

Logarithms, Exponents and Carryover Basis

By **BRUCE D. STEINER**

The author discusses how the carryover basis provisions of Section 1023, prorating the appreciation of property in determining fresh-start basis, fail to implement properly the assumption of a constant rate of appreciation, and how the proposed Technical Corrections Bill would partially correct this situation.



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Prior to the Tax Reform Act of 1976, Section 1014¹ generally provided that the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent was the fair market value at the date of the decedent's death, or at the alternate valuation date.²

The Tax Reform Act of 1976 added a new Section 1023, which provides for a carryover basis with certain adjustments in the case of property acquired from a decedent dying after 1976. Section 1023(h) provides an adjustment to the carryover basis for a "fresh start,"³ so as not to subject pre-1977 appreciation to income tax. Section 1023(h)(1) provides that in the case of appreciated marketable bonds and securities, the carryover basis for determining gain shall be increased to the December 31, 1976, fair market value. Thus, if decedent purchased a readily tradable stock for \$20, which had appreciated to \$30 on December 31, 1976, and to \$35 upon the date of his death, his estate or beneficiary would take a

¹All statutory references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated.

²Sec. 1014 continues to apply in the case of decedents dying before 1977.

³The other principal adjustment is for federal and state estate and transfer taxes attributable to appreciation. Sec. 1023(c) and (e). This and certain other adjustments shall be ignored for purposes of this discussion.

basis of \$30 for determining gain, but a basis of \$20 for determining loss.⁴

Property Other than Marketable Bonds and Securities

In the case of property other than marketable bonds and securities, Section 1023(h)(2) provides that the appreciation be prorated between the pre-1977 and post-1976 portions of the holding period. For example, if decedent purchased a diamond ring on December 31, 1966, for \$1,000, and died on December 31, 1986, at which time it was worth \$4,849, the fresh-start rule would allow a step-up for half of the appreciation (since half of the holding period occurred before 1977).⁵ The new basis would be computed as follows:

Carryover basis		\$1,000
Appreciation	\$3,849	
X pre-1977 portion ..	50%	1,925
		<hr/>
New basis		\$2,925

The adjustment is made in this manner regardless of the actual December 31, 1976, value of the ring. This avoids the necessity of obtaining appraisals as of December 31, 1976; however, it poses a burden where records as to the decedent's basis and date of acquisition are not readily available. Furthermore, it makes an unrealistic assumption as to the rate of appreciation. In the above example, an asset appreciating at an annual rate of 8.2139% per annum would increase in value from \$1,000 to \$4,849 over 20 years. However, after ten years, it would be worth only \$2,202—i. e., it just more than doubles every ten years. By simply prorating the increase in value, the Code gives too large a fresh-start adjustment.

This shortcoming is corrected in part for tangible personal property by Section 3(c)(1) of H. R. 6715, the Technical, Clerical and Conforming Amendments of the Tax Reform Act of 1976. The bill amends Section 1023(h) by providing that the minimum basis for determining gain on carryover basis property that is tangible personal property shall be the date of death value, divided by "1.0066 to the *n*th power where *n* equals the number of full calendar months which have elapsed between December 31, 1976, and the date of the decedent's death."

This provision, foreboding at first glance, but simple to compute with the aid of a calculator or a logarithmic table, provides for an alternative fresh-start adjustment by discounting back from

the date of death value to December 31, 1976, at 0.66% per month, compounded monthly. This is equivalent to 8.2139% per annum, compounded annually.⁶

Where the appreciation in fact occurred at this rate, this method will not be to the advantage of the taxpayer. In the above example, it would yield a new basis of \$2,202—i. e., the precise value on December 31, 1976.

Where the appreciation in fact occurred at a faster rate, the effect of this method is reduced. Assuming the same ring was purchased on December 31, 1971, for \$1,000, but appreciated at 11.1% per annum, it would be worth \$1,693 on December 31, 1976, and \$4,849 on December 31, 1986. Prorating the appreciation yields a new basis of \$1,000 plus one-third of the \$3,849 of appreciation. Thus, the fresh-start adjustment is \$1,283 and the new basis is \$2,283. However, discounting back at 0.66% monthly yields a new basis of \$2,202, as in the previous situation.

Thus, the proposed change is a step in the direction of reaching a result in conformity with the purposes of the fresh-start provisions.

Recommendations

A better method of estimating the December 31, 1976, value⁷ would be to combine the two methods, ascertaining the amount of appreciation and assuming it occurred at a uniform rate. Thus, in the last example, the increase in value from \$1,000 to \$4,849 over 15 years would be found to be an annual rate of 11.1%. This rate would be applied to the particular asset to estimate the correct December 31, 1976, value: here, \$1,693.

Theoretically, a more ideal method⁸ would be to take into account different rates of appre-

⁴Cf. Sec. 1015(a), which provides different bases for determining gain and loss in the case of a gift of property whose fair market value at the time of the gift is less than the donor's adjusted basis.

⁵Sec. 1023(h)(2)(C) prescribes a computation based on the exact number of days in each portion of the holding period. The computation was made in the manner in the text for purposes of simplicity.

⁶The legislative history indicates that under the formula, the post-1976 appreciation is assumed to accrue at approximately 8% per year. Joint Committee on Taxation Staff Description of H. R. 6715 at 20. However, the drafters presumably failed to consider the effects of monthly compounding. The base should have been 1.006434 in order to take this into account if it were intended to assume an 8% annual appreciation rate.

⁷Assuming that any fresh-start adjustment is desirable.

⁸From a theoretical point of view, annual or periodical taxation of appreciation (which would be

ciation in different years as actually occurred, by reference to a cost-of-living or other index. Analogous provisions of the Code include Sections 483(b)⁹ and 6621.¹⁰ Although the computations would be extremely complicated, tables could be published. In order to compute a December 31, 1976, fresh start, one would need to know the date of commencement of the holding period, the decedent's basis, and the value at death, which information is similarly needed under present law (pursuant to the Tax Reform Act of 1976,

prior to amendment thereto), as well as for the method discussed in the preceding paragraph. ●

(Footnote 8 continued.)

administratively difficult) or, at least, the treatment of death as a taxable disposition merits consideration. Regardless of the method selected, indexing or some form of adjustment for inflation should be considered in this as well as other areas of the tax law. A detailed discussion of these items is beyond the scope of this paper.

⁹ Rates of unstated interest are provided by regulation and have been adjusted.

¹⁰ Interest rate on, *inter alia*, deficiencies and overpayments, adjusted every two years to 90% of average prime rate.

1977 IRS Annual Report on Estate and Gift Taxes

The amount of money that the federal government gained from estate and gift taxes paid during 1977 showed an increase of 37.3% over 1976, according to figures released by the Commissioner of Internal Revenue in his 1977 Annual Report. These sources accounted for collections in excess of \$2 billion.

The dramatic increase in collections from estate and gift taxes last year slightly outpaced the increase in the number of returns filed. While the number of estate tax returns filed registered only a slight increase, U. S. taxpayers filed more than 380,000 gift tax returns, almost a 25% increase over 1976 figures.

Despite the impressive statistics, the IRS revealed that estate and gift taxes accounted for just 2.1% of total tax collections for 1977.

Although more estate and gift tax returns were being filed last year, the number of audits conducted that year dropped from the preceding year. The IRS audited 53,804 estate and gift tax returns, meaning that a taxpayer ran a 1 in 10 risk of having his return selected for an audit.

Much of the IRS report concerned activity within the courts. Statistics indicated that the taxpayer who, in 1977, contested his liability in any court, save the U. S. Supreme Court, was likely to lose. Although the taxpayer's best chance for success was in the Tax Court where he won 45.2% of the cases, his chances for success diminished still further when the litigation took place, or was continued, in other forums. For example, the government prevailed 68.2% of the time in the U. S. Court of Claims, 66.3% in the U. S. District Courts, and 69.8% in the U. S. Courts of Appeals. The statistics generally mirrored those of a year ago.

The taxpayer should not, however, be unduly impressed by his almost 50% chance of victory in the Tax Court. The IRS report also indicated that the government won 75.3% of cases in the Courts of Appeals that had originated in the Tax Court (markedly more than its appellate record on cases appealed from the U. S. District Courts.)—CCH FEDERAL ESTATE AND GIFT TAX REPORTS No. 63, July 5, 1978.