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Repealing Stepped-Up Basis and Endorsing Gutman's Proposal to Tax Capital Gains at Death

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REPEALING STEPPED-UP BASIS AND ENDORSING GUTMAN'S PROPOSAL TO TAX CAPITAL GAINS AT DEATH

Farah Modarres∗

The "stepped-up basis" rule allows unrealized capital gains to escape income taxation when an individual passes an asset at death. Congress attempted to repeal the tax loophole in recent years, but political disputes concerning its replacement delayed any potential changes. This Note examines the two frequently considered options to replace stepped-up basis: carryover basis and taxing capital gains at death. I argue that Congress should implement a system taxing capital gains at death. Specifically, I endorse the framework introduced by tax scholar Harry L. Gutman to tax capital gains at death as it properly addresses liquidity and valuation concerns often raised by opponents. Gutman's proposal is the most politically viable option to replace stepped-up basis, and it will ensure unrealized capital gains are appropriately subject to income tax.

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I. INTRODUCTION

On March 18, 2020, which coincides with the beginning of the COVID-19 pandemic, the combined wealth of all US billionaires equaled $2.947 trillion.[1] By January 18, 2021, their combined wealth equaled $4.085 trillion.[2] This over $1 trillion gain represents almost four times the cost of the $267 billion stimulus package passed by Congress in 2020 to assist 159 million individuals experiencing health, job, home, and food insecurity due to the pandemic.[3] Moreover, between March 21, 2020 and October 7, 2020, 67 million Americans lost their jobs.[4]

Although the pandemic illuminated the extensive wealth disparities in the US, the clear economic and social discrepancies between affluent and low-income families have existed since World War II.[5] Over time, large amounts of wealth have become concentrated in the hands of a few.[6] Wealthy families pass economic stability to their future generations through dynastic wealth transfers but the advantages are not solely limited to finances.[7] Handing down capital equates to handing down power.[8] Wealth transfers pass on political power, social capital, and a sense of societal control, to heirs.[9]

1. Chuck Collins, *U.S. Billionaire Wealth Surges Past $1 Trillion Since Beginning of Pandemic—Total Grows to $4 Trillion*, INST. FOR POL'Y STUD. (Dec. 9, 2020), https://ips-dc.org/u-s-billionaire-wealth-surges-past-1-trillion-since-beginning-of-pandemic/ [https://perma.cc/M95R-HTMP].

2. Press Release, Ams. for Tax Fairness; Inst. for Pol'y Stud., 10 Months into Crisis, U.S. Billionaires' Wealth Continues to Climb, Up $1.1 Trillion—Nearly 40%, at 3 (Jan. 26, 2021), https://americansfortaxfairness.org/wp-content/uploads/1-25-21-National-Billionaires-Report-10-Month-Press-Release-.pdf [https://perma.cc/EV8B-BUEY].

3. *Id.*; Collins, *supra* note 1.

4. Collins, *supra* note 1.

5. *See* Chad Stone et al., *A Guide to Statistics on Historical Trends in Income Inequality*, CTR. ON BUDGET & POL'Y PRIORITIES (Jan. 13, 2020), https://www.cbpp.org/research/poverty-and-inequality/a-guide-to-statistics-on-historical-trends-in-income-inequality [https://perma.cc/2PT8-EYS4] ("The best survey data show that the share of wealth held by the top 1 percent rose from 30 percent in 1989 to 39 percent in 2016, while the share held by the bottom 90 percent fell from 33 percent to 23 percent.").

6. *Id.*

7. *See* Eric Kades, *Of Piketty and Perpetuities: Dynastic Wealth in the Twenty-First Century (and Beyond)*, 60 B.C. L. REV. 145, 192 (2019) ("Franklin Roosevelt, decades later, declared that large pools of dynastic wealth 'amount to the perpetuation of great and undesirable concentration of control in a relatively few individuals over the employment and welfare of many, many others.'").

8. *See* Miranda Perry Fleischer, *Divide and Conquer: Using an Accessions Tax to Combat Dynastic Wealth Transfers*, 57 B.C. L. REV. 913, 914 (2016).

9. *Id.* at 914–17.

Since the pandemic started in March 2020, America's top 10 wealthiest families median net worth grew 25 percent.[10] However, this growth is hardly surprising. Since 1983, the wealth of 27 of America's 50 wealthiest families grew 1,007 percent.[11] The names of the wealthiest American families may sound familiar. The Walton family, owner of the "largest retailer in the world," Walmart, leads the list with a $247 billion net worth.[12] The Koch family follows with a net worth of $100 billion.[13] Discussing and implementing new tax policies to address the passing of large inheritances in billionaire families is vital to ensure an economy that works for all. Dynastic wealth transfers, in part, stem from the ease at which US taxpayers use loopholes to avoid taxation.[14] Congress should prioritize reforming the tax code to address these glaring loopholes to progress toward a more equitable system.

One loophole is Internal Revenue Code (IRC) section 1014, also called stepped-up basis.[15] Coined "the greatest tax loophole of all time" and the "angel of death loophole,"[16] the stepped-up basis rule allows gains accumulated from appreciated capital assets to escape income tax when passed at death.[17] This loophole enables beneficiaries to take a basis equal to the asset's fair market value at the time of the

10. CHUCK COLLINS ET AL., SILVER SPOON OLIGARCHS: HOW AMERICAN'S 50 LARGEST INHERITED-WEALTH DYNASTIES ACCELERATE INEQUALITY 4 (2021), https://ips-dc.org/wp-content/uploads/2021/06/Silver-Spoon-Oligarchs-Americas-Wealth-Dynasties-2021-Full-Report.pdf [https://perma.cc/32RM-BG3U].

11. *Id.* at 7.

12. *Billion-Dollar Dynasties: These Are the Richest Families in America*, FORBES (Dec. 17, 2020, 6:00 AM) [hereinafter *Billion-Dollar Dynasties*], https://www.forbes.com/sites/kerryadolan/2020/12/17/billion-dollar-dynasties-these-are-the-richest-families-in-america/ [https://perma.cc/BK23-EEL5]; James Leggate, *Walmart: What to Know About the 'Largest Retailer in the World,'* FOX BUS. (Sept. 29, 2019), https://www.foxbusiness.com/markets/walmart-5-things-to-know [https://perma.cc/2VGS-XT3T].

13. *Billion-Dollar Dynasties*, *supra* note 12.

14. COLLINS ET AL., *supra* note 10, at 16.

15. I.R.C. § 1014 (2018); *see* Richard Schmalbeck et al., *Advocating a Carryover Tax Basis Regime*, 93 NOTRE DAME L. REV. 109, 110 (2017) (explaining that I.R.C. § 1014 is referred to as a "step-up basis" rule).

16. David Ellis, *What Is the Greatest Tax Loophole of All Time?*, ACCOUNTINGWEB (Sept. 8, 2017), https://www.accountingweb.com/tax/individuals/what-is-the-greatest-tax-loophole-of-all-time [https://perma.cc/5KBP-C2AH]; Jeff Hoopes, *What Is the Step Up in Basis at Death "Loophole"?*, UNC TAX CTR. (Aug. 5, 2020), https://tax.unc.edu/index.php/news-media/what-is-the-angel-of-death-tax-loophole/ [https://perma.cc/584J-4RXF].

17. Schmalbeck, *supra* note 15; Brian Faler, *Zelenak Explains How a Loophole that Gives Big Tax Breaks on Inherited Assets Was Created*, DUKE L. (Jan. 29, 2020, 5:02 AM), https://law.duke.edu/news/zelenak-explains-how-loophole-gives-big-tax-breaks-inherited-assets-was-created/ [https://perma.cc/8AWK-HYXB].

decedent's death rather than the decedent's original basis.[18] The stepped-up basis rule allows accumulated gains on assets to pass tax-free to beneficiaries.[19] Congress has attempted to repeal stepped-up basis twice but failed both times.[20]

Reevaluating the stepped-up basis provision is particularly essential after the 2010 transfer tax reforms.[21] The unified credit against estate tax ("estate tax exemption") amount, which is currently $11.7 million per individual in 2021,[22] guarantees only a small percentage of the population is subject to the estate tax.[23] Previous arguments advocating for stepped-up basis claim that the estate tax will ensure unrealized gains that escape taxation due to the stepped-up basis system are taxed.[24] However, with the increasing estate tax exemption amount, the estate tax does not neutralize the code's inability to tax capital gains at death. In conjunction with the estate tax exemption amount, recent legislation allowing married individuals to max out their estate tax exemptions further supports the reevaluation of stepped-up basis.[25]

Overall, unrealized gains escaping taxation goes against our tax system's core policy to ensure wealth accretions are taxed.[26] In considering the significant wealth accumulation resulting from the stepped-up basis rule, many tax experts agree that an overhaul of the income tax treatment at death is necessary.[27] The two best options for repealing stepped-up basis are implementing a carryover basis regime or treating death as a realization event. These two options address the income tax treatment at death, but their application also directly affects the estate tax system.

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18. I.R.C. § 1014(a)(1).
19. I.R.C. § 1014.
20. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520, 1525; Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, 124 Stat. 3296, 3300.
21. *See* Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act, 124 Stat. 3296.
22. Sara Wells, *IRS Announces Increased Gift and Estate Tax Exemption Amounts*, JD SUPRA (Nov. 17, 2021), https://www.jdsupra.com/legalnews/irs-announces-increased-gift-and-estate-2522344/ [https://perma.cc/Y3N7-6TPK].
23. I.R.C. § 2010(c).
24. Stephen Vasek, *Death Tax Repeal: Alternative Reform Proposals*, 92 TAX NOTES 955, 962 (2001).
25. I.R.C. § 2010(c).
26. Comm'r v. Glenshaw Glass Co., 348 U.S. 426, 426 (1955).
27. COLLINS ET AL., *supra* note 10.

This Note proposes replacing stepped-up basis with a system that taxes capital gains at death. More specifically, this Note supports the recent proposal by Harry L. Gutman that properly resolves some of the main concerns with taxing gains at death. Gutman's proposal adequately tackles liquidity issues making it a better option than the recent proposal under the Biden administration. With some further tweaks noted in Part IV of this Note, Gutman's proposal is the most effective and politically viable option to endorse in the goal to replace stepped-up basis.

Part II explains and critiques the current stepped-up basis system.[28] Part II also provides some background on the estate tax system's broader role in the entirety of the transfer tax system and includes a discussion about portability.[29] Additionally, this part provides an in-depth look at the mechanics of stepped-up basis.[30] Part III of this Note points out the issues with the current income tax treatment at death and why Congress should repeal stepped-up basis.[31]

Part IV addresses the two systems offered to replace stepped-up basis: carryover basis and taxing capital gains at death.[32] This part illustrates the mechanics of each option and how they differ from a stepped-up basis regime. Additionally, this part reviews President Biden's "Green Book" proposal and Gutman's proposal to treat death as a realization event. Specifically, the part also identifies what makes Gutman's proposal superior.[33]

Finally, Part V will review some of the benefits of adhering to Gutman's proposal and also mention some critiques.[34] Addressing critiques is necessary to ensure a compelling proposal that both political parties in Congress and the average taxpayer could embrace.

II. BASICS OF THE TAX TREATMENT AT DEATH

A. Understanding the Federal Estate Tax System

The federal estate tax applies to the transfer of wealth at death.[35] Congress created the estate tax to help fund government spending

28. *See infra* Part II.
29. *See infra* Section II.A.
30. *See infra* Section II.B.
31. *See infra* Part III.
32. *See infra* Part IV.
33. *See infra* Section IV.B.i.
34. *See infra* Part V.
35. I.R.C. § 2031 (2018).

during World War I and the Spanish-American War.[36] Additionally, government officials believed the estate tax would also reduce the increasing concentration of wealth.[37] Although the estate tax had the indirect purpose of redistributing wealth, the system's main goal was to "reallocate the tax burden" on the wealthy.[38]

The estate tax differs from the income tax mainly by the method the tax base is calculated.[39] Unlike the income tax, the estate tax base does not include only realized gains from the sale of assets.[40] The estate tax applies to a decedent's entire gross estate valued at fair market at the time of death.[41] Congress designed the estate tax system not to tax every transfer at death, only significant wealth transfers.[42]

The estate tax is a part of a larger tax regime, the US transfer tax system.[43] The transfer tax system has three tax regimes: the estate tax, the gift tax, and the generation-skipping transfer tax.[44] The gift tax and estate tax work together to ensure that gratuitous transfers made during an individual's life and at death are subject to tax. Individuals often die with assets they want to pass on to family members, such as a house, car, jewelry, or stocks. Below, I've simplified the essential steps to determine an individual's estate tax liability.

First, a decedent's gross estate is calculated by adding up the fair market value of all "real or personal, tangible or intangible" property at death.[45] Fair market value is "the price at which the property would

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36. Joseph J. Thorndike, *Tax History: The Century of the Estate Tax: Made for Revenue, Not Redistribution*, TAX ANALYSTS (Aug. 31, 2016), http://www.taxhistory.org/thp/readings.nsf/ArtWeb/F6769F770B0FC2898525803700432EE1 [https://perma.cc/PN4J-2SHH]; Darien B. Jacobson et al., *The Estate Tax: Ninety Years and Counting*, 27 SOI BULL. 118, 120–21 (2007), https://www.irs.gov/pub/irs-soi/ninetyestate.pdf [https://perma.cc/AL6R-V6JJ].

37. Thorndike, *supra* note 36.

38. *Id.* ("[T]he estate tax wasn't supposed to remedy those problems, at least not directly. Instead, the tax was designed to reallocate the tax burden. As legal historian Ajay Mehrotra has observed, lawmakers 'had a pragmatic, rather than radical or reactionary, notion of redistribution.' They did not seek principally to recast society or refashion the economy in any thoroughgoing sense. 'Rather, they sought to reallocate the costs of underwriting a modern state across geographical regions and socioeconomic classes.'" (quoting AJAY K. MEHROTRA, MAKING THE MODERN AMERICAN FISCAL STATE: LAW, POLITICS, AND THE RISE OF PROGRESSIVE TAXATION, 1877–1929, at 27 (2013))).

39. *What Is a Tax Base?*, TAX FOUND., https://taxfoundation.org/tax-basics/tax-base/ [https://perma.cc/4H7R-MHTT] (defining tax base as "the total amount of income, property, assets, consumption, transactions, or other economic activity subject to taxation by a tax authority").

40. I.R.C. §§ 2031–2046 (2018).

41. *Id.* §§ 2031, 2032.

42. *Id.*

43. *See id.* §§ 2001–2801.

44. *Id.*

45. *Id.* § 2031.

change hands between a willing buyer and a willing seller."[46] The valuation issues dealing with calculating gross estate are complex, but for matters of this discussion, this Note uses the general definition when valuing an asset for estate tax purposes.

After calculating gross estate, the next step is determining any deductions to subtract from the gross estate. Some frequently used deductions include transfers to a trust,[47] transfers to government entities or charities,[48] and estate and inheritance taxes paid at the state level.[49] One important deduction to note is the marital deduction. The marital deduction allows spouses to transfer an unlimited amount of assets to their surviving spouse tax-free without using their estate tax exemption.[50] Therefore, if an individual passes and leaves everything to their surviving spouse, the marital deduction completely wipes out their gross estate, and the entire estate will pass tax-free.[51] After taking out any applicable deductions, the net taxable estate is reached.[52] Prior lifetime gifts are then added to the tax base since the gift and estate tax systems work in tandem in applying to any gratuitous transfers made during life and at death.[53] Any gift tax previously paid on those prior lifetime gifts would reduce the net taxable estate.

Finally, the estate tax exemption amount reduces the net taxable estate to determine whether a taxpayer owes tax.[54] The 2021 estate tax exemption amount is $11.7 million.[55] Any amount that exceeds the $11.7 million exemption is subject to tax at a 40 percent rate.[56] However, the high exemption amount ensures most estates are not subject

46. Treas. Reg. § 20.2031-1(b) (2020).

47. I.R.C. § 2056.

48. *Id.* § 2055.

49. *Id.* § 2058.

50. *Id.* § 2056.

51. *Id.*

52. *Id.* § 2051.

53. *Id.* § 2503. Note that gifts made by the decedent during life that were $10,000 or under would not be included. *Id.* Only "adjusted taxable gifts" are added back. *Id.* This includes gifts under I.R.C. section 2503, which are gifts excluded as taxable gifts, and any prior gifts are swept into the gross estate at death. *Id.*

54. While the exemption amount when computing the estate tax is really a credit, most practitioners explain it as an exclusion equaling $11.7 million for 2021. In reality, it is a credit that shelters the decedent's property from estate tax up to the basic exclusion amount. Thus, the credit is actually $4,625,800 in 2021, meaning this amount of tax calculated does not have to be paid. However, simplicity purposes, this Note explains it as an exclusion up to $11.7 million.

55. Randi Schuster, *Gift and Estate Tax Planning in 2021*, BAKER TILLY (Jan. 12, 2021), https://www.bakertilly.com/insights/gift-and-estate-tax-planning-in-2021 [https://perma.cc/KKJ4-4XLZ].

56. I.R.C. § 2001(c).

to tax. Even in 2018, when the exclusion amount was $11.18 million, only 0.07 percent of estates paid the estate tax.[57] For decedents in 2022, the estate tax exemption amount will be $12.06 million.[58] The estate tax exemption amount may sunset in 2025, meaning the exemption amount would decrease to $5 million, its amount prior to 2017.[59]

The mechanics of the estate tax system is best understood through an example. In 2021, an individual dies with an entire gross estate worth $8 million. After calculating $500,000 in various deductions, an individual would have a net taxable estate of $7,500,000.[60] After reaching the net taxable estate, the estate tax exemption shelters the decedent's estate from tax. Since the taxable estate is less than the exemption amount of $11.7 million, no estate tax is due. This entire transfer at death will pass to the decedent's beneficiaries without estate tax implications. The example illustrates the ease with which decedents avoid the estate tax because of the excessive exemption amount.

B. Stepped-Up Basis at Death

Compared to the estate tax system, the income tax system's central principle is that "all wealth accretions are subject to tax."[61] In 1955, the U.S. Supreme Court in *Commissioner v. Glenshaw Glass Co.*[62] honed in on the definition of income. The Court defined income as "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."[63] The central concept is that an individual's income each year does not include the change in value of an existing asset until a gain is *realized*. Income must be clearly realized, meaning that a tax on an increase is deferred until the sale or exchange of the asset. Therefore, a taxpayer that owns an asset, such as a house, does not have to include the asset's change in value each year in their income.

57. *How Many People Pay the Estate Tax?*, TAX POL'Y CTR. (May 2020), https://www.taxpolicycenter.org/briefing-book/how-many-people-pay-estate-tax [https://perma.cc/4B5E-BD8R].

58. *What's New—Estate and Gift Tax*, INTERNAL REVENUE SERV. (Nov. 15, 2021), https://www.irs.gov/businesses/small-businesses-self-employed/whats-new-estate-and-gift-tax [https://perma.cc/VZ7P-DTTG].

59. Schuster, *supra* note 55 ("The current exemption will sunset on Dec. 31, 2025, and will return to the Obama exemption of $5 million, adjusted for inflation. The adjusted exemption in 2026 is projected to be between $6 million and $7 million.").

60. Assuming the individual did not use up its exclusion during its life through inter vivos gifts. Gifts over $10,000 would be subtracted out of the individual's exemption amount.

61. Schmalbeck et al., *supra* note 15, at 109.

62. 348 U.S. 426 (1955).

63. *Id.* at 431.

Upon the sale or exchange of an asset, the realized gain is recognized and generally included in a taxpayer's income tax base.[64] Gain for determining inclusion is calculated using the following formula: Gain = Amount Realized - Adjusted Basis.[65] The amount realized is how much the asset is sold for, which is its fair market value at the time of sale.[66] The adjusted basis is typically the amount originally paid for the asset.[67] Gain is taxable, or in the event of a loss, a taxpayer can deduct the loss.[68] Although an individual can defer income tax on the increase in value of an asset by holding onto it, the main preface is that appreciation on an asset will eventually be taxed when the asset is sold. In comparison, most forms of income, such as salary, are immediately taxed as earned.[69]

The stepped-up basis rule alters the income tax treatment at death rather than the estate tax.[70] However, the stepped-up basis rule is an important ancillary issue that significantly affects the administration of the estate tax. In essence, the stepped-up basis rule allows beneficiaries inheriting assets to receive a new adjusted basis equal to the asset's fair market value at the decedent's death.[71] The adjusted basis is crucial because it determines the imposition of tax. If the basis is higher, then there is less tax liability. By taking a new basis, gains the asset accrues during the decedent's lifetime will escape taxation, which is why stepped-up basis is considered the "angel of death" tax loophole.[72]

Below is an example of the mechanics of stepped-up basis. In 2001, Katie purchased a home in Los Angeles for $200,000, which is her original basis. When Katie's son, Brian, inherited the home upon

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64. Nonrecognition principles may apply. *See* Will Kenton, *Realized Gain*, INVESTOPEDIA (June 25, 2021), https://www.investopedia.com/terms/r/realizedprofit.asp [https://perma.cc/8HKL-8KBU].

65. I.R.C. § 1001(a) (2018).

66. *Id.* § 1001(b).

67. Note that basis can be altered over the ownership period. Deductions taken for depreciation and casualty losses are subtracted from the basis because they effectively reduce the property owner's cost of ownership and the value of the property. *Id.* § 1001(a).

68. *Id.* § 165.

69. *Id.* § 61.

70. *Id.* § 1014.

71. *Id.*

72. Grace Enda & William G. Gale, *What Are Capital Gains Taxes and How Could They Be Reformed?*, BROOKINGS (Feb. 14, 2020), https://www.brookings.edu/policy2020/votervital/what-are-capital-gains-taxes-and-how-could-they-be-reformed/ [https://perma.cc/8EAX-TPLR]. I.R.C. § 1014(c) denies the privilege of stepped-up basis for income in respect of the decedent. It is also important to note that not all assets are subject to a step-up in basis.

Katie's death in 2015, the value of the Los Angeles home was $600,000. Because of the stepped-up basis rule, Brian's new basis in the home is $600,000. If Brian immediately sold the home next year for $650,000, he would pay capital gains tax on the selling price minus his basis. Therefore, Brian would only be taxed on $50,000. If stepped-up basis did not apply, and Brian had to keep Katie's original basis, Brian would have to pay capital gains tax on $400,000, the difference between the selling price and Katie's original basis of $200,000.

This readjustment of basis allows beneficiaries to minimize their capital gains liability. However, the issue with this loophole is that it allows $400,000 of gain to go untaxed, which would normally be taxed if the decedent sold or gifted the asset during their lifetime. The stepped-up basis rule allows taxpayers to hold onto appreciated assets until death to ensure those gains avoid taxation. Stepped-up basis is a clear retreat from the central idea of ensuring that unrealized gains are eventually taxed.

An even more troubling example is if billionaires, like Elon Musk, hold onto their asset's stock until death. With Musk's basis in Tesla stock is likely close to $0, the appreciation of stock during his lifetime will go untaxed if he holds onto the stock till his death. His beneficiaries will receive a stepped-up basis in the stock and can sell it the next day with minimal income tax consequences. The stepped-up basis rule enables wealthy taxpayers who are more likely to own appreciating assets to avoid income tax on gains through proper tax planning.

C. The Estate Tax Exemption and Portability

The portability of the estate tax exemption is also important to consider in analyzing the stepped-up basis system. In 2010, President Obama signed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act.[73] The legislation introduced many changes to the transfer tax system, including the concept of "portability."[74] Portability essentially provides married couples with the option to be

73. Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, 124 Stat. 3296.

74. Bridget J. Crawford & Wendy C. Gerzog, *Portability, Marital Wealth Transfers, and the Taxable Unit*, *in* CONTROVERSIES IN TAX LAW: A MATTER OF PERSPECTIVE 247, 247 (Anthony C. Infanti ed., 2015).

treated as a marital unit at the death of either spouse.[75] Any leftover estate tax exemption that was unused by a decedent spouse can be given to the surviving spouse to increase their estate tax exemption.[76]

Currently, each individual has an estate tax exemption amount equal to $11.7 million.[77] Prior to 2017, each spouse in a married couple would have a separate exclusion amount. The remaining exclusion amount would disappear at death and provide no further tax benefit. For the best tax consequences, tax planners attempted to equalize assets between spouses to take full advantage of each of their estate tax exemptions.[78] However, portability allows the exemption to "port over" to the surviving spouse.[79] The only way to claim portability is if a surviving spouse files a federal estate tax return at their spouses' death, even if they are not required to do so.[80] Portability ensures that the exemption amount will remain viable for the second spouse's use. Essentially, even after the first spouse passes away, a married couple can transfer $23.4 million in gifts and bequests without exposure to any gift or estate tax in 2021.[81] As described below, when a taxpayer makes a portability election, they can also receive a double stepped-up basis through proper tax planning.[82]

III. CRITIQUE OF STEPPED-UP BASIS

From a tax perspective, the stepped-up basis rule is beneficial to any taxpayer transferring a capital asset at death. Therefore, many taxpayers, especially wealthy individuals, are not concerned about replacing the loophole. However, recent changes to the tax treatment of transfers at death further illuminate the need to repeal stepped-up basis.

A. Who Benefits?

Repealing stepped-up basis would result in a more equitable income tax treatment at death. The stepped-up basis rule typically only

75. *Id.*
76. I.R.C. § 2010(c).
77. Schuster, *supra* note 55.
78. Crawford & Gerzog, *supra* note 74, at 247–48.
79. *Id.* Note that you must make this election soon after death.
80. *Frequently Asked Questions on Estate Taxes*, INTERNAL REVENUE SERV., https://www.irs.gov/businesses/small-businesses-self-employed/frequently-asked-questions-on-estate-taxes [https://perma.cc/CH5P-BFEK].
81. I.R.C. § 2010(c).
82. See *infra* Section III.A.

benefits wealthy taxpayers since most of the population's wealth is not held in capital assets.[83] In reality, American taxpayers' wealth is primarily received through wages and held in bank accounts.[84] Thus, stepped-up basis primarily impacts the income tax treatment at the death of wealthy individuals with capital assets, such as homes or stocks. Most taxpayers are not aware of the substantial benefits provided by the stepped-up basis loophole. In fact, "untaxed appreciation represents 36 percent of the value of all bequests but 56 percent of the value bequests exceeding $10 million."[85]

After the introduction of portability, the benefits of the stepped-up basis rule have amplified. As mentioned in Part II, tax planners have a new avenue to use stepped-up basis twice in community property states through portability. The goal for tax planners is to get a stepped-up basis at both spouses' deaths.[86] Upon the first spouse's death, assets can be passed outright or in trust to the surviving spouse using the marital deduction.[87] Those assets receive a new stepped-up basis and are not taxed until surviving spouse's death.

Therefore, the first spouse can transfer all of their assets at a stepped-up basis to the surviving spouse. Since the marital deduction wipes out the gross estate, the surviving spouse will receive the decedent's entire estate without being subject to tax.[88] The surviving spouse can also receive the entirety of the deceased spouse's unused exemption amount due to portability. At the surviving spouse's death, the assets receive another step-up in basis, and the potential $23.4 million estate tax exclusion amount for 2021 protects the entire estate from tax.[89] The marital deduction and portability allows beneficiaries

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83. Seth Hanlon & Galen Hendricks, *Congress Can't Miss This Chance to Close the Biggest Tax Loophole for the Ultrawealthy*, CTR. FOR AM. PROGRESS (June 23, 2021), https://www.americanprogress.org/article/congress-cant-miss-chance-close-biggest-tax-loophole-ultrawealthy/ [https://perma.cc/LZ6X-A6Q5].

84. Chuck Marr et al., *Substantial Income of Wealthy Households Escapes Annual Taxation or Enjoys Special Tax Breaks*, CTR. ON BUDGET & POL'Y PRIORITIES (Nov. 13, 2019), https://www.cbpp.org/research/federal-tax/substantial-income-of-wealthy-households-escapes-annual-taxation-or-enjoys [https://perma.cc/PP36-359E].

85. Lily L. Batchelder, *What Should Society Expect from Heirs? The Case for a Comprehensive Inheritance Tax*, 63 TAX L. REV. 1, 86 (2009).

86. Jim Freeman, *Step-Up in Cost Basis: What California Residents Need to Know*, FIN. ALTS. (Dec. 20, 2020), https://www.financialalternatives.com/financial-alternatives-inc/2020/12/20/step-up-in-cost-basis-what-california-residents-need-to-know [https://perma.cc/JC9F-F47Z].

87. I.R.C. § 2056 (2018).

88. *Id.* §§ 2010(c), 2044. The statement assumes the decedent made no gifts during life or other bequests.

89. Ben Geier, *What Is the Lifetime Gift Tax Exemption?*, SMARTASSET (Jan. 17, 2022), https://smartasset.com/retirement/lifetime-gift-tax-exemption [https://perma.cc/F4KP-AADV].

to receive a double benefit of maximizing the stepped-up basis potential and increasing the wealth that passes through appreciated assets.

The benefits of stepped-up basis will only result if an individual holds onto an asset until their death. This leads to a "lock-in" effect because of the ability for taxpayers to escape taxation at death altogether.[90] Wealthy individuals are incentivized to hold onto appreciated capital assets instead of selling them and can often do so without financial burden.[91] The ability to completely avoid tax instead of just deferring tax is the best-case scenario for taxpayers.[92] Thus, the incentive is to avoid a realization event during life that would cause accumulated gains to become taxable.[93]

The lock-in effect hinders the natural flow of the economy. Furthermore, owners of capital assets may hold onto underperforming assets that they otherwise would sell to receive the step-up in basis to avoid income tax on gains.[94] Thus, one of the main goals in replacing stepped-up basis is to reduce the lock-in effect and allow for the natural flow of the economy to ensue.

B. Technological Advancements Make a New System Viable

One of the main reasons for implementing a stepped-up basis rule is because of administrative convenience. However, because of significant technological advancements in recent years, these original arguments are moot. Prior to current technology, determining an asset's basis at death was rather challenging due to poorly-kept records. In congressional hearings discussing the repeal of stepped-up basis, many legislators argued that implementing carryover basis instead is impractical because of inadequate documentation.[95]

At the time Congress originally passed stepped-up basis, record keeping was not very accurate and was limited to paper.[96] Additionally, photocopies of records would have to be produced by hand and,

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The survivor's credit will continue to enjoy CPI adjustments between the deaths, but the first decedent's unified credit will have been frozen at death, minus the amount used by the first decedent during life and at death.

90. Schmalbeck et al., *supra* note 15, at 127.

91. *Id.*

92. *Id.*; Jane G. Gravelle, *Sharing the Wealth: How to Tax the Rich*, 73 NAT'L TAX J. 951, 958 (2020).

93. Schmalbeck et al., *supra* note 15, at 144; Faler, *supra* note 17; I.R.C. § 1001(c).

94. Enda & Gale, *supra* note 72.

95. Lawrence Zelenak, *Taxing Gains at Death*, 46 VAND. L. REV. 361, 388 (1993).

96. Schmalbeck et al., *supra* note 15, at 128.

therefore, copies of records were scarce.[97] However, this argument is hard to find credible considering basis has always been necessary for determining gain, loss, or a gratuitous transfer during an individual's lifetime.

Currently, the administrative burdens of determining basis are not concerning anymore due to technological advancements. Congress's "need for accurate tax basis reporting" and advancements in the way individuals keep records make the issues with determining original basis unproblematic.[98] Moreover, "in 2008, Congress instituted legislation that requires third-party vendors (primarily, brokerage firms) that hold nominee title to taxpayers' investments to record, track, and report the tax basis that taxpayers have in their investments."[99] Therefore, the argument that careless record-keeping impeded basis determination is not viable as support for a stepped-up basis system anymore. Moving toward a system requiring basis determination post-death would not hinder any system replacing stepped-up basis.

C. Attempts to Repeal Stepped-up Basis

The conversation around repealing stepped-up basis is not new. Congress has been aware of the unfairness stemming from the stepped-up basis rule for some time. Repealing stepped-up basis is challenging due to disagreements in Congress regarding its replacement. Historically, the main proposal to replace stepped-up basis is implementing a carryover basis system.

In 1976, Congress introduced the first proposal to repeal stepped-up basis.[100] Congress attempted to repeal stepped-up basis and implement a carryover basis system, which is the same basis rule for the transfer of gifts during life.[101] Carryover basis meant that beneficiaries would receive the decedent's basis.[102] Keeping the basis the same as the decedents served as a placeholder to ensure appreciation would eventually be taxed when the beneficiary sold the asset.

Because the estate tax exemption amount doubled from $60,000 to $120,000 between 1942–1977, Congress felt it was necessary to

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97. *Id.*

98. *Id.* at 112.

99. *Id.* at 130–31.

100. Garrett Watson, *History of Attempted Changes to Step-Up in Basis Shows Perilous Road Ahead*, TAX FOUND. (Sept. 28, 2021), https://taxfoundation.org/biden-estate-tax-unrealized-capital-gains-at-death/ [https://perma.cc/PXD2-GHHP].

101. *Id.*

102. *Id.*

change the basis rules at death to increase revenue that was lost.[103] Revenue decreased because fewer individuals were subject to the estate tax due to the increased exemption.[104] The proposal to replace stepped-up basis with carryover basis passed in Congress but never actually reached implementation.[105] After significant public backlash, the 1976 carryover basis legislation was eventually retroactively repealed in 1980 before the rule was implemented.[106] Many critics of the change argued that stepped-up basis was already a long-standing understood system, and it worked well from an administrative standpoint.

In 2001, Congress attempted to institute a carryover basis regime again under the Bush administration.[107] This time the Bush administration was attempting to eliminate the estate tax.[108] One of the reasons Congress initially implemented stepped-up basis was because they did not want income to be taxed twice at death, once at the income tax level and again at the estate tax level.[109] However, because of the decision to eliminate the estate tax, Congress also did not want unrealized gains on assets to completely pass tax-free at death.

> [T]he 2010 carryover tax basis regime began with a straightforward rule: in the recipient's hands, the income tax bases of assets owned by a decedent would be the lesser of (i) the decedent's adjusted basis in the property and (ii) the property's fair market value at the date of the decedent's death.[110]

This legislation ensured that the beneficiary would take the lesser amount even if the carryover basis was higher than the fair market value at the decedent's death.[111]

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103. *See Federal Estate and Gift Tax Rates, Exemptions, and Exclusions, 1916–2014*, TAX FOUND. (Feb. 4, 2014), https://taxfoundation.org/federal-estate-and-gift-tax-rates-exemptions-and-exclusions-1916-2014/ [https://perma.cc/B3JF-TL8G].

104. Schmalbeck et al., *supra* note 15, at 117.

105. *Id.*

106. *Id.* at 122.

107. *Id.* at 112.

108. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 501, 115 Stat. 38, 69; Emily Horton, *The Legacy of the 2001 and 2003 "Bush" Tax Cuts*, CTR. ON BUDGET & POL'Y PRIORITIES (Oct. 23, 2017), https://www.cbpp.org/research/federal-tax/the-legacy-of-the-2001-and-2003-bush-tax-cuts [https://perma.cc/56W5-8TG4].

109. STAFF OF THE JOINT COMM. ON TAX'N, BACKGROUND AND ISSUES RELATING TO CARRYOVER BASIS 3 (Comm. Print 1979).

110. Schmalbeck et al., *supra* note 15, at 123.

111. *Id.* at 123.

The 2001 legislation repealed stepped-up basis at death after 2009 and put in place a carryover basis system.[112] The legislation repealing stepped-up basis was intended to be a temporary provision.[113] However, in 2010, Congress retroactively repealed the legislation as part of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.[114] The new legislation reinstated the estate tax and the stepped-up basis rule.[115] However, Congress allowed for an "opt-out" election that executors could make for decedents dying in 2010.[116] The election allowed beneficiaries to opt for a carryover basis rather than a stepped-up basis. Surprisingly, "60 percent of returns opted for carryover basis" with even higher percentages for larger estates.[117]

The same arguments in 1978 and 2001 for the repeal of stepped-up basis still ring true today. The rising estate tax exemption amount has essentially eliminated the estate tax that was once a backstop to the stepped-up basis regime. Only "4,100 estate tax returns will be filed for people who die in 2020, of which only about 1,900 will be taxable—less than 0.1 percent of the 2.8 million people expected to die in that year."[118] Since only 1,900 people of the 2.8 million people who died in 2020 were subject to the estate tax, it is clear that the estate tax "backstop" is nonexistent. Congress needs to take thoughtful steps to repeal stepped-up basis to ensure gains on capital assets do not escape income taxation.

IV. REPLACING STEPPED-UP BASIS

Tax experts have mainly discussed two proposals to replace stepped-up basis. First is the concept of carryover basis, which I mentioned in Part II. The second option is implementing a tax system that would treat death as a realization event, also known as taxing capital gains at death. This part introduces President Biden's recent proposal to treat death as a realization event and compares it to Harry L.

112. *Id.*
113. *Id.* at 112.
114. *Id.* at 125.
115. Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, 124 Stat. 3296, 3300.
116. *Id.*
117. Gravelle, *supra* note 92, at 958.
118. *How Many People Pay the Estate Tax?*, *supra* note 57.

Gutman's alternate proposal. Gutman's proposal is the best option for replacing stepped-up basis for the reasons described below.

A. Carryover Basis

Congress consistently examined implementing carryover basis as an option to replace stepped-up basis.[119] A carryover basis system means that a beneficiary's basis in an asset will equal the decedent's basis instead of a stepped-up basis.[120] In comparison to stepped-up basis, carryover basis ensures unrealized gains accrued will eventually be subject to income tax when the beneficiary sells the asset.[121]

The difference between carryover basis and stepped-up basis can be illustrated using the example outlined in Section II.B.[122] If Brian received the Los Angeles home following Katie's death, his basis in the property equals Katie's original purchase price of the home. Therefore, Brian would receive the home with a basis of $200,000 instead of the home's fair market value at Katie's death, which was $600,000. When Brian sells the home the next year for $650,000, he would be subject to income tax on the realized gain. Thus, Brian would need to pay capital gain taxes on his $450,000 gain ($650,000 - $200,000). The result is that the gains accumulated over Katie's lifetime are eventually taxed when Brian or his beneficiaries sell the home. Unlike under a stepped-up basis system, carryover basis ensures that the appreciation is *eventually* taxed regardless of whether the asset is sold during life or transferred at death.

Multiple factors support a carryover basis proposal. First, the initial argument for stepped-up basis to ensure income is not taxed twice is not significant. With 0.07 percent of estates that actually pay tax, it does not seem reasonable to argue that stepped-up basis is necessary to avoid double taxation when most estates are not subject to a single level of taxation.[123] The estate tax, which once was essential to ensure that unrealized gains did not escape taxation, is not the same force that it used to be. While the estate tax only raises 0.6 percent of revenue, the projected revenue from implementing carryover basis is

119. *See supra* Section III.C.
120. Schmalbeck et al., *supra* note 15, at 111.
121. *Id.* at 146–47.
122. *See supra* Section II.B.
123. *How Many People Pay the Estate Tax?*, *supra* note 57.

substantial.[124] "The Penn Wharton Budget Model estimates a gain . . . beginning at $10 billion in the first year and rising to $27 billion by the [tenth] year. The Congressional Budget Office estimates a smaller gain, beginning at $5 billion and rising to $17 billion after 10 years."[125]

However, the main issue with a carryover basis regime is that it only increases the lock-in effect for beneficiaries. The beneficiary of an asset will continue to hold onto an asset out of concern for the income tax consequences if they sell the property. The current owner of an asset would not have an incentive during life to hold onto an asset, which would decrease the lock-in effect.[126] However, opponents argue a lock-in effect would only increase for beneficiaries since they would hold onto assets out of concern for a significant tax liability upon sale.[127] This lock-in effect would only increase as decedents pass down assets each generation and appreciation of the asset continues, increasing their potential tax liability.[128] The lock-in effect affects "the mobility of capital" and causes assets that a taxpayer normally would sell to be maintained out of fear of significant tax liability.[129]

Overall, carryover basis has been a compelling and often explored option to replace stepped-up basis. However, it does not go far enough to end the lock-in effect inhibiting reinvestment. With previous failed attempts to impose a carryover basis regime, it is necessary to explore a new system to replace stepped-up basis, such as treating death as a realization event.

B. Death as a Deemed Realization Event

The alternative and more controversial proposal to replace stepped-up basis is to treat death as a realization event by taxing capital gains at death. Treating death as a realization event means that an asset will be treated as if it was sold in the year the decedent passes away.[130] The asset would be subject to capital gains tax, which would reduce the gross estate value by the gains subject to tax and increase

124. Andrew Lundeen, *The Estate Tax Provides Less than One Percent of Federal Revenue*, TAX FOUND. (Apr. 7, 2015), https://taxfoundation.org/estate-tax-provides-less-one-percent-federal-revenue/ [https://perma.cc/2HCC-3LQW].

125. Gravelle, *supra* note 92, at 958 (citations omitted).

126. STAFF OF THE JOINT COMM. ON TAX'N, *supra* note 109, at 20.

127. *Id.*

128. *Id.*

129. *Id.*

130. Gravelle, *supra* note 92, at 959.

the asset's basis to its fair market value.[131] The asset's basis would be the same under a stepped-up basis regime, but the gains accrued over the decedent's lifetime would be subject to capital gains tax at death.[132] This system would limit the "maximum deferral possibility to a single lifetime."[133]

Many tax experts agree that taxing gains at death is likely the best option to deal with unrealized gains at death.[134] However, because of administrative and liquidity concerns associated with the system, legislation treating death as a realization event seemed politically unachievable to pass in Congress.[135] The main advantage of taxing gains at death is its potential to raise significant and consistent revenue.[136] Since the 1990s, politicians discussed the potential advantages of taxing capital gains at death.[137] The Congressional Budget Office in 1993 listed the "failure to tax gain at death as the fourth largest item in the tax expenditure budget."[138]

Currently, taxing gains at death is projected to increase revenue significantly.[139] Studies "estimate[d] that taxing accrued gains at death and raising the capital gains tax rate to 28 percent would bring in $290 billion between 2021 and 2030."[140] However, with a $1 million exemption, this revenue would be decreased.[141] Although revenue would decrease, the exemption is important because it mainly concentrates the tax on wealthy individuals. With an exemption of $1.3 million, "64 percent [of the revenue] would be paid by the top 1 percent and 85

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131. *Funding Our Nation's Priorities: Reforming the Tax Code's Advantageous Treatment of the Wealthy*: *Hearing Before the Subcomm. on Select Revenue Measures of the Comm. on Ways and Means*, 117th Cong. (2021) (statement of Harry L. Gutman, Chief of Staff [retired], Joint Comm. on Taxation).

132. *See* Gravelle, *supra* note 92, at 962.

133. Zelenak, *supra* note 95, at 367. The concept that deferral would be limited to a single lifetime enforces the idea that the taxpayer who earned the amount should be subject to tax. Specifically, the taxpayer should be subject to a tax rate that appropriately reflects the rate at the specific time of appreciation.

134. *See id.* at 370.

135. As mentioned, changing the stepped-up basis rule mainly affects the wealthy. Most individuals in Congress either are independently wealthy themselves or are backed by wealthy taxpayers.

136. Zelenak, *supra* note 95, at 371.

137. *See id.* at 370.

138. *Id.* at 371. The Budget office estimated a revenue loss of "more than $24 billion in 1991, more than $26 billion in 1992, and more than $28 billion in 1993." *Id.*

139. Grace Enda & William G. Gale, *How Could Changing Capital Gains Taxes Raise More Revenue?*, BROOKINGS (Jan. 14, 2020), https://www.brookings.edu/blog/up-front/2020/01/14/how-could-changing-capital-gains-taxes-raise-more-revenue/ [https://perma.cc/6DVZ-LB7S].

140. *Id.*

141. *See* Zelenak, *supra* note 95, at 372.

percent by the top 10 percent."[142] Taxing gains at death would result in a significant and steady increase in revenue compared to implementing carryover basis.

The main concerns with taxing gains at death are valuation and liquidity issues. As discussed previously in terms of carryover basis, determining a decedent's original basis in an asset was previously a concern. Mainly this was due to a lack of record-keeping, which has improved with the implementation of technology.[143] Taxing capital gains at death is burdensome because it requires determining both an asset's original basis and the asset's fair market value at death.[144] An asset is treated as though it was sold at the decedent's death, and, therefore, basis and fair market value of the asset needs to be determined.[145] This is even more onerous than a carryover basis system because it requires two factual determinations, while carryover basis only requires a determination about the original basis.[146] This also "requires valuation of some privately-held and non-marketable assets, like family businesses or art, that may be difficult to value."[147]

Along with valuation concerns are issues related to a taxpayer's liquidity. By taxing gains at death, a decedent's estate is liable for the tax. However, the estate did not actually receive a gain from the sale of the asset, so many individuals may find it difficult to pay the tax if their wealth is mainly held in the asset rather than cash.[148] Individuals might have to sell the asset or another asset to keep one more valuable.[149] A system that taxes capital gains at death may prove burdensome on estates that do not have excess liquidity to pay a tax on the "phantom" sale. Additionally, forced sales could occur, causing beneficiaries to part with meaningful assets to meet tax obligations at death.[150]

A proposal that purposefully addresses these main concerns can lessen the difficulties with taxing gains at death. By concentrating on these apprehensions, proposals to tax capital gains at death can

142. Gravelle, *supra* note 92, at 959.

143. Schmalbeck et al., *supra* note 15, at 129.

144. *Id.* at 151.

145. *Id.*

146. *Id.*

147. Enda & Gale, *supra* note 139.

148. Schmalbeck et al., *supra* note 15, at 151.

149. *Id.* Other options are for decedents to buy life insurance to cover the liability or pay the tax over a period of time. Enda & Gale, *supra* note 139.

150. Schmalbeck et al., *supra* note 15, at 151.

become more politically feasible. Recently, President Biden introduced a system that would treat death as a realization event.[151] Congress is no longer considering President Biden's proposal because of pushback it received for not adequately addressing the important liquidity issues.[152] In comparison, Harry L. Gutman recently introduced a variation of taxing gains at death.[153] His proposal addresses the necessary concerns to make a system treating death as a realization event a practical option to replace stepped-up basis.[154]

1. "Green Book" Proposal

In May 2021, President Biden released his Fiscal Year 2022 budget, also known as the "Green Book."[155] The Green Book included a proposal to repeal stepped-up basis and instead treat death as a realization event.[156] Biden proposed to treat transfers of appreciated property by gift or at death as realization events.[157] During life, if an individual gifts an asset, this would be a realization event resulting in taxable income to the donor to the extent the fair market value at the time of the gift exceeds the donor's adjusted basis.[158] Transfers at death would also be considered realization events that would result in taxable income.[159] In addition, the proposal includes an exemption amount of $1 million.[160] The first $1 million of gain would not be subject to tax, and gains over $1 million would be treated as capital gains.[161] Since a taxpayer pays income tax on the gains accumulated

151. *Details of President Biden's Proposed Reformation of Capital Gains and Transfer at Death Rules*, THOMSON REUTERS: TAX & ACCT. (June 3, 2021), https://tax.thomsonreuters.com/news/details-of-president-bidens-proposed-reformation-of-capital-gains-and-transfer-at-death-rules/ [https://perma.cc/6SBR-QGCW]; *see* DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2022 REVENUE PROPOSALS 1 (May 2021) [hereinafter *Green Book*], https://home.treasury.gov/system/files/131/General-Explanations-FY2022.pdf [https://perma.cc/88T3-89KA].

152. Christine M. Sapers et al., *From the Green Book: Administration's Tax Proposals for Individual Income Taxation*, LOEB & LOEB LLP (June 2021), https://www.loeb.com/en/insights/publications/2021/06/from-the-green-book [https://perma.cc/9WG3-G4XZ]; Kate Dore, *House Democrats' Plan Drops Repeal of a Tax Provision for Inheritances*, CNBC (Sept. 14, 2021, 9:55 AM), https://www.cnbc.com/2021/09/13/house-democrats-plan-drops-repeal-of-a-tax-provision-for-inheritances.html [https://perma.cc/H8BB-X98E].

153. Harry L. Gutman, *Taxing Gains at Death*, 170 TAX NOTES FED. 269, 269–70 (2021).

154. *Id.* at 269.

155. *Green Book*, *supra* note 151.

156. *Id.* at 61–62.

157. *Id.* at 62

158. *Id.*

159. *Id.*

160. *Id.* at 63.

161. *Id.*

over the decedent's lifetime, the beneficiary would receive the asset at a stepped-up basis.[162]

The proposal also includes a provision ensuring that income is not taxed twice by the income tax and estate tax. The legislation included a deduction against the decedent's gross estate for income tax paid due to the realization event at death.[163] This deduction makes sense because if a taxpayer transferred these assets during life, they would be subject to income tax only, and the transfer would decrease the taxpayer's gross estate. "Without it, the total taxes at death, federal and state, could exceed 80 percent [for] some estates."[164] Additionally, the proposal includes exceptions to address liquidity issues, including provisions dealing with personal residences, personal effects such as collectibles and heirlooms, and capital gains on small business stock.[165]

In tandem with treating transfers of appreciated property as realization events, President Biden proposed increasing long-term capital gain rates to equal the current ordinary income tax rates.[166] A capital gain results from selling a capital asset, such as a home or stock. These gains are subject to a different rate of tax than ordinary income.[167] The ordinary income rates are higher than capital gain rates and are applied to gross income, including income such as salaries, bonuses, and rents.[168] This proposal argues that the preferential capital gain rates benefit the ultra-wealthy who keep most of their income in capital assets rather than individuals who receive wages.[169] Therefore, taxing gains at death and increasing the long-term capital gain rate would equalize the treatment between taxpayers with and without capital assets.[170]

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162. *Id.*

163. Sapers et al., *supra* note 152; Gutman, *supra* note 153, at 278.

164. Richard B. Covey & Jerome J. Caulfield, *Taxing Unrealized Appreciation on Lifetime Transfers and at Death*, CARTER LEDYARD (July 20, 2021), https://www.clm.com/taxing-unrealized-appreciation-on-lifetime-transfers-and-at-death/ [https://perma.cc/NAU7-4F57].

165. *Green Book*, *supra* note 151, at 63.

166. *Id.* at 62.

167. I.R.C. § 1(h) (2018). The current long-term capital gain rates are 0%, 15%, and 20%. *Id.* Long-term capital gain rates are applied to assets held longer than 12 months. *Id.*

168. *The Tax Policy Center's Briefing Book: How Are Capital Gains Taxed?*, TAX POL'Y CTR. (May 2020), https://www.taxpolicycenter.org/briefing-book/how-are-capital-gains-taxed [https://perma.cc/K4GN-SMWS]; *see* I.R.C. § 61 (defining gross income). Ordinary income rates are 10%, 12%, 22%, 24%, 32%, 35% and 37%, depending on your tax bracket based on the amount of income you earn. I.R.C. § 1(j).

169. *Details of President Biden's Proposed Reformation of Capital Gains and Transfer at Death Rules*, *supra* note 151.

170. *Id.*

As mentioned, the liquidity issues stemming from taxing gains at death concern many taxpayers. Many family-owned businesses and farms have taken issue with a deemed realization regime.[171] One rancher exclaimed, "Biden's liberal plan would force many family farms and ranches to be sold off to pay his higher capital gains taxes."[172] Many farm owners who have been in control of their businesses and land for generations feel similarly.[173] To address this issue, Biden included in his plan a provision that family-owned businesses and farms "could defer the tax as long as the business stayed in family hands."[174] When beneficiaries of the farm sell the asset, they would have fifteen years to pay the appreciation.[175] However, Biden's plan did not go far enough to convince Congress that the plan would protect individuals who may be rich in assets but cash poor.[176]

President Biden's plan did not decrease the concern surrounding the liquidity issues arising from treating death as a realization. In combination with the liquidity issues stemming from this proposal, President Biden's proposal to raise capital gain rates made the plan challenging to pass due to the political divisiveness in Congress. This failed attempt is a valuable learning experience in shaping a proposal more viable to pass in Congress.

2. Harry L. Gutman's Proposal

Harry L. Gutman recently introduced another variation of treating death as a realization event. Gutman served as deputy tax legislative counsel in the Treasury Department Office of Tax Policy and was responsible for overseeing policy issues related to estate, gift, and generation-skipping taxes.[177] He is an expert in this area and was invited in May 2021 to testify before the House Ways and Means Committee

171. *See* Glenn Kessler, *Ad Exaggerates Potential Impact of Biden Estate-Tax Plan*, WASH. POST (Oct. 19, 2021, 3:00 AM), https://www.washingtonpost.com/politics/2021/10/19/ad-exaggerates-potential-impact-biden-estate-tax-plan/ [https://perma.cc/MX5N-DYU5].

172. *Id.*

173. Tim Grant, *As Tax Changes Loom, Farmers Worry About the Next Generation*, AP NEWS (June 19, 2021), https://apnews.com/article/joe-biden-business-6019bbf1969016cbd2749b213ba47a08 [https://perma.cc/3B8Q-NY6P].

174. Kessler, *supra* note 171.

175. *Green Book*, *supra* note 151, at 63.

176. Taylor Tepper, *What Investors Should Learn from the Failed Bid to End Stepped-up Basis*, FORBES (Sept. 21, 2021, 8:00 AM), https://www.forbes.com/advisor/investing/stepped-up-basis-lessons/ [https://perma.cc/E5UE-3ZDH].

177. *Harry L. Gutman*, IVINS PHILLIPS BARKER, https://www.ipbtax.com/attorneys-Hank_Gutman [https://perma.cc/QA7B-HGN4].

regarding repealing stepped-up basis and implementing a system treating death as a realization event.[178]

In a Tax Notes article from January 2021, Gutman states that "a provision that forgives the income tax on unrealized appreciation is particularly indefensible."[179] Gutman advocates that death be treated as a realization event.[180] However, the unique aspect of his proposal is that the recognition of gain is limited to marketable assets.[181] His variation indicates that only "marketable assets" and lifetime transfers will be treated as realization events.[182] The transfer of "nonmarketable assets" would be realization events but would not require recognizing gain until the beneficiary or donee is no longer the owner.[183] At that point, the beneficiary or donee would be subject to tax.[184] Additionally, similar to President Biden's, Gutman's proposal would include a deduction against the decedent's gross estate for income tax paid.[185]

Gutman's proposal distinguishes between marketable and nonmarketable assets to address some of the liquidity concerns that result from a pure deemed realization system.[186] Marketable assets are what Gutman considers as liquid assets, which makes classifying the transfer of these assets as a recognition event appropriate.[187] Examples of marketable assets are stocks, bonds, and mutual funds.[188] These types of assets can be liquidated and turned into cash quickly.[189] Gutman's proposal considers that an individual who dies with marketable assets can easily liquidate them and pay the income tax on the appreciated gains over the decedent's lifetime.[190]

In comparison, nonmarketable assets would be assets like farms and small businesses that are illiquid since taxpayers cannot as easily

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178. *Id.*; *see Funding Our Nation's Priorities: Reforming the Tax Code's Advantageous Treatment of the Wealthy*: *Hearing Before the Subcomm. on Select Revenue Measures of the Comm. on Ways and Means*, *supra* note 131.

179. Gutman, *supra* note 153, at 270.

180. *Id.* at 273.

181. *Id.*

182. *Id.*

183. *Id.* at 274–76.

184. The tax would include an interest charge that would equate to "the present value of the deferred tax with the tax that would have been paid at death." *Id.* at 274. This deferral would not apply to lifetime transfers. *Id.*

185. *Id.* at 278.

186. *Id.* at 272.

187. *Id.* at 273–74.

188. *Id.* at 272.

189. *Id.* at 274.

190. *Id.* at 272.

sell them.[191] To pay an income tax on nonmarketable assets at death would be unfair to farms and small businesses because it could result in the forced sale of the asset just to pay the tax.[192] Gutman does note that these assets allow individuals to borrow against them, but that "is not an ideal solution."[193] Gutman's proposal attempts to balance the argument that taxing gains at death is necessary to properly tax unrealized gains while also wanting to guarantee small businesses and farms are not subject to impractical tax consequences at death. Nonmarketable assets would be valued at death, but the tax payment would be deferred until the property was sold or transferred by the transferee.[194] A gain would be taxed at the effective rate on the decedent's death along with interest charges to equate to the present value of the deferred tax.[195] However, the transferor of nonmarketable property can elect to recognize the gain on an asset-by-asset basis.[196]

Gutman also revisits portability issues. He suggests ending the treatment of the marital unit as a single taxpayer.[197] Instead, the idea is that transfers to a surviving spouse would fall under the estate tax marital deduction but still be considered realization events.[198] However, a nonrecognition statute would defer the realized gain until the surviving spouse sells the property or passes it to a beneficiary.[199] Therefore, the decedent's gain on appreciated assets would eventually be taxed even if passed on to the surviving spouse.

Gutman's proposal identifies the main issue of liquidity that President Biden's plan lacked. Gutman's proposal identifies the concern that a deemed realization system can result in unfavorable consequences for many asset-rich, cash-poor taxpayers who do not have the available funds to pay. By separating marketable and nonmarketable assets, the burden will fall on high-net-worth individuals that can pay tax on a deemed sale of liquid assets. Gutman's proposal is a good starting point to repeal stepped-up basis and impose a system that treats death as a realization event. The proposal is more politically

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191. *Id.* at 274.
192. *Id.*
193. *Id.*
194. *Id.*
195. Realized losses could be used to offset net recognized gains.
196. Gutman, *supra* note 153, at 274.
197. *Id.* at 275.
198. *Id.*
199. *Id.* at 275–76.

viable since it decreases the burden on the average taxpayer and focuses on high-net-worth individuals.

V. JUSTIFICATION/CRITIQUE OF GUTMAN'S PROPOSAL

Gutman's proposal is the best option moving forward in advocating for a system that taxes capital gains at death. It addresses the liquidity issues lacking in President Biden's recent proposal. It also addresses many of the undesirable consequences of a stepped-up basis system. Furthermore, it also resolves the lock-in effect resulting from a carryover basis regime. Overall, Gutman's proposal is the most comprehensive deemed realization at death proposal to replace stepped-up basis. Analyzing deduction and portability concerns associated with Gutman's proposal helps ensure its political viability and future workability as a part of the tax code.

A. Raising Revenue

One of the main benefits of taxing capital gains at death is that tax revenue would rise significantly. Under President Biden's plan, the "Penn Wharton Budget Model (2020a) estimates a gain . . . beginning at $10 billion in the first year and rising to $27 billion by the [tenth] year."[200] Specifically, combined with Biden's suggested increase in the capital gain rate, the revenue from treating death as a realization event would be immense.

Gutman's proposal would likely result in less revenue than Biden's plan because he differentiates between realizing only marketable assets instead of all assets. Since fewer assets would be realized by individuals at death, less revenue would result. However, the increased political viability of Gutman's plan outweighs the loss in revenue from a more inclusive plan like President Biden's. Without both Democrats' and Republicans' support, legislation to tax gains at death would not pass in Congress. Leaders in Congress are not concerned with the impact that taxing gains at death have on wealthy individuals. Rather, leaders are more concerned for their constituents that own small family-owned businesses that might face a substantial tax bill if stepped-up basis is repealed.[201] Therefore, the cost-benefit analysis of having a more inclusive system that results from more realization of assets, like President Biden's proposal, is not advantageous given its

200. Gravelle, *supra* note 92, at 958.
201. *See* Tepper, *supra* note 176.

unlikelihood to ever pass in Congress. Gutman's proposal specifically resolves the issue that makes taxing gains at death politically challenging.

B. Lock-In Effect

Taxing gains at death would effectively eliminate the lock-in effect compared to implementing a carryover basis system. Under a system that taxes capital gains at death, a family holding onto an asset would be subject to capital gains tax at every generation. This system provides no incentive to hold onto an asset because the gains will be taxed if they sell it, gift it, or die with it. Eliminating the lock-in effect would assist in restoring the natural flow of the economy and would not incentivize individuals to hold onto assets.

In fact, much of the revenue resulting from taxing capital gains at death would not result from the tax itself.[202] It would be a consequence of ending the lock-in effect, causing individuals to realize most of the gain on appreciated assets while they are alive.[203] Since many individuals would sell assets during their lifetime, more individuals would have a decreased gross estate. Furthermore, income tax imposed due to transfers at death being treated as a deemed realization event would result in a deduction against the gross estate, further reducing the gross estate and estate tax applicability.

Therefore, one consideration in taxing gains at death is reforming the estate tax exemption amount. Reform is necessary to ensure that an added burden is not placed on individuals at death due to a lowered exemption amount, which is set to sunset to $5 million in 2026.[204] The House Ways and Means Committee recently released proposals to alter the estate tax system to pay for Biden's proposed Build Back Better Act.[205] The proposal accelerates the reduction of the estate tax exemption amount to $5 million beginning in 2022 rather than in 2026.[206]

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202. Zelenak, *supra* note 95, at 372.

203. *Id.*

204. Katherine L. Jeffrey, *Proposed Federal Tax Law Changes Affecting Estate Planning*, DAVIS WRIGHT TREMAINE LLP (Oct. 20, 2021), https://www.dwt.com/insights/2021/10/federal-estate-tax-changes-2022 [https://perma.cc/D7ST-5CN7].

205. Alex Durante et al., *House Build Back Better Act: Details & Analysis of Tax Provisions in the Budget Reconciliation Bill*, TAX FOUND. (Dec. 2, 2021), https://taxfoundation.org/build-back-better-plan-reconciliation-bill-tax/ [https://perma.cc/2A4U-4STN].

206. Jeffrey, *supra* note 204. The proposal also alters the use of grantor trusts. Grantor trusts have been an extremely helpful tool for tax planners to avoid the estate tax. It "allows transferring assets out of a grantor's estate for estate tax purposes, while having the grantor remain the owner for income tax purposes. This has provided the benefit of allowing transactions between a grantor

Lowering the estate tax exemption might not be the best option if Congress eventually enacts a deemed realization at death system. A better option is to retain the high exemption amount, but phase it out based on estate size.[207] Phasing out the exemption amount would ensure that the estate tax is concentrated on high wealth levels.[208] Since the estate tax under a deemed realization event at death system is no longer a backstop to the appreciated gains that pass tax-free, the estate tax should have the primary intent of taxing the ultra-wealthy. Additionally, by keeping the high exemption amount, the political viability of a system that taxes gains at death increases.

Therefore, a comprehensive proposal should also include a discussion about reforming the exemption amount. Specifically, maintaining a high exemption that is phased out by estate size is likely the best alternative in tandem with a deemed realization at death system.

C. Deductions and Portability

As noted, if a taxpayer sells an asset during life, this decreases their gross estate. To have a similar effect at death, the capital gains tax paid would need to be deductible in computing the taxable estate.

Biden's proposal suggests treating transfers of appreciated property at death as realization events.[209] However, transfers to a surviving spouse would result in a carryover basis of the asset.[210] This could cause uncertainty where some assets would be taxed at death while others receive a carryover basis. The issue is that once the assets are passed with a carryover basis to the surviving spouse and some are

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and his/her grantor trust to occur without income tax ramifications (sales, loans, leases, etc.)." *Id.* The proposal includes the following changes to grantor trusts:

> First, the proposed legislation would require inclusion in a grantor's estate of the value of all assets held in a grantor trust as of the grantor's date of death.
>
> Second, any sale transactions between a grantor and a grantor trust would be subject to income taxation as if between the grantor and a third party.
>
> Third, all distributions from a grantor trust to a beneficiary other than the grantor or the grantor's spouse will be treated as a taxable gift from the grantor to the distribution recipient.
>
> Finally, if a grantor chooses to "turn-off" the grantor trust power during his or her lifetime, thereby commuting the trust into a nongrantor trust, the proposed legislation would treat such action as an additional gift of the assets of the trust to the trust beneficiaries, valued as of the date the power is relinquished.

Id.

207. Gravelle, *supra* note 92, at 959.

208. *Id.*

209. *Green Book*, *supra* note 151, at 62.

210. *Id.* at 63.

non-spousal transfers, how should the income tax liability that is deductible under the estate tax be calculated in the event portability is elected?

In response to Gutman's proposal, nonmarketable property essentially creates a deferred tax liability since it will not be subject to tax until transferred.[211] The deduction received on assets subject to a realization event would also have to be portable to the surviving spouse. Therefore, the deduction reduces the gross estate at the surviving spouse's death.[212] The deferred tax would not reduce the property's value in calculating the gross estate for the decedent, but it might reduce the value in the hands of the beneficiary. However, in the case of a transfer to a spouse, the reduced value in property may decrease the value calculated for purposes of the marital deduction for the original owner's taxable estate.[213] One suggestion to combat this is to reduce the taxable estate when the deferred tax actually becomes deductible.[214] The deferred tax would then be deductible when the surviving spouse transfers the property during life or at death.[215] Advocates for Gutman's proposal to tax capital gains at death should address these deduction and portability issues that stem from calculating the gross estate for the decedent.

VI. CONCLUSION

The tax system's main goal is to raise revenue for the government, but many social goals underly tax policymaking. Among them is designing a system with the policy of minimizing dynastic wealth transfers to create an equal playing field of opportunities. The biggest issue with dynastic wealth transfers is not just capital that such transfers provide to the generations who inherit them; it is the fact that with large sums of money often come the ability to influence others.[216] Concentrations of wealth have adverse effects on the essence of democracy "to the extent that an objective of democracy is to give all participants an equal voice."[217]

211. Covey & Caulfield, *supra* note 164.
212. *Id.*
213. *Id.*
214. *Id.*
215. *Id.*
216. Fleischer, *supra* note 8, at 914.
217. James R. Repetti, *Democracy, Taxes, and Wealth*, 76 N.Y.U. L. REV. 825, 840 (2001).

One way to address some of these inequalities is by closing tax loopholes, such as stepped-up basis. The best proposal to replace stepped-up basis and ensure capital gains accumulated over an individual's lifetime are subject to tax is through a system that taxes capital gains at death. Gutman's recent proposal is the best option to accomplish this task. In advocating for Gutman's proposal, it is also important to tackle some of the secondary issues affecting the estate tax that result. Advocates should consider the critiques discussed in this Note to make it the most efficient and practical option to pass in Congress. Replacing stepped-up basis is only one of many steps toward creating a more equitable tax system.