal or state estate tax and, furthermore, his wife will receive title to the real estate with a \$10 million tax basis, which can be sold at that point with no taxable gain.

### C. I.R.S. Challenges in Policing the Tax Basis Problem

The I.R.S. has not fared well in the last two decades. Enveloped in controversy,<sup>131</sup> the agency has watched its funding dwindle and its staffing cut.<sup>132</sup> At the same time, Congress has expanded the agency's scope of responsibilities and weakened its enforcement arm.<sup>133</sup> With audit rates hovering at historic lows,<sup>134</sup> in all but the most egregious cases, taxpayer aggressiveness will often go undetected.

When it comes to policing tax basis reporting, the I.R.S. faces unique challenges. Unlike other reporting distortions that computer algorithms can pinpoint, such as excessive charitable deductions and business entertainment expenses, overstated tax basis can be elusive.<sup>135</sup> More specifically, regardless of the sale price, a particular asset can have any tax basis or no basis at

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<sup>131</sup> See, e.g., Alan Rappoport, *In Targeting Political Groups, I.R.S. Crossed Party Lines*, N.Y. TIMES (Oct. 5, 2017), <https://www.nytimes.com/2017/10/05/us/politics/irs-targeting-tea-party-liberals-democrats.html>. A federal watchdog investigating whether the Internal Revenue Service unfairly targeted conservative political groups seeking tax-exempt status said that the agency also scrutinized organizations associated with liberal causes from 2004 to 2013. The findings by the Treasury Department's inspector general mark the end of a political firestorm that embroiled the I.R.S. in controversy, led to the ouster of its commissioner and prompted accusations the tax collection agency was being used as a political weapon by the Obama administration.

<sup>132</sup> See *supra* note 12.

<sup>133</sup> See, e.g., U.S. GOV'T ACCOUNTABILITY OFFICE (GAO), *Enforcement of Tax Laws, in* GAO-17-317, HIGH-RISK SERIES: PROGRESS ON MANY HIGH RISK AREAS, WHILE SUBSTANTIAL EFFORTS NEEDED ON OTHERS 500, 506 (1998) ("Between fiscal years 2011 and 2016, IRS's annual appropriations declined about \$ 900 million. Likewise, staffing has declined: full-time equivalent staff members funded by annual appropriations declined by 12,000 between fiscal year 2011 and fiscal year 2016, a 13 percent reduction. At the same time, IRS's enforcement performance has declined .... [R]eductions in examinations can reduce revenue collected and may indirectly reduce voluntary compliance."); Kristin E. Hickman, *Administering the Tax System We Have*, 63 DUKE L.J. 1717, 1730 (2014) ("Anecdotally, Treasury and IRS officials bemoan the amount of time they spend implementing the Patient Protection and Affordable Care Act (ACA)."); Bruce Bartlett, *Slashing the IRS Budget--Penny-Wise and Pound-Foolish*, FISCAL TIMES (Jan. 17, 2014), <http://www.thefiscaltimes.com/Columns/2014/01/17/Slashing-IRS-Budget-Penny-Wise-and-Pound-Foolish> [<https://perma.cc/XWC9-LNJA>] (in light of budgetary constraints, the IRS lacks the ability to fulfill its taxpayer compliance mission); Associated Press, *Income Tax Audits Plummet as IRS Loses Agents to Budget Cuts*, FORTUNE (Mar. 5, 2017), <http://fortune.com/2017/03/05/income-tax-audits-irs-agents/> [<https://perma.cc/9TML-AUBE>] ("The number of people audited by the IRS in 2016 year dropped for the sixth straight year, to just over 1 million. The last time so few people were audited was 2004. Since then, the U.S. has added about 30 million people.").

<sup>134</sup> INTERNAL REVENUE SERV., PUB 55B, Data Book 2017, at 21 (2018), <https://www.irs.gov/pub/irs-soi/17databk.pdf> [<https://perma.cc/WSN4-4AXG>] (noting in calendar year 2016, 0.5% of all filed tax returns were audited).

<sup>135</sup> Joseph M. Dodge & Jay A. Soled, *Debunking the Basis Myth Under the Income Tax*, 81 IND. L. J. 539, 563 (2006) ("A basis figure entered on Schedule D can neither be incorrect on its face nor ... can it fail to match an information return submitted to the IRS.").

all.<sup>136</sup>

Time lag is another problem that plagues accurate tax basis identification. When a taxpayer dies and the recipient receives property, it may be years or decades before the issue of tax basis is relevant (i.e., when there is a sale, exchange, or other disposition). Ascertaining the fair market value of assets is never easy; when this exercise relates back years or several decades, it compounds the tax basis accuracy problem.

Finally, insofar as application of the basis equal to fair market value rule is concerned, even if a taxpayer takes an aggressive valuation position, it usually engenders little financial risk. This is because valuation is an art, not a science. This, combined with the fact a taxpayer always has recourse to a reasonable cause defense,<sup>137</sup> means as long the taxpayer's reporting position is (i) not negligent or reckless and (ii) backed by a reputable appraiser, an accuracy-related penalty will likely not apply.<sup>138</sup> Thus, in most cases, if the I.R.S. successfully challenges the reported tax basis, the taxpayer would simply owe additional tax on the understatement plus interest.

#### *D. Need for Congressional Reform*

Aside from the revenue losses associated with the tax basis issues described here a concomitant problem is that of equity. The financial benefits associated with tax basis maximization inure largely to the wealthy and, as such, further tilt a tax system towards inequity, which already faces serious criticism on those grounds.<sup>139</sup> Support for this proposition is readily found in numerous studies that report the majority of appreciated assets are in the hands of the affluent.<sup>140</sup> The tax basis maximization methodologies just enumerated enable potential income to escape taxation, further exacerbating wealth concentrations.

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<sup>136</sup> Admittedly, due to the advent of third-party tax basis reporting, *see* Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 403, 122 Stat. 3765, 3854-60, some taxpayer derelictions will be easy to detect. More specifically, the Code now requires third-party brokers to retain tax basis records on behalf of their clients related to marketable securities. *See* I.R.C. § 6045(g). Therefore, in those instances when taxpayers report a basis that does not accord with the third-party information return, the I.R.S. will be on notice to challenge the taxpayer's reporting position; however, in all other cases, the I.R.S. can detect overstated basis only through costly and time-consuming audits.

<sup>137</sup> I.R.C. § 6664(c).

<sup>138</sup> I.R.C. § 6662(a).

<sup>139</sup> *See* James M. Poterba & Scott Weisbenner, *The Distributional Burden of Taxing Estates and Unrealized Capital Gains at Death*, in *RETHINKING ESTATE TAX AND GIFT TAXATION* 422, 422-49 (William G. Gale, James R. Hines Jr. & Joel Slemrod eds., 2001) (observing that large portions of wealthy taxpayers' estates are comprised of unrealized capital gains); David M. Herszenhorn, *Consensus on Need to Revise Tax Code, but Partisan Split on Specifics*, N.Y. TIMES (Feb. 21, 2016), <https://www.nytimes.com/2016/02/21/business/yourtaxes/consensus-on-need-to-revise-tax-code-but-partisan-split-on-specifics.html> (quoting Vice President Biden saying stepped-up tax basis benefits "two-tenths of 1 percent of the population that is already very wealthy [and] does not need it...").

<sup>140</sup> *See generally* Edward N. Wolff, *A CENTURY OF WEALTH IN AMERICA* (2017). *See also* Christopher Ingraham, *The Richest 1 Percent Now Owns More of the Country's Wealth than at Any Time in the Past 50 Years*, WASH. POST (Dec. 6, 2017), [https://www.washingtonpost.com/news/wonk/wp/2017/12/06/the-richest-1-percent-now-owns-more-of-the-countrys-wealth-than-at-any-time-in-the-past-50-years/?noredirect=on&utm\\_term=.a738e5b9dcae](https://www.washingtonpost.com/news/wonk/wp/2017/12/06/the-richest-1-percent-now-owns-more-of-the-countrys-wealth-than-at-any-time-in-the-past-50-years/?noredirect=on&utm_term=.a738e5b9dcae) [<https://perma.cc/S62B-RBRP>] ("The top 20 percent of households actually own a whopping 90 percent of the stuff in America....").

Congress should respond by taking one or more measures to curtail taxpayer methodologies designed to maximize the tax basis of their assets. Three such counter measures – (1) reinvigorating the transfer tax regime, (2) instituting a universal carryover tax basis rule, and (3) stiffening penalty exposure – should be considered. These proposed reforms are not mutually exclusive.

1. Reinvigorating the Transfer Tax Regime. For well over a century the nation’s transfer tax regime has performed an admirable job in retarding undue wealth concentrations. Indeed, some commentators argue that it hasn’t gone far enough.<sup>141</sup> That is to some degree a matter of taste, but it appears to be true that most taxpayers are concerned about growing income and wealth inequality, and our wealth transfer tax was at least one effective element in controlling that.

In light of the wealth inequality concern, Congress could strengthen the transfer tax regime in a number of ways.<sup>142</sup> Perhaps the most critical element of this effort would be to lower the exemption amount. Although it would be more difficult technically, closing a myriad of loopholes would also be highly desirable.<sup>143</sup> The tools to rekindle the transfer tax regime thus exist; what has thus far been lacking is the necessary political will to effectuate change.

2. Instituting a Universal Carryover Tax Basis Rule. The basis equal to fair market value rule appears to have been incorporated into the Code as a result of administrative error, approximately a century ago.<sup>144</sup> Since then, the administrative convenience associated with this rule has been viewed as sufficient to justify its retention.<sup>145</sup> Yet, as the information technology age advances, where books and records are easily stored and readily retrieved, tax basis identifications have never been easier. The ease of tax basis identification subverts the administrative convenience argument embraced by proponents of the basis equal to fair market value rule, making it appear anachronistic in nature.

The adoption of a universal carryover tax basis rule would be an attractive alternative to the basis equal to fair market value rule.<sup>146</sup> Just as in the gift context, anytime a taxpayer transferred an asset – whether during life or upon death – the recipient of such property would have the transferor’s tax basis in the asset. If, for whatever reason, the recipient could not identify the asset’s tax basis, he or she could make a good faith estimate (or perhaps be compelled to report a basis of

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<sup>141</sup> See, e.g., Mark L. Ascher, *Curtailing Inherited Wealth*, 89 MICH. L. REV. 69, 73 (1990) (“My proposal views inheritance as something we should tolerate only when necessary -- not something we should always protect.”).

<sup>142</sup> The following are just a small smattering of available articles on this topic: Dennis L. Belcher & Mary Louise Fellows, *Report on Reform of Federal Wealth Transfer Taxes: Task Force on Federal Wealth Transfer Taxes*, 58 TAX LAW. 93 (2004); John E. Donaldson, *The Future of Transfer Taxation: Repeal, Restructuring and Refinement, or Replacement*, 50 WASH. & LEE L. REV. 539 (1993); Harry L. Gutman, *Reforming Federal Wealth Transfer Taxes After ERTA*, 69 VA. L. REV. 1183 (1983); Paul B. Stephan, III, *A Comment on Transfer Tax Reform*, 72 VA. L. REV. 1471 (1986).

<sup>143</sup> See Gutman, *supra* note 142.

<sup>144</sup> See *supra* note 43.

<sup>145</sup> See S. REP. No. 96-394, at 122 (1979) (“Administrators of estates have testified that compliance with the carryover basis provisions has caused a significant increase in the time required to administer an estate and has resulted in raising the overall cost of administration. The committee believes that the carryover basis provisions are unduly complicated. The committee therefore believes that the carryover basis provisions should be repealed.”).

<sup>146</sup> See *supra* note 50.

zero).<sup>147</sup> For nearly a century, the carryover tax basis world has worked in the gift-giving context; there is no reason why its extension to the realm of testamentary bequests would not fare just as well.

The virtues of Congress instituting a carryover tax basis at death are twofold. First, it preserves an asset's taxable gains/losses, contributing to the integrity of an income tax system; and, because asset dispositions generally result in more gains than losses,<sup>148</sup> Congress can hope to collect more revenue without raising tax rates. In addition, through this rule's institution, Congress would be restoring a modicum of equity to the Code, as recipient heirs paid tax on the appreciation of the inherited assets they received.

3. Stiffening the Penalty Regime. Taxpayers who know there is little or no downside risk, are more apt to take aggressive tax reporting positions. Study after study confirms this simple proposition.<sup>149</sup>

As previously noted,<sup>150</sup> from the I.R.S.'s vantage point, the problem of tax basis misreporting is particularly nettlesome: The agency cannot use traditional methods, such as a computerized DIF score, to identify possible taxpayer defalcations. Instead, oversight requires that the agency conduct an actual labor-intensive audit.<sup>151</sup> However, the I.R.S.'s limited resources rarely permit the agency recourse to this option.

To ensure better taxpayer compliance, Congress should consider adjusting two existing Code provisions. First, Congress should narrow the acceptable range of value overstatements. To achieve this objective, it should penalize third-party appraisers who supply taxpayers with date-of-death appraisals that are 120% or greater than the asset's actual fair market value. (The current threshold for penalty imposition pertains to property valuations that are 150% or more of actual fair market value.)<sup>152</sup> Second, taxpayers can currently sustain a reasonable cause defense if they

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<sup>147</sup> See generally Jay A. Soled, *Exploring and (Re)Defining the Boundaries of the Cohan Rule*, 79 TEMP. L. REV. 939 (2006).

<sup>148</sup> See *supra* notes 107-109 and accompanying text.

<sup>149</sup> Susan B. Long, Commentary, *The Influence of Tax Audits on Reporting Behavior*, in WHY PEOPLE PAY TAXES: TAX COMPLIANCE AND ENFORCEMENT 115 (Joel Slemrod ed., 1992); Henrik Jacobsen Kleven, Martin Knudsen, Claus Thustrup Kreiner, Soren Pedersen & Emmanuel Saez, *Unwilling or Unable to Cheat?*, 79 ECONOMETRICA 651 (2011); Niels Johannesen, Patrick Langetieg, Daniel Reck, Max Risch & Joel Slemrod, *Taxing Hidden Wealth: The Consequences of U.S. Enforcement Initiatives on Evasive Foreign Accounts*, (Nat'l Bureau of Econ. Res., Working Paper No. 24366, 2018), <https://www.nber.org/papers/w24366> [<https://perma.cc/YKJ4-GCS2>]; Joel Slemrod, *Tax Compliance and Enforcement* (Nat'l Bureau of Econ. Res., Working Paper No. 24799, 2018), <https://www.nber.org/papers/w24799> [<https://perma.cc/7P9W-59HH>].

<sup>150</sup> See *supra* note 134 and accompanying text.

<sup>151</sup> *Id.*

<sup>152</sup> I.R.C. § 6662(e). Insofar as charitable gifts are concerned that require a qualified appraisal (defined as "an appraisal document that is prepared by a qualified appraiser ... in accordance with generally accepted appraisal standards...") Treas. Reg. § 1.170A-17(a)(1)), Treas. Reg. § 1.170A-17(a)(3)(vi) requires that every appraiser make the following declaration:

I understand that my appraisal will be used in connection with a return or claim for refund. I also understand that, if a substantial or gross valuation misstatement of the value of the property claimed on the return or claim for refund results from my appraisal, I may be subject to a penalty under Code Sec. 6695A, as well as other applicable penalties. I affirm that I have not been barred from presenting

reasonably relied on the expertise of a professional.<sup>153</sup> Congress, however, could repeal the reasonable cause defense anytime an asset's appraised value exceeded actual fair market value by 120% or more.

The effects of repealing the reasonable cause defense might prove particularly interesting. Presumably, taxpayers themselves would have an incentive to exercise more care in the selection of skilled and honest appraisers, and exercise more restraint in the signaling they give regarding their preferences for the highest possible appraised values. In addition, appraisers would have increased malpractice exposure, if their careless or dishonest appraisals led to penalty imposition on their clients, inducing greater care on their part. Finally, as appraisers face greater liability exposure, they would likely bear enhanced insurance premiums, potentially diminishing their incentive to overstate the basis of inherited assets.

## V. CONCLUSION

In the income tax realm, tax basis has always been of central importance. It functions as a metric that enables taxpayers to calculate their asset gains and losses. For close to a century, to lessen their transfer tax exposure, taxpayers have placed a premium on minimizing asset values; in the income tax realm, this kept application of the basis equal to fair market rule applicable at death largely in check.

But this de facto check-and-balance system between the transfer and income tax regimes is no longer in place. Now that Congress has emasculated the transfer tax regime, taxpayers are subscribing to new strategies such as inflating date of death asset values, retaining rather than gifting their assets (in the case of older-generation taxpayers), gifting rather than retaining their assets (in the case of younger-generation taxpayers), establishing specialized trusts, and changing their domiciles, all in an effort to maximize the tax basis of the assets they own.

To preserve the nation's tax base, something must be done. However, in view of the budget and workforce constraints, addressing the tax basis issue administratively by more I.R.S. tax audits is unrealistic. The only meaningful solution lies in the legislative branch of government: Congress must institute reforms lest the nation's tax base be put in grave jeopardy. Possible reforms include reinvigorating the transfer tax regime, eliminating the basis equal to fair market value rule, and/or instituting a stiffer penalty regime related to taxpayers artificially inflating the tax basis of their inherited assets.

When it comes to tax basis reporting, the stakes are high. Tax basis determinations are pivotal in terms of accurately determining taxpayer gains and losses. More must therefore be done to insure that this key component of the nation's income tax system be respected.

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evidence or testimony before the Department of the Treasury or the Internal Revenue Service pursuant to 31 U.S.C. section 330(c).

Consideration should be given to whether appraisals prepared by qualified appraisers for tax basis reporting purposes should be required to make the same or similar declaration.

<sup>153</sup> I.R.C. § 6664(c).