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CAN CAPITAL GAINS CARRY-OVER BASIS REPLACE THE ESTATE TAX?

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Some proponents of estate tax repeal contend that the estate tax can be partially replaced by a change in the way capital gains are taxed. For example, Senator Jon Kyl has introduced a bill (S. 275) that would, under some circumstances, require heirs to pay capital gains taxes when they sell an inherited asset. This would represent a change from current law, which provides a full exemption from capital gains taxes for inherited assets. The evidence suggests, however, that this change in capital gains taxation — known as a "carry-over basis" provision, because the original basis or purchase price is carried over to the heirs — would have a quite limited effect, would lower the cost of estate tax repeal by only a small amount, and would be exceedingly difficult, if not impossible, to implement.

- According to the Congressional Budget Office, estate tax revenues will total more than $400 billion between 2002 and 2011. Some Members of Congress have claimed that as much as half or two-thirds of the revenue loss from repealing estate tax could be replaced by implementing a carry-over basis provision. Estimates by the Joint Committee on Taxation show, however, that *less than 13 percent* of the ten-year revenue loss from estate tax repeal would be recouped through such a change.

- Moreover, the Kyl proposal would exempt $2.8 million of inherited capital gains from being taxed under the carry-over basis provision. This would mean that a couple could shelter $5.6 million from capital gains taxation. The Joint Committee estimate that 13 percent of the revenue loss from estate tax repeal could be recouped is based on the assumption that *none* of the inherited assets would be sheltered from taxation. Once an exemption of the size that Senator Kyl has proposed is included, the amount of revenue that a carry-over basis provision can replace shrinks to an even smaller level.

- Senator Kyl's proposed carry-over basis provision is similar to one enacted in the 1970s. That change was found to be so complicated as to be unworkable, and it was repealed before it took effect. There are major problems with having to maintain adequate records for assets held for very long periods of time and for heirs to determine the price that a decedent paid to acquire an asset decades earlier. Furthermore, a large exemption such as Senator Kyl has proposed magnifies the complexities, since the exemption would be allocated to some inherited assets and not to other assets, with families selecting which assets to cover under the exemption so as to minimize future capital gains taxes. The problems of distinguishing between "exempt" and "non-exempt" assets would multiply over time. Given the severity of these complexities, there is a likelihood

that any new carry-over basis provision would subsequently be repealed, just as the carry-over basis provision enacted in the 1970s was.

Gains on Assets Held Until Death Escape Income Taxes

Without the estate tax, capital gains included in an estate would never be taxed at all. Under current law, the gain that results from the appreciation of an asset is subject to income tax only when the asset is sold. Upon the sale of an asset, the difference between the purchase price and the sale price is taxed as a capital gain. If a person holds an asset until he or she dies, however, the heirs inherit the asset at its value at the time of the decedent's death. The gain on the asset from the time of purchase to the time of the decedent's death is never taxed under the income tax.

Some of the capital gains income that escapes taxation under the income tax may be taxed under the estate tax. The appreciated value of the asset is included in the estate and, if the estate is large enough, subject to taxation.

A substantial proportion of assets subject to the estate tax appear to be unrealized capital gains — that is, assets that have appreciated in value but where the appreciation has not yet been taxed as capital gains. Estimates that economists James Poterba and Scott Weisbenner recently made, based on data from the Survey of Consumer Finances, suggest that unrealized capital gains make up about 37 percent of the value of estates worth more than $1 million and about 56 percent of estates worth more than $10 million.

Carry-over Basis Could Replace Only Small Fraction of Revenue Loss

The estate tax repeal bill (H.R. 8) that Congress passed and President Clinton vetoed last year included a similar provision that would have taxed some of these capital gains. That provision would have required that, for purposes of capital gains tax, heirs of large estates must value a portion of assets at the original purchase price of the asset. In other words, the original "basis" would "carry over" to the new owner. If the heirs of such estates later sold the assets, capital gains taxes would be due on the difference between the price for which they sold the assets and the original price the individual who died paid for the asset.

The estate tax repeal provision in President Bush's budget does not include a carry-over basis provision. Senator Jon Kyl, however, has introduced a bill that would repeal the estate tax immediately and subject assets in excess of $2.8 million per decedent to carry-over basis. Thus, a total of $5.6 million would be exempt from capital gains tax for a married couple.

Despite the substantial portion of estates that consist of unrealized capital gains, only a modest amount of revenue could be realized by applying capital gains taxes when appreciated assets eventually are sold by heirs. The Joint Committee on Taxation estimates that changing the rules to require payment of capital gains taxes on inherited assets when those assets are sold

Sorting Out the Cost of Estate Tax Repeal Options

Supporters of replacing the estate tax with capital gains carry-over basis claim that implementation of carry-over basis will offset a large portion of the cost of repealing the estate tax. The media has carried reports that repeal with carry-over basis could cost as little as $110 billion over ten years, well under half the cost of the Bush repeal. It is unlikely, however, that this lower cost results from the carry-over basis provision. Rather, it is likely that an apples-to-oranges comparison is being made, with most of the cost difference resulting from a slower phase-in of estate tax repeal.

The Administration's budget estimates that its proposal to repeal the estate tax would cost $267 billion between 2002 and 2011. Other estimates, derived from Joint Committee on Taxation figures from last May, would put the cost of the Bush proposal at about $294 billion over ten years. Both estimates reflect the fact that the Bush proposal would reduce estate tax rates beginning in 2002, although actual repeal would not occur until 2009.

Senator Kyl proposes in his bill (S. 275) that the estate tax be repealed immediately. In its place, he would require heirs to value inherited assets at the decedent's original purchase price, with an exemption of $2.8 million for individuals (and $5.6 million for couples) from this provision. Imposition of carry-over basis is intended to replace part of the revenues lost by repeal of the estate tax.

But the Joint Committee on Taxation has estimated that carry-over basis with *no* exemptions would raise only $52.5 billion over ten years. Carry-over basis with Senator Kyl's $2.8 million exemption would raise significantly less than that. With the Congressional Budget Office estimating estate tax revenues of $402 billion between 2002 and 2011, immediate estate tax repeal — even if coupled with capital gains carry-over basis — would cost *as much as or more* than the phased-in repeal that President Bush has proposed.

Estimates that cite far lower costs are likely to be referring to the estate tax repeal with carry-over basis in last year's H.R. 8, which Congress passed and President Clinton vetoed. That bill, which cost $105 billion over ten years, slowly reduced the estate tax rates beginning in 2001 and then repealed the estate tax only in 2010. (The carry-over basis became effective when the estate tax was repealed.) HR. 8 phased down the estate tax prior to repeal *at a much slower rate* than the Bush proposal. Under the Bush Administration proposal, the maximum estate tax rate in 2008 (the last year before repeal) would be 15 percent; under H.R. 8, it would still be 42.5 percent in that year. Compared to the Bush proposal, the low cost of last year's bill reflects not the carry-over basis provision, but the slow phase-in. Because the Kyl bill repeals the estate tax immediately, it would have a much higher cost than H.R. 8. (An earlier version of a carry-over basis provision that Senator Kyl offered as an amendment to a reconciliation bill in 1999 would have repealed the estate tax in 2008; that version would have resulted in lower costs than S. 275.)

could raise revenues of $52.5 billion in the 2002-2011 period.[1] This can be compared to total estate tax revenues of $402 billion that are expected to be collected over the same period.[2] Thus

[1] Congressional Budget Office, *Budget Options,* February 2001, Option REV-28-B.

[2] Congressional Budget Office, *The Budget and Economic Outlook, Fiscal Years 2002-2011,* January 2001, p. 54.

carry-over basis could replace approximately 13 percent of estate tax revenues over this ten-year period.

The Joint Committee on Taxation estimate assumes the carry-over basis is applied to *all* inherited assets. The approach in the Kyl bill, however, exempts $2.8 million of assets per decedent and $5.6 million per couple from carry-over basis. With such a large exemption, substantially less than 13 percent of the revenues lost as a result of estate tax repeal would be replaced.

An examination of the data suggests why such a small proportion of the estate tax revenue would be replaced by carry-over basis.

- As noted above, the Poterba-Weisbenner study found that unrealized capital gains made up about 37 percent of the assets of estates valued at more than $1 million in 1998.

- Over one-quarter of the unrealized capital gains in these estates are held as part of the value of active businesses, that is, businesses in which the decedents are active participants. These businesses arguably have a somewhat low probability of being sold (compared, for example, to the probability of marketable securities turning over). The unrealized capital gains held in active businesses are found primarily in estates valued at over $10 million, where they make up 70 percent of the unrealized gains. To the extent that these businesses continue to be operated by heirs, the unrealized gains would not become subject to taxation through carry-over basis.

- Another nearly one-quarter of the unrealized capital gains are included in the value of primary residences. Most of these unrealized gains are in estates valued between $1 million and $5 million. Much of these gains also are unlikely to be taxed through carry-over basis. Under current law, the first $500,000 for a couple (or $250,000 for a single person) of the gain on a primary residence is exempt from taxation. This exemption would create a large incentive to sell the primary residence before death, in order to take advantage of the exemption and avoid passing on the full accrued capital gains tax liability to the heirs.

- Given that unrealized capital gains comprise 37 percent of taxable estates, and that about half of the gains can be attributed to active businesses or primary residences and thus are unlikely to be taxed under carry-over basis, it is reasonable to assume that only about half of unrealized capital gains — or roughly 19 percent of the value of taxable estates — would be subject to tax under carry-over basis. Some proportion of those remaining 19 percent of assets — including other real estate, other business assets, and some marketable stocks — also are likely to continue to be held by heirs for many years after inheritance. Thus, it is easy to

see why the Joint Committee on Taxation estimates that carry-over basis would replace only 13 percent of estate tax revenue.[3]

Some proponents of replacing the estate tax with carry-over basis suggest that additional revenues would be raised as a result of additional sales of assets *prior* to death. It is widely thought that under current law, taxpayers in the latter part of their lives are reluctant to sell appreciated assets and pay capital gains tax. If they instead hold the assets until the assets become part of their estate, their heirs would inherit the assets at market value and capital gains taxes would never have to be paid. A change to carry-over basis, it is argued, would level the playing field with respect to when an asset is sold and therefore lead to additional asset sales prior to death.

Analysis of the types of assets held in estates, however, suggests that any additional revenue from the "unlocking" effect described above is likely to be modest. It is the same roughly 19 percent of the assets in the average estate — the unrealized capital gains that are in neither active businesses nor primary residences — that make up the universe of assets likely to be sold and subject to capital gains taxation either by the decedent before death or by the heirs after death. Thus, it is not credible, even under the most favorable assumptions, that much more than 19 or 20 percent of the revenue lost as a result of estate tax repeal could be replaced by carry-over basis.

This conclusion is bolstered by another estimate the Joint Committee on Taxation has made. This estimate examines a possible change in tax law under which all unrealized capital gains would be taxable on the final income tax return of a decedent, as if they had been realized at the time of death. Even in this extreme case, which would not be dependent on choice of time to sell the asset, only 22 percent of estate tax revenues would be replaced by capital gains taxes.[4]

Substituting Carry-over Basis Creates Complexities that May be Unsurmountable

Substituting carry-over basis for the estate tax also poses a number of practical problems that are likely to make it very difficult or impossible to administer.

Carry-over basis proposals typically include large exemption amounts that shelter some substantial portion of inherited capital gains from taxation. While a policy of carry-over basis

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[3] The tax rates that apply to capital gains and the rates that apply to estates are different, with the rate on long-term capital gains set at 20 percent while the marginal estate tax rate reaches 55 percent for the largest estates. This could mean that some adjustment would be necessary when comparing revenues that result from taxing assets according to either the estate tax or the capital gains tax under carry-over basis. While the marginal estate tax rate is higher than the capital gains rate, the average estate tax rate — which reflects the impact of exemptions and deductions — was only 19.8 percent in 1998. As a result, we assumed that it is reasonable to look only at the amounts of assets that would be subject to either the estate tax or the capital gains tax under carry-over basis, without adjustment for differential tax rates.

[4] Congressional Budget Office, *Budget Options*, February 2001, Option REV-28-A. This option would raise $86.4 billion from 2002-2011, compared to the $402 billion that the estate tax is estimated to bring in over that period.

does not necessarily require such large exemptions, policymakers may find some exemption necessary to prevent taxation of appreciated assets in estates that are not large enough to be subject to the estate tax under current law.

As noted, the Kyl proposal would exempt $2.8 million of appreciation of inherited assets per decedent from capital gains taxation, meaning that a couple could pass on $5.6 million of appreciated assets without the heirs paying any taxes on the gains in value between the date of purchase and the date of death. Implementation of a $5.6 million or other large exemption amount per couple would be quite complex.

- If assets have been held for a long time, records on the original purchase price could be missing, and it could be difficult to establish the price for which the decedent purchased them.[5]

- Still more complexity would be added by opportunities for allocating the exemptions to best advantage. A wealthy person (or executor) would have the opportunity to minimize capital gains taxes by carefully choosing which assets would qualify for the exemption from carry-over basis and which assets would not, based on factors such as the likelihood of an asset being held or sold by the heirs.

- Once the assets were inherited, the record keeping and enforcement burden of distinguishing between assets that retained their original purchase price as a basis and assets that were revalued at death would be substantial. When the second generation passes on estates that include a mix of protected and unprotected assets, the complexities would multiply.

The difficulties inherent in administering a carry-over basis provision are well known. A carry-over basis provision was enacted a little over 20 years ago, but it never took effect because of these complexities. The Tax Reform Act of 1976, which lowered the estate tax rate and increased the amount of an estate exempt from estate taxes, applied capital gains taxes to inherited assets when sold, based on the original purchase price of the asset. That provision was repealed in 1980, before it took effect. According to a Congressional Research Service report, the primary rationale for repeal was the concern that the carry-over basis would result in great administrative burdens for estates, heirs, and the Treasury Department.

The estate tax repeal legislation that Congress passed and President Clinton vetoed last year made its carry-over basis provision effective in 2010, at the time the estate tax would have been fully repealed. Since the carry-over basis is likely again to be found unworkable, there is a substantial probability that any such provision would be repealed as the time for implementation approached.

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[5] Some have suggested using a rule of thumb, such as 50 percent of market value, as the basis in situations where records do not exist to establish the basis. This is the assumption used in the Joint Committee on Taxation estimates. While that type of arbitrary rule would be possible, it could be viewed as inherently unfair and lead to extensive litigation to establish blame for loss of the documents.