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A CURSORY LOOK AT THE NEW CARRYOVER BASIS RULES*

RICHARD J. BOLES†

Even the minimally alert taxpayer will be concerned about the recent changes in the estate and gift tax laws brought about by the Tax Reform Act of 1976.¹ Indeed, these changes will suggest to him that a thorough review of his estate plan is in order. This article will briefly examine the new carryover basis rules and the planning implications inherent in those rules.

Prior to the Act the basis of property acquired from a decedent was its fair market value at date of death. If the property had appreciated in value since the decedent acquired it, the resulting gain would never be subject to an income tax since the decedent's beneficiaries took a stepped-up basis in the property. However, had the decedent transferred this property during his lifetime, the donee would have taken a carryover basis in the property. A subsequent sale of the property by the donee would then cause any appreciation in value to be recognized for income tax purposes.

It is this distinction between death and lifetime transfers that the Act views with a glass eye. New Code section 1023² addresses this point by providing that the basis of property acquired from a decedent after December 31, 1976, is to be the same as the decedent's basis immediately before his death.³

Exceptions to the carryover basis rules are made for property when the income attributable to it is already taxed to the recipient. For example, the following items are specifically exempted: income in

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1. Pub. L. No. 94-455, 90 Stat. 1520 (amending INT. REV. CODE OF 1954) (to be codified in scattered sections of 5, 7, 19 & 26 U.S.C.).

2. Section 2005 amends I.R.C. § 1014(d) to provide that in the case of a decedent dying after December 31, 1976, § 1014(d) will not apply to any property for which a carryover basis is provided by § 1023. Existing § 1023 is then redesignated § 1024 and a new § 1023 enacted.

3. I.R.C. § 1023(a)(1).

respect of a decedent;⁴ life insurance proceeds;⁵ a joint and survivor annuity when the surviving annuitant is taxable under Code section 72 and payments under a deferred compensation plan;⁶ property included in the gross estate by reason of being the subject of a gift in contemplation of death;⁷ property includible because subject to a revocable power in the decedent;⁸ property subject to a general power of appointment in the decedent;⁹ stock or stock options to the extent income in respect of such stock or stock option is includible in gross income;¹⁰ and stock in a foreign personal holding company.¹¹

In addition the executor may elect to exempt up to \$10,000 of assets from the carryover basis rules if those assets were personal or household effects in the hands of the decedent.¹² The executor must make this election not later than the time prescribed for filing the estate tax return, and the Secretary is to provide by regulation the manner of making the election.¹³ If an election is timely made these items will receive a stepped-up basis as under existing law. However, the basis of personal and household effects cannot be stepped up to an amount in excess of their fair market value.¹⁴ Apparently, Congress felt it was inappropriate to allow losses incurred upon the disposition of household and personal effects to be offset against gain generated from the disposition of investment type assets.

The words "personal and household effects" are not self defining and could create a troublesome area. However, the Committee on Ways and Means noted that generally these items would include clothing, furniture, sporting goods, jewelry, stamp and coin collections, silverware, china, crystal, cooking utensils, books, cars, televisions, radios, and stereo equipment.¹⁵

4. *Id.* § 1023(b)(2)(A).

5. *Id.* § 1023(b)(2)(B).

6. *Id.* § 1023(b)(2)(C). This exception applies only if the transferee disposes of the property prior to the death of the transferor, and a gain or loss is recognized for tax purposes.

7. *Id.* §§ 1023(b)(2)(D), 2035. This exception applies only if the transferee disposes of the property prior to the death of the transferor, and a gain or loss is recognized for tax purposes.

8. *Id.* § 2038. This exception applies only if the transferee disposes of the property prior to the death of the transferor, and a gain or loss is recognized for tax purposes.

9. *Id.* § 2041.

10. *Id.* § 1023(b)(2)(E).

11. *Id.* § 1023(b)(2)(F).

12. *Id.* § 1023(b)(3)(A).

13. *Id.* § 1023(b)(3)(C).

14. *Id.* § 1023(a)(2).

15. HOUSE COMM. ON WAYS AND MEANS, REPORT ON THE ESTATE AND GIFT TAX

With the exceptions noted above, all other property acquired from a decedent is carryover basis property. Four adjustments to the basis of this carryover basis property are provided for and must be made in the following sequence:

(A) The first adjustment permits the adjusted basis of any marketable bond or security to be stepped up to its fair market value on December 31, 1976.¹⁶ A marketable bond or security is one for which there was a market on a stock exchange, in an over-the-counter market, or otherwise.¹⁷ One must, of course, wait for the regulations to learn what the words "or otherwise" mean in the statute. This definition of marketability has a high potential for becoming a fertile area of conflict between taxpayers and the Internal Revenue Service. For instance, would stock in a closely held corporation owned by an Employee Stock Ownership Plan be a marketable security? Time and the courts will tell.

For carryover basis property other than marketable bonds or securities, if the value of such property at date of death exceeds its adjusted basis in the hands of the decedent, then for purposes of determining gain, the basis of such property shall be increased by the amount of this difference less any amounts claimed by the decedent during the period he held the property for depreciation, amortization or depletion.¹⁸ This amount is then multiplied by a fraction the numerator of which is the number of days during which the decedent held the property prior to January 1, 1977, and the denominator of which is the total number of days the decedent held the property.¹⁹ The product obtained is then adjusted for the depreciation, amortization or depletion attributable to the period the decedent held the property prior to January 1, 1977.²⁰

REFORM ACT OF 1976, H.R. REP. NO. 1380, 94th Cong., 2d Sess. 38 (1976), reprinted in [1976] U.S. CODE CONG. & AD. NEWS SUPP. 9A, at 496.

16. I.R.C. § 1023(h)(1).

17. *Id.* § 1023(h)(2)(E).

18. *Id.* § 1023(h)(2)(B).

19. *Id.* § 1023(h)(2)(C).

20. *Id.* §§ 1023(h)(2)(B)(i) & (ii). Assume, for example, that decedent acquired property January 1, 1974, at a cost of \$30,000. He died on January 1, 1984, when the fair market value of the property was \$80,000. Decedent had claimed a total of \$12,000 for depreciation deductions of which \$3,600 was deducted prior to January 1, 1977.

(a)	\$80,000	Fair market value at death
	—\$18,000	Decedent's adjusted basis
	<hr/>	
	\$62,000	Appreciation in value

The effect of this rule is that no appreciation occurring before January 1, 1977, will be subject to the new carryover basis rules. However, all carryover basis property, except marketable bonds and securities, is treated as if any appreciation in value that exists at the decedent's death occurred at a uniform rate during each year the decedent held the property. This valuation must be used even though the executor can establish that the fair market value on December 31, 1976, was different from the value arrived at by using this method. If there is a substantial improvement to the property after the decedent acquired it the improvement will be treated as a separate property for purposes of this adjustment.

(B) After making the adjustment to basis described above, the basis of appreciated carryover basis property that is subject to tax in the hands of the person acquiring it may then be increased by an amount that bears the same ratio to the federal and state estate taxes as the net appreciation in value of such property bears to the fair market value of all property that is subject to tax.²¹ The rule may be expressed as follows:

$$\frac{\text{Upward basis adjustment}}{\text{Federal and state estate taxes}} = \frac{\text{Net appreciation in value of such property}}{\text{Fair market value of all property subject to tax}}$$

(C) If the sum of \$60,000 now exceeds the aggregate bases of all carryover basis property (after making the adjustments to basis permitted under paragraphs (A) and (B) above), then the basis of each carryover basis property shall be increased by an amount that bears the same ratio to the amount of that excess as the net appreciation in value of such property bears to the net appreciation in value of all

-\$12,000	Total depreciation taken
<u>\$50,000</u>	Gain to be pro-rated over holding period
(b) \$50,000	$\frac{3 \times 366}{10 \times 366} = \$15,000$ pro-rated gain
(c) \$15,000	Pro-rated gain
+\$ 3,600	Depreciation taken prior to January 1, 1977
<u>\$18,600</u>	Basis adjustment
<u>+\$18,000</u>	Decedent's adjusted basis
\$36,600	Adjusted basis under fresh start rule

21. *Id.* § 1023(c).

such property.²² However, for this purpose the basis of personal and household effects may not be increased to a value greater than fair market value.²³

In addition, if the executor has elected to exempt up to \$10,000 of personal and household effects from the carryover basis rules then the basis of these items is not counted in determining the \$60,000 minimum basis. The rule is expressed in the following equation:

$$\frac{\text{Upward basis adjustment}}{\$60,000 \text{ less bases of all carry-over property}} = \frac{\text{Net appreciation in value of such property}}{\text{Net appreciation in value of all such property}}$$

(D) Finally, if the person acquiring appreciated carryover basis property actually pays any state an estate, inheritance, or succession tax with respect to such property, and for which the estate is not liable, then the basis of such property (after making the adjustments to basis permitted in paragraphs (A), (B) and (C) above) shall be increased by an amount that bears the same ratio to the aggregate amount of all such taxes paid by such person as the net appreciation in value of such property bears to the fair market value of all property acquired by such person which is subject to such taxes.²⁴ This rule may be expressed as follows:

$$\frac{\text{Upward basis adjustment}}{\text{Aggregate amount of all death taxes paid to any state}} = \frac{\text{Net appreciation in value of such property}}{\text{Fair market value of all property acquired which is subject to such state death taxes}}$$

It must be emphasized that the adjustments to basis of carryover property permitted above must be made in the order indicated.²⁵ Further, the adjustments to basis permitted for federal and state estate taxes, death taxes paid to any state with respect to such property, and the \$60,000 minimum bases of all carryover basis property shall not increase the basis of such property above its fair market value.²⁶

Apparently in applying the adjustments to basis the fair market value of the property is to be determined under the special valuation

22. *Id.* § 1023(d)(1).

23. *Id.* § 1023(d)(2).

24. *Id.* § 1023(e)(2).

25. *Id.* § 1023(f)(2).

26. *Id.* § 1023(f)(1).

rule for farms and closely held businesses if the executor has elected to use that valuation method for estate tax purposes.²⁷

If property subject to a mortgage or other indebtedness is included in the gross estate undiminished by such mortgage or indebtedness, then for purposes of the basis adjustments described above, the fair market value of such property treated as included in the gross estate shall be the fair market value of such property net of the mortgage or indebtedness.²⁸ Thus the adjustments to basis for property passing subject to a mortgage or indebtedness will be the same regardless of whether the mortgage or indebtedness is recourse or non-recourse debt.

The adjustment to basis for federal and state estate taxes²⁹ is only permitted for property that is subject to tax. Property for which a charitable or marital deduction is allowed would not be subject to tax and, therefore, it would seem no basis adjustments would be permitted for the amount of this property.³⁰ The Committee on Ways and Means gives an example in which the decedent makes a specific bequest of property to his children with the residue of his estate passing to his surviving spouse. Property in the residuary estate actually used to pay administration expenses and estate taxes would not qualify for the marital deduction. The amount of property so used is, therefore, subject to tax even though it was originally part of the residue.³¹

If the person acquiring carryover basis property from a decedent is unable to determine the basis of such property in the hands of the decedent immediately prior to death, then the basis will be treated as being the fair market value of such property as of the date (or approximate date) the decedent acquired it. If the decedent did not purchase the property the basis will be the fair market value of the property as of the date it was acquired by the last preceding owner in whose hands it did not have a basis determined in whole or in part by reference to its basis in the hands of a prior holder.³² In other words, a presumption is established that the decedent (or last purchaser) paid a fair

27. *Id.* § 2032A; MANAGERS OF COMM. OF CONFERENCE ON THE TAX REFORM ACT OF 1976, JOINT EXPLANATORY STATEMENT, H.R. CONF. REP. NO. 1515, 94th CONG., 2d Sess. app. A, at 613 (1976), reprinted in [1976] U.S. CODE CONG. & AD. NEWS SUPP. 9A, at 1356.

28. I.R.C. § 1023(g)(4).

29. *Id.* § 1023(c).

30. *Id.* § 1023(f)(4).

31. HOUSE COMM. ON WAYS AND MEANS, REPORT ON THE ESTATE AND GIFT TAX REFORM ACT OF 1976, H.R. REP. NO. 1380, 94th Cong., 2d Sess. 40 (1976), reprinted in [1976] U.S. CODE CONG. & AD. NEWS SUPP. 9A, at 498.

32. I.R.C. § 1023(g)(3).

market value price for the property. Time will tell whether this purchase price will prove to be a less elusive figure than basis immediately before death. How depreciation allowed or allowable with respect to such property is to be accounted for must await the issuance of regulations by the Internal Revenue Service. Any depreciation recapture inherent in any carryover basis property is to be recognized when the person acquiring such property from the decedent disposes of it.

Under existing law if an estate or trust distributes appreciated property in satisfaction of a right to receive a specific dollar amount, gain is recognized to the extent the fair market value of the property exceeds its adjusted basis in the hands of the estate or trust. With the new carryover basis rules the satisfaction of a pecuniary bequest with appreciated carryover basis property could have disastrous tax consequences. With the estate no longer taking a stepped-up basis the recognized gain would be far greater than previously experienced. In order to avoid this trap for the unwary, new Code section 1040 provides that if the executor of an estate satisfies the right of any person to receive a pecuniary bequest with appreciated carryover basis property, gain shall be recognized only to the extent the fair market value of such property, on the date of distribution, exceeds its fair market value on the date of decedent's death. In other words, only the appreciation occurring between the date of death and date of distribution will be recognized for tax purposes. This same rule is to be applied when by reason of the death of a decedent a person has a right to receive from a trust a specific dollar amount that is the equivalent of a pecuniary bequest, and the trustee satisfies such right with carryover basis property.³³

The executor's burden is further increased in that he must file with the Internal Revenue Service such information with respect to carryover basis property as may be prescribed by regulation.³⁴ Failure to furnish the information required, for other than reasonable cause, results in a penalty of \$100 for each such failure, but not in excess of \$5,000 for all such failures.³⁵ In addition, the executor is required to furnish in writing to each person acquiring property from a decedent the adjusted basis of such item;³⁶ failure to do so results in a penalty of \$50 for each such failure, but the total amount imposed for all such

33. *Id.* § 1040(b).

34. *Id.* § 6039A(a).

35. *Id.* § 6694(a).

36. *Id.* § 6039A(b).

failures shall not exceed \$2,500.³⁷ There is little here to comfort an executor.

These rules do not simplify our tax system. Indeed, the average taxpayer will probably be persuaded that they constitute another giant step backwards in the effort to simplify the tax laws. It is certain that the carryover basis rule will generate additional revenue but at what cost to a tax structure already staggering under the weight of its own complexity is yet to be determined.

37. *Id.* § 6694(b).