(by its accompanying GCM) to a situation when stock was issued. Moreover, we think that the 1987 NSAR and the 1998 LB we think that clarify that section 108(e)(6) resolves the issue in fact patterns like the ones in the Deemed Payment FSAs, the legislative history examples, and the Example. We believe that post-BTA, *Fender Sales* is not appropriate authority to rely on in a section 108(e)(6) transaction to trigger a deemed payment of interest to the creditor-shareholder — whether for withholding tax purposes or for any other federal tax purpose.[44]

[44]As noted previously, we acknowledge that as discussed in the Deemed Payment FSAs, other rules such as section 482 or section 7872 may create a deemed payment to which a withholding tax applies. However, when no specific rule is applicable, we do not think that in a section 108(e)(6) transaction, *Fender Sales*, common law principles, or the deemed payment created by section 108(e)(6) itself for the limited purpose of determining COD income should trigger a deemed payment of interest to the creditor-shareholder that is subject to withholding.

# Estate Tax Relief and the Erosion Of Capital Gains Tax Revenues

**By Richard Schmalbeck and Jay A. Soled**

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One consequence of Congress raising the estate tax exemption to $5 million is that far fewer estates will be subject to it. When an estate is taxable, executors have a strong incentive to minimize the value of any asset whose worth is uncertain; in later years, because the relatively low value becomes the heir's basis in the asset, capital gains tax revenues generally increase. Raising the estate tax exemption reduces executors' incentives to minimize asset values, costing an estimated $8 billion annually in lost income tax revenue.

The tax rule for assigning basis to assets inherited from a decedent is both conceptually defective and costly from a revenue perspective. It is, however, a rule that is deeply entrenched, and unlikely to be reviewed by Congress. Its effects are thought to be partly mitigated by the presence of an estate tax, which imposes at least some tax burden on unrealized appreciation at death. But a robust estate tax has another effect related to income tax collections that is not as widely noted: When an estate tax applies, executors have powerful incentives to report assets at their lowest defensible values. This reporting stance reduces estate tax liabilities, and also results in relatively low asset bases for the heirs, preserving more unrealized gain for future income tax collections.

The temporary increase in the estate tax exemption level from $1 million (the permanent exemption) to $5 million (the exemption for 2011 and 2012), will reduce the number of estate tax returns by more than tenfold. While this reduction is viewed by many taxpayers and practitioners as one of the virtues of the temporary rules, it means that many fewer estates will face incentives to assign the lowest defensible valuations to assets passing from decedents.

In this article, the authors explore the implications of the altered incentive landscape for asset value reporting purposes. More specifically, in the absence of a robust estate tax (that is, when estates enjoy a high exemption figure), executors will be incentivized to report assets with the highest defensible values, resulting in concomitantly higher asset bases. Those higher bases will subsequently produce smaller gains, larger losses, and/or enhanced depreciation deductions. This leads the authors to predict income tax revenue losses of about $80 billion computed over a 10-year scoring period.

## A. Introduction

Supporters of the federal estate tax primarily cite its usefulness in modulating the concentration of wealth over time and its modest but nontrivial contributions to federal tax revenues.[1] In recent years Congress has eschewed much of the revenue-generating capacity of the tax by cutting estate tax rates and massively increasing the threshold estate size at which the tax begins to apply. Under temporary provisions applying in 2011 and 2012, the exemption level will be $5 million, compared with the permanent tax threshold of $1 million (to which the law will revert in 2013, absent further action by Congress).[2] Congress has thus retained some control over wealth concentration through a diminished but still significant estate tax on very-high-wealth estates, while dramatically reducing the proportion of estates subject to the tax and its reporting requirements — from nearly 5 percent of estates a decade ago to less than four-tenths of 1 percent of estates today.[3]

To its credit, that legislative strategy has provided a pragmatic compromise between members in Congress who might prefer a traditional, more broadly based wealth transfer tax and those who would prefer to have no wealth transfer tax at all. But an important ancillary effect of that compromise approach has been largely ignored: A fivefold increase in the threshold of taxability of the wealth transfer tax system has greatly eroded the effect that the estate tax has traditionally had in controlling the revenue losses associated with the application of section 1014, which allows each inherited asset a tax basis equal to its fair market value at the time of the decedent's death.[4] We estimate the *income* tax revenue loss associated with estate tax relief to be $80 billion over a 10-year scoring period.

The source of that revenue loss is simple. If there is no estate tax liability, executors will have a strong incentive to attach the highest defensible value to the estate's assets to secure the largest tax basis possible. A high tax basis is universally favorable to the heirs: If it is a depreciable assset, it will produce larger depreciation deductions while the asset is held and, whatever the nature of the asset, either a smaller gain or larger loss on its disposition. If, however, there were an estate tax liability, the executor will be subject to a powerful countervailing incentive posed by the fact that a higher valuation of assets will generally increase the amount of the estate tax liability. The tension between the desire of the executor to report the lowest defensible values and the desire of the heirs to obtain the highest possible bases in their inherited assets served a useful purpose. Because the stakes were not symmetrical (that is, historically, estate tax rates have towered over capital gains tax rates), the tension normally resulted in diminished estate tax collections but augmented collections of tax on capital gains.[5]

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[1] *See, e.g.*, Michael J. Graetz, "To Praise the Estate Tax, Not to Bury It," 93 *Yale L. J.* 259 (1983); Richard Schmalbeck, "Does the Death Tax Deserve the Death Penalty?" 48 *Cleve. St. L. Rev.* 749 (2000). Graetz more recently expressed his strong support for the estate tax in a short column for *The Wall Street Journal* on September 20, 2010, titled "It's Fair, and We Need the Revenue."

[2] Section 302(a)(1); Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, 124 Stat. 3296, 3301 (2010).

[3] Brian Raub and Joseph Newcomb, "Federal Estate Tax Returns Filed for 2007 Decedents," IRS *Statistics of Income Bulletin* (Summer 2011), at 182, 184, shows that about 108,000 estate tax returns were filed for decedents dying in 2001. The same article indicates that in 2007, the most recent year for which data are available, only about 9,200 estates had gross values in excess of $5 million. *Id.* at 190. In both years, there were about 2.4 million deaths in the United States. Table 78, "Statistical Abstract of the United States, 2011," p. 65. Because of declines in both the real estate and stock markets since 2007, it seems unlikely that the number of estates with more than $5 million of assets will be larger in 2011 than it was in 2007; however, the number of deaths — the denominator of the fraction representing the proportion of estates that face estate tax reporting obligations — will probably be somewhat larger in 2011 than it was in 2007 because the population of the United States that is elderly is increasing as the baby-boom generation ages into the unhappy ranges of the mortality tables.

(Footnote continued in next column.)

[4] Or the value at a date exactly six months following the decedent's death, if so elected by the executor of the estate. Section 2032. Because most assets — especially those that decedents retain in their estates at their death — have values that exceed their tax bases, this rule is frequently referred to as a "stepped-up basis at death" rule, although it may occasionally lead to a stepped-down basis instead.

[5] Special situations exist that could invert that asymmetrical relationship, but they are rare. The rates on both taxable estates and capital gains have varied considerably over the last dozen years, but in no tax year did the generally applicable capital gains rate exceed the minimum estate tax marginal rate. And the heirs also have the advantage of being able to defer the capital gains exaction indefinitely, possibly even using section 1014 themselves if they continue to hold the assets in question until their own deaths. Finally, for income tax purposes, heirs are taxed only on the excess of the amount realized over basis, while

(Footnote continued on next page.)

But the billions of dollars held by decedents leaving estates in the range from $1 million (the permanent estate tax threshold) to $5 million (the temporary threshold) will over the next two years likely pass to heirs at significantly higher valuations, with concomitantly smaller capital gains collections in future years than would have been the case had the permanent threshold of taxability applied. And although the temporary estate tax exemption is scheduled to expire at the end of 2012, it is clear that Congress will consider, among other options, extending it or making it permanent. In the course of that consideration, it would be wise to consider the implications that such a large exemption has on likely future income tax revenues, as well as the implications on collections from the estate tax itself.

In the sections that follow, this article traces the income tax revenue implications associated with raising the estate tax exclusion amount. The article first details how taxpayers have traditionally sought to value a decedent's assets. Next, it explores current strategies of exploiting section 1014 and attaching high values to a decedent's assets. In light of those strategies, in the section that follows, we offer an income tax revenue loss projection. The penultimate section of this article then sets forth code protections that the IRS is supposed to use against inflated basis asset practices and how those protections are likely to prove ineffectual. Finally, in the last section of the article, we offer our conclusions.

**B. Traditional Incentives to Minimize Valuation**

For the past century, the nation's estate tax has applied broadly to most significant intergenerational wealth transfers. Low- and middle-income decedents would have been able to pass to their heirs assets like their personal residences and modest portfolios of investment assets without the intrusion of the estate tax.[6] But substantial asset holdings were likely to place the estate within the range of the estate tax. Although the estate tax exclusion amount has fluctuated, the estate tax has historically applied to between 1 and 7 percent of the overall population.[7] When the estate tax did apply to a decedent's estate, in the last 24 years, the marginal tax rates were significant, ranging as high as 77 percent and never below 38 percent.[8]

When an estate tax applies, it tends to keep valuation abuse of section 1014 in check. The opening words of the regulations promulgated under section 1014 (reg. section 1.1014-1) acknowledge both the presumption that the estate tax will apply to most significant intergenerational asset transfers and the usefulness of tying estate tax valuations to the tax basis of the assets so transferred: ''The purpose of section 1014 is, in general, to provide a basis for property acquired from a decedent which is equal to the value placed upon such property for purposes of the Federal estate tax.''

Over the past century, tax advisers have devised a wide variety of valuation strategies to minimize their clients' transfer tax burdens. Some of those strategies are put into effect during the taxpayer's lifetime; others are put into effect at the time of the taxpayer's death.

Traditional valuation strategies that taxpayers have employed during their lifetimes generally have fallen within one of three categories. The first involves straightforward gift-giving of assets whose values are relatively low at the time of the gifts but have substantial potential for appreciation.[9] The next involves business entity formation such as limited partnerships and limited liability companies specifically designed to enable taxpayers to take advantage of so-called minority and marketability valuation discounts.[10] The final strategy entails the formation of special kinds of trusts, such as

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estate tax rates apply to the entire amount in question once the value of the estate exceeds the amount of the exemption.

[6]Note that gains on personal residences are largely exempt from income taxation anyway as long as the property and ownership requirements set forth in section 121 are met. And assets such as publicly traded stock and interests in widely held mutual funds are less problematic than assets such as land and privately held business interests, which are more difficult to value and more likely to be held by decedents of significant wealth.

[7]Darien B. Jacobson, Brian G. Raub, and Barry W. Johnson, ''The Estate Tax: Ninety Years and Counting,'' IRS *Statistics of Income Bulletin* (Summer 2007), at 125 (Figure F).

[8]The Revenue Act of 1941, P.L. 77-250, 55 Stat. 687, imposed a 77 percent rate. The Economic Recovery Tax Act of 1981, P.L. 97-34, 95 Stat. 172, increased the unified credit from $47,000 to $192,800 (equivalent to increasing the exemption from $192,800 to $600,000) which meant that by the time the latter credit was in force (for decedents dying in 1987 and later years), the unified credit effectively swallowed the estate tax brackets below 38 percent. From that point forward, the first dollar exposed to the estate tax has been burdened by a 38 percent marginal tax rate.

[9]*See, e.g.*, Philip R. Fink, ''A Gift in Time Can Save an Estate Tax Gold Mine,'' 64 *Prac. Tax Strategies* 80 (Feb. 2000) (explaining the numerous advantages associated with making lifetime transfers instead of testamentary bequests).

[10]*See, e.g.*, Brant J. Hellwig, ''On Discounted Partnership Interests and Adequate Consideration,'' 28 *Va. Tax Rev.* 531 (2009) (''Family limited partnerships have dominated the judicial landscape in the estate and gift tax arena for nearly a decade. . . . Their principal advantage lies in the prospect of significant estate and gift tax savings generated through the exploitation of discounts used to value equity interests in closely held entities''). *See generally* Laura E. Cunningham, ''Remember the Alamo: The IRS Needs Ammunition in Fight

**(Footnote continued on next page.)**

grantor-retained annuity and income trusts, which strategically raise the value of the taxpayer's retained value while simultaneously reducing the value of the gifted remainder interest.[11]

At death, taxpayers and their advisers have employed other valuation strategies particularly focused on non-fungible assets, such as jewelry, buildings, and land, that have no one ascertainable fair market value. Instead, the FMV of those assets is best expressed as a range of values. In the absence of a single fixed value, when a taxpayer dies owning title to non-fungible property, the executors of the decedent's estate retain an appraiser who is often instructed — sometimes explicitly, but more often with a wink and a nod — to appraise the decedent's assets at the lowest possible FMV within the range of acceptable values.

That tendency to undervalue a decedent's assets has produced an almost comical estate tax valuation jurisprudence over the years. One spectacular example is *Estate of Kelly v. Commissioner*.[12] The estate consisted mostly of shares of stock in a closely held publishing corporation. Each share was valued at $516 on the estate tax return. The IRS agent who initially reviewed the return proposed a value of $1,000 per share. The final IRS assessment, however, reflected a determination that the value was $4,000 per share. Four expert witnesses testified at the trial, appraising each share of stock respectively at $980 or $822 (the estate's experts) and $4,000 or $3,400 (the IRS's experts). The Tax Court split the baby — as is often but not invariably the case in these disputes — deciding that the appropriate valuation was $2,200 per share.

Many other cases involving closely held stock or unincorporated business interests reflect the same pattern of widely dispersed appraisals. For example, in *Reilly v. United States*,[13] the executor's expert testified that shares of a closely held corporation were worth $39.23 per share, while the IRS argued for a valuation of $110, more than 2.75 times as much. The court valued the shares at $87.64. In *Estate of Thompson v. Commissioner*,[14] the difference of opinion was even more dramatic: The estate valued shares of a private company at $3.59 per share; the IRS suggested a valuation of $66.26 per share, more than 18 times what the estate claimed; and the court found a value of $27.75 per share.[15]

Similarly, valuing assets such as real estate interests and collectibles such as art, carpets, and antiques has proved to be highly uncertain. In *Estate of Feuchter v. Commissioner*,[16] the estate's two experts valued the estate's land holdings at $401,100 and $477,000, respectively. The IRS's expert valued the land at $2,718,000, more than five times the estate's valuation. The court found the value to be $628,000. In *Estate of Smith v. Commissioner*,[17] the estate valued 425 pieces of sculpture left by the decedent at $714,000, while the IRS argued for a value about six times as large, $4,282,000. The court decided that the value was $2.7 million.

Those cases are merely a sample of the many valuation disputes that have been litigated. We have not tried to construct a comprehensive set of all those cases nor to draw a random sample of them because any such study would be flawed by an unavoidable selection bias: Litigated cases consist only of those in which the parties seriously and significantly dispute the value of the assets involved, and so they cannot represent all situations in which valuation may be adjusted on audit. Those cases nevertheless convey some sense of how difficult it can be to arrive at precise valuations of inherently difficult-to-value assets. The cases are bound by a common underlying thread: Decedents' estates are almost always anxious to achieve the lowest valuation possible for their assets. Those valuation strategies have a common goal of minimizing taxpayers' overall transfer tax burdens. The use of those valuation strategies, however, often came at a significant income tax cost. Lifetime transfers require that the recipient take the donor's tax basis in the asset being transferred,[18] which for appreciated property is less than the asset's FMV at the time of transfer. Second, even when taxpayers owned property at death and section 1014 previously came into play, taxpayers' use of valuation

Against FLP,'' *Tax Notes*, Special Supplement, Mar. 13, 2000, p. 1461, *Doc 2000-7414*, or *2000 TNT 49-104*; Leo L. Schmolka, ''FLPs and GRATS: What to Do?'' *Tax Notes*, Special Supplement, Mar. 13, 2000, p. 1473, *Doc 2000-7415*, or *2000 TNT 49-105*.

[11]*See, e.g.*, James M. Dalaney, ''Split Interest Valuation: The Devil Is in the Detail,'' 37 *Cap. L. Rev.* 929, 954 (2009) (''With the evolution of the zeroed-out GRAT, the estate planning profession seems to have once again frustrated the goals of the Treasury''); Denver S. Gilliand, ''Fractional Interests Make for a Better QPRT,'' 32 *Real Prop. Prob. & Tr. J.* 145, 180 (1997) (''QPRTs [qualified personal residence trusts] as an exception to the Chapter 14 valuation rules, offer some significant estate tax planning opportunities'').

[12]T.C. Memo. 1955-129. Most of these cases are memo opinions because disputes over purely factual issues are typically the only issues in the case.

[13]71 AFTR 2d 93-5013 (S.D. Ind. 1988).

[14]499 F.3d 129, 135 (2d Cir. 2007), *Doc 2007-19605*, *2007 TNT 165-7*.

[15]The IRS asserted valuation penalties under section 6662, described below, in this case, but the court did not sustain their imposition, noting that the court's valuation was closer to the estate's valuation than to the IRS's valuation.

[16]T.C. Memo. 1992-426.

[17]57 T.C. 650 (1972).

[18]Section 1015(a).

appraisals at the low end of the valuation spectrum resulted in a significant reduction of the assets' tax bases in the hands of the decedents' heirs.[19]

The reason the foregoing lifetime and testamentary valuation strategies have remained intact over the past century is straightforward. In almost all cases involving a taxable estate, the savings in estate tax is both greater in magnitude and more immediately realized than the associated income tax detriments. Consider the following illustration:

In 2009 an unmarried taxpayer dies owning title to two assets, a block of 1,000 shares of Google stock, worth $500,000, and title to a building worth between $3 million and $4.5 million. In 2009 the applicable exclusion amount was $3.5 million. Insofar as the Google stock is concerned, there is no flexibility in reporting its value; as a marketable security, its value is readily ascertainable.[20] But the valuation of the building does not fall into that category; instead, because the building is an asset that is not readily exchanged on an open market, the estate will likely retain the services of a qualified appraiser. If the appraiser understood what was at stake (and the executor had every reason to make sure he did), he would have rendered an appraisal of the building at the low end of the valuation spectrum, namely, $3 million.

The Google stock value of $500,000 and the building appraisal at $3 million would have reduced the taxpayer's potential federal estate tax exposure to zero. The "price" for that estate tax reduction was that the taxpayer's tax basis in the building under section 1014 would be locked at $3 million rather than a higher dollar figure along the valuation spectrum. The practical consequence of that lower tax basis for the building was that the taxpayer would experience one or more of the following: a larger taxable gain or a smaller taxable loss on future disposition, smaller depreciation deductions, or a reduction of other tax saving benefits.

For example, if the decedent's estate were to sell the building 11 months later for $4.5 million, it would experience a $1.5 million long-term capital gain ($4.5 million amount realized - $3 million tax basis),[21] taxable at preferential capital gains rates. Assuming the 2010 capital gains tax rate of 15 percent, that would have produced an income tax liability of $225,000 ($4.5 million - $3 million tax basis) x 15 percent). That is a bargain compared with the $675,000 estate tax liability that would have been imposed on the decedent's estate had the building instead been valued at $4.5 million (aggregate estate of $5 million ($500,000 Google stock + $4.5 million building) - the $3.5 million estate tax exclusion times the then 45 percent prevailing estate tax rate).

### C. Valuation Incentives During 2011 and 2012

For very large estates, the incentives to minimize the valuation of assets passing to subsequent generations will in 2011 and 2012 be similar to those described in the preceding section, but somewhat attenuated. The relatively low (by historical standards) estate tax rate of 35 percent in 2011 and 2012 is still larger, and its imposition more immediate, than the long-term capital gains rate of 15 percent that will be faced by the heirs on disposition of their inherited assets. There will be special cases in which the potential income tax savings may exceed the estate tax lost because of a higher valuation, but they will be rare.

Nevertheless, by significantly increasing the applicable exclusion amount and lowering the maximum estate tax rate, the 2010 tax act fundamentally changes the transfer tax landscape for the next two years (or more, if the temporary rules are extended or made permanent). In a nutshell, the larger temporary exemption takes most estates that would have been exposed to the estate tax (under the permanent rules) out of the range of taxability. At least 90 percent of the estates with assets exceeding $1 million will not exceed $5 million in total value and will thus be effectively exempt from the estate tax.

In 2001, when Congress passed the Economic Growth and Tax Relief Reconciliation Act of 2001,[22] it recognized that repeal of the estate tax was incompatible with maintenance of the date-of-death tax basis rule of section 1014. Accordingly, when the estate tax was to be suspended in 2010, a modified carryover basis rule became effective.[23]

Although the temporary rules for 2011 and 2012 do not technically amount to a repeal of the estate tax, the dramatic reduction in the number of estates to which the tax will apply in those years amounts to a de facto repeal for 90 percent of the estates to which the permanent rules would have applied (that is, those estates in the $1 million to $5 million

[19]Section 1014(a).

[20]*See* reg. section 20.2031-2(b)(1) (the FMV of marketable securities is "the mean between the highest and the lowest quoted selling prices on the valuation date"). If the block of stock is very large, the estate may be able to successfully claim a discount for "blockage," arguing that liquidating a large block of stock immediately would depress the market price. Because of the market capitalization and highly active trading of this stock, however, attempts to assert a blockage discount would be unlikely to succeed.

[21]Section 1223(9).

[22]P.L. 107-16, 115 Stat. 38.

[23]*Id.* at section 542(a).

range). Under those circumstances, Congress might have been wise to add a carryover basis rule covering estates whose asset values exceeded $1 million but not $5 million. Unfortunately, Congress did not choose to do that.

Following the 2010 act, heirs inheriting assets in 2011 and 2012 from estates below the $5 million threshold will presumably be inclined to appraise inherited assets whose value cannot be determined with certainty at the high end of the range that may be reasonably defensible.[24]

The effect of the high exemption level can be illustrated by revisiting the scenario described in the preceding section: In 2011 an unmarried taxpayer dies owning title to two assets, namely, a block of 1,000 shares of Google stock, worth $500,000, and a building worth between $3 million and $4.5 million. In 2011 the estate tax exclusion is $5 million. As before, the value of the Google stock is readily ascertainable, and its new section 1014 basis will presumably be correctly reported.[25] The building, however, is an asset that is not readily exchanged on an open market. Accordingly, the estate will likely retain the services of a qualified appraiser who, in contrast to the prior illustration, will probably render a value at the high end of the valuation spectrum, namely, $4.5 million.

The Google stock value of $500,000 and the building appraisal of $4.5 million will not produce any federal estate tax exposure because the decedent's gross estate value equals the amount of the applicable exclusion of $5 million. And, happily for the heir, the higher building valuation will give her a tax basis in the building of $4.5 million. The practical consequence of that higher basis is that later, on the sale or disposition of the building, the taxpayer will experience a smaller taxable gain or a larger taxable loss; and, in the meantime, if the building is used in a trade or business, the taxpayer will enjoy the benefits of larger depreciation deductions.

Generally, estates whose value exceeds $5 million will continue to have incentives to value assets at the lowest defensible amounts, even in 2011 and 2012. However, there may be a few situations in which even estates that are still subject to a positive estate tax liability in those years may wish to use high asset valuations when they can (for example, to secure future depreciation deductions that can shelter ordinary income). For example, suppose a decedent dies in 2011 owning one asset, a printing press that is worth between $5 million and $6 million and has a five-year recovery period for depreciation purposes. Suppose further that the decedent was, and the heir is, a resident of California — a state that has no estate tax but does have a state income tax that ranges as high as 10 percent.

Under that fact pattern, depending on prevailing interest rates, it might make sense for the decedent's executors to use the $6 million valuation figure even though the estate thereby incurs a $350,000 federal estate tax on the $1 million that exceeds the $5 million estate tax exclusion. By using the higher valuation, the recipient taxpayer can now depreciate an extra $1 million over five years. Ultimately, that $1 million of ''bonus'' deductions will produce approximately $450,000 of additional federal and state income tax savings. While the foregoing tax savings must be discounted to be appropriately compared with the estate tax payment in 2011, in a low-interest-rate environment, the income tax savings associated with that strategy is likely to compare favorably with the upfront estate tax costs associated with using a high valuation for the asset.

### D. Projected Income Tax Revenue Losses

There are several obstacles to estimating the income tax revenue loss associated with the temporary exemption of estates in the $1 million to $5 million range. One difficulty is that we must project the effect of behavior changes. The altered incentive structure will surely affect behavior, but to what degree? Another difficulty is that as a series of temporary adjustments in the estate tax exemption took effect over the course of 2002-2009, the IRS ceased receiving estate tax returns from many estates that would have been within the relevant interval.[26] Thus, not only revenue was lost, but also data about estates that had asset values within the relevant ranges.

Despite the difficulties, it is possible to construct a model within which reasonable estimates can be derived. We begin with an IRS Statistics of Income

[24]Jay A. Soled and Leonard Goodman, ''Asset Valuations, Tax Basis, and New Estate Planning Considerations,'' 81 *CPA Journal* 50 (2011). There will be only two categories of taxpayers that might not embrace a high valuation asset strategy. First, there will be the superwealthy taxpayers who have estate tax exposure who will still probably use traditional estate valuation strategies (see Section B). Second, there will be some taxpayers in states that maintain estate/inheritance taxes who, too, might still choose to use traditional estate valuation strategies (again, see Section B). *See, e.g.*, Joel Michael, ''State Estate, Inheritance, and Gift Taxes Five Years After EGTRRA,'' *State Tax Notes*, Dec. 25, 2006, p. 871, *Doc 2006-23899*, or *2006 STT 248-1* (summarizing the status of state transfer tax regimes).

[25]*See supra* discussion in note 4.

[26]The exemption level was temporarily raised to $1 million for decedents dying in 2002-2003, to $1.5 million for decedents dying in 2004-2005, to $2.5 million for decedents dying in 2006-2008, and to $3.5 million for decedents dying in 2009. Section 521(a), Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16, 115 Stat. 38, 71 (2001).

report on the estates of decedents who died in 2004, when the applicable exclusion amount for estates was $1.5 million.[27]

In 2004, 35,596 decedents left gross estates valued between $1.5 million and $5 million, leaving total gross estates of more than $86 billion. Some 14,818 of those decedents left estates valued between $1.5 million and $2 million, totaling more than $25 billion in value. To round out this sample to cover the ''missing estates'' and hence the entire interval from $1 million to $5 million, we have assumed that at least as much value passed from the missing estates having values between $1 million and $1.5 million as actually was reported for estates in the immediately succeeding interval, ranging from $1.5 million to $2 million.[28] The modified sample produced by that adjustment passed just under $112 billion in assets ($86 billion actually reported plus $25 billion in estimated reportings) as a result of deaths occurring in 2004.

The SOI data break down the assets that passed to heirs into 23 categories. The next step in our estimation method involved separating those categories into ones that contained assets whose values could be authoritatively determined with some precision (cash, bonds, publicly traded stock, life insurance, and others), and those whose values likely could not be determined with precision (closely held stock, real estate, unincorporated business assets, works of art, and others). We found that for estates within that interval, about 35.8 percent of assets passing to heirs were of the hard-to-value sort, amounting to more than $40 billion of assets.

At this point, our method required a heroic assumption regarding the degree of undervaluation or overvaluation that might occur in the presence or absence of an estate tax. The cases demonstrate that there is often a very wide gap between the valuation initially proposed by an estate's executor and the valuation suggested by the IRS in assessing a deficiency. For example, in *Estate of Kelly*, described above, the IRS assessment was based on a valuation that was nearly eight times the value reported on the estate tax return. There is, of course, a considerable selection bias in statistics developed from litigated cases because those cases are the ones that were controversial enough that the parties decided to litigate them. So we have used a much more moderate assumption about valuation. What we have assumed is that for the hard-to-value assets, an estate that is subject to an estate tax will report a value that is one-third smaller than the (somewhat hypothetical) true value of the asset. Conversely, in a situation in which there is no estate tax, heirs are likely to claim a value that is one-third larger than this Platonic ideal of a true value. We also, somewhat generously, assume that assets that are amenable to more precise valuation are reported for all purposes at their true values, even though one can imagine that many of those assets have at least a little variability that will be exploited by executors or heirs, as the case may be. We believe that assumption is conservative, on the basis of a review of the case law on estate tax valuation disputes and on grounds that the penalty structure of section 6662 provides a safe harbor from penalties for valuation errors that are actually significantly larger than what we have assumed typically happens.[29]

Applying those assumptions to the data for 2004 decedents suggests that hard-to-value assets for estates between $1 million and $5 million in size would likely have been reported at only two-thirds their values, and that the $40 billion so reported probably had a true value of about $60 billion ($40 billion plus (1/3 x $60 billion actual FMV)). Had the same assets passed from an estate that was not subject to estate tax, we estimate that their values at the date of death would ultimately be reported at a one-third markup over their true values, which in this case would be $80 billion ($60 billion + (1/3 x $60 billion actual FMV)). The $40 billion difference

[27]Brian G. Raub, ''Federal Estate Tax Returns Filed for 2004 Decedents,'' IRS *Statistics of Income Bulletin* (Spring 2008), at 115. Although there is also data available for decedents who died in 2007 (see note 3, *supra*), the exemption in that year was $2 million — a level that leaves out many of the estates that we need to examine to develop reasonable revenue loss estimates. In general, the choice of older data produces a lower revenue loss estimate than more recent data would; that choice is thus consistent with our efforts to produce a conservative estimate of the revenue loss.

[28]This, too, is conservative. The population exposed to the estate tax has not in recent years been more than about 5 percent of all deaths. It is thus at the extreme right side of a normal distribution and has the steep slope associated with the extreme ends of bell curves. There can be no doubt, based on earlier reports when the estate tax reached more estates, that there must have been at least as much value passed to heirs from estates in the $1 million to $1.5 million bracket as passed from estates in the $1.5 million to $2 million bracket. Even in the 2004 data, it can be seen that as one moves into higher brackets, the total value passing from estates within those brackets declines. For example, in 2004 more than $41 billion of assets passed from decedents leaving estates in the $2 million to $3.5 million bracket, but less than $20 billion passed from decedents in the next-higher bracket, from $3.5 million to $5 million. Although each estate in the lower bracket of those two was on average smaller, that factor is overwhelmed by the fact that the number of estates within the lower bracket was much larger.

[29]That is, a taxpayer will not risk exposure to section 6662 penalties unless her valuation is 50 percent in excess of the correct value; our assumption of a one-third overvaluation is thus well within the safe area under the existing penalty structure.

between those two valuation judgments represents the excess section 1014 bases in assets passing from those estates in a system in which no estate tax applies to estates within this interval, compared with the bases that would be reported in a system in which an estate tax would apply to those estates.

That collective overreported basis can be converted to a rough revenue loss estimate by multiplying the excess basis by the applicable capital gains rate. Because we are comparing what might have been collected for assets of decedents dying in 2011 and 2012 had the 2010 act not been added to law, it is appropriate to use the permanent capital gains rate that would have applied in the absence of the 2010 act, which is 20 percent. Thus, about $8 billion of federal income tax revenue per year is at stake in the question whether an estate tax should apply to estates with assets between $1 million and $5 million. (Of course, for those states that impose an income tax, a significant amount of state income tax revenue is being forfeited as well.)

Because the hypothetical revenue loss would generally be spread over the years following 2011 and 2012 as the assets are sold, discounting for present value might be appropriate. However, a recent study published by the IRS involving panel data suggests that most assets are sold within the first several years of ownership.[30] About two-thirds, in fact, are sold within five years. It is also true that some of the revenue loss associated with overvaluation of inherited property takes the form of excess depreciation deductions that begin to accrue immediately. While we concede that some discounting for time value would probably be appropriate, we note also that there are offsetting adjustments that would also be appropriate that we have not made. For example, the annual number of deaths in 2011 and 2012 will surely exceed the number in 2004 because of the aging of the baby-boom generation. We note as well that wealth has grown since 2004. As this article goes to press, the Dow Jones, NASDAQ, and NYSE averages were 10 to 20 percent higher than their 2004 averages.[31] Although the slow recovery from the recession of 2008 has meant only modest growth in wealth since 2004, there has surely been some growth, as well as a growth in the segment of the population most likely to be exposed to the estate tax. Our judgment is that those latter two factors are actually more significant than the time value factor and that on balance, leaving out adjustment for all three factors can only bias our results on the conservative side.

The income tax revenue loss we project has an ironic quality: While the estate tax is often thought of as a backstop for the income tax, particularly when it comes to unrealized appreciation,[32] there is also a sense — to date largely unnoticed — in which the income tax backstops the estate tax. When taxpayers have drastically undervalued assets to mitigate their estate tax burdens, the income tax system has since recouped some of the lost estate tax revenue by preserving a low-basis asset in the hands of the decedents' heirs. In the absence of a meaningful estate tax, that backstop has been significantly marginalized.[33]

When the debate over the future of the estate tax resumes, Congress should assess the revenue stakes by looking not only at the direct effect of the estate tax but also at its indirect effect on income tax revenues. According to the Tax Policy Center, the direct effect of allowing the permanent estate tax provisions to resume in full (that is, with a $1 million exemption and a top rate of 55 percent) would be $27 billion of revenue in 2013 and larger amounts in the following years, compared with extending the temporary provisions applying to 2011 and 2012 ($5 million exemption and a 35 percent flat rate).[34] But regardless of the rate chosen, including estates with assets between $1 million and $5 million within the reach of the estate tax would also produce an additional $8 billion of income tax revenue.

### E. IRS Challenges of Inflated Tax Bases

A general income tax maxim is that taxpayers usually wish to accelerate deductions and defer

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[30]Janette Wilson and Pearson Liddell, ''Sales of Capital Assets Panel Data, Tax Years 1999-2003,'' IRS *Statistics of Income Bulletin* (Summer 2009), at 197.

[31]The 2004 averages were as follows: Dow Jones Industrials, 10,783; NASDAQ Composite, 2,175; Standard & Poor's 500, 1212. Statistical Abstract of the United States, 2011, at 749.

[32]*See* Harry L. Gutman, ''Reforming Federal Wealth Transfer Taxes After ERTA,'' 68 *Va. L. Rev.* 1183, 1191 (1983) (''The transfer tax serves as a 'backstop' to the income tax by taxing the wealth that taxpayers accumulate through tax-preferred income sources'').

[33]One important yet unarticulated way to conceptualize how this backstop feature operates is as follows: Over the last 10 years, the estate tax produces approximately $20 billion to $25 billion annually. *See supra* note 7, at Figure H. But in assessing annual revenue generation, Congress should also factor in the estate tax's ability to keep section 1014 in check. By limiting section 1014's application, the estate tax indirectly generates another $8 billion to $15 billion of annual income tax revenue (when estates in excess of $5 million are also taken into account), making the estate tax a truly robust contributor to the solvency of the federal fisc.

[34]The estate tax is projected to produce $40.5 billion in 2013 under the permanent rules and only $13.5 billion if the current temporary rules are extended. By the year 2021, the permanent rules would produce $86.5 billion in revenue, while the current temporary rules would produce only $24.4 billion. Tax Policy Center, Table T11-0156, *available at* http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=3037.

income to maximize the time value of money advantages associated with tax deferral. Accordingly, most tax accounting rules are designed to prevent inappropriate acceleration of deductions or deferral of income. Tax accounting rules are frequently less attentive to the opposite problem, in which a taxpayer, for a variety of idiosyncratic reasons, may wish to accelerate income or defer deductions.[35] The same can be said of the estate tax: It is ill-designed to prevent taxpayers who want to inflate asset values from capitalizing on the basis equals FMV rule of section 1014.[36] Penalties admittedly exist to curb valuation overstatements, but they will likely prove ineffectual.

Before discussing the possible exposure audited tax returns have to penalty imposition, an important point must be made. Regardless of the penalty regime in place, the IRS will have the daunting threshold task of detecting inflated asset tax bases. In most cases, the IRS will have no particular reason to believe that an asset's tax basis should be the subject of scrutiny. As noted, under the temporary provisions applying in 2011 and 2012, very few estates will have to file an estate tax return.[37] In the absence of an estate tax return, taxpayers are left largely to their own devices to determine the FMV of a decedent's assets. And, with little fear that the IRS is looking over their shoulders, taxpayers are apt to respond aggressively to reduce their future income tax burdens.

In the subsections that follow, we explore the possible consequences in the unusual cases in which the IRS is able to detect that taxpayers have used inflated asset tax bases in reporting gains, losses, or depreciation deductions. In subsections 1, 2, and 3, we conduct penalty analyses applicable to taxpayers, appraisers, and tax practitioners, respectively. In subsection 4 we explore ethical issues for tax practitioners regarding inflated tax bases.

**1. Taxpayers' exposure to the accuracy-related penalty.** The tax basis of an asset is relevant in several different contexts. First, if the asset is used in a trade or business or held for the production of income, computation of depreciation allowances for the asset will be determined by reference to its basis.[38] Use of an inflated tax basis will produce depreciation/amortization deductions in excess of what are allowable, causing an underreporting of income. Second, if an asset is subsequently sold, gain or loss is determined by comparing the amount realized on the sale with the asset's adjusted basis. If the basis is overstated, that calculation will produce either the underreporting of a gain or the overreporting of a loss. In either event, that would cause the taxpayer's income to be underreported. Finally, the basis of an asset may be relevant if a taxpayer disposes of the asset via a charitable gift, theft loss, or condemnation.[39] In all those cases, overvaluation of the asset's basis may lead to overstatement of a deduction and understatement of income.

If the valuation misstatement is ''substantial'' — that is, if the value or adjusted basis of any property is 150 percent or more of the correct amount[40] — an accuracy-related penalty equal to 20 percent on the underlying tax deficiency may be imposed.[41] When the valuation misstatement is ''gross'' — that is, if the value or adjusted basis of any property is 200 percent or more of the correct amount[42] — the penalty rate is raised to 40 percent of the underlying tax deficiency.[43]

**2. Appraisers' exposure to the accuracy-related penalty.** In 2006[44] Congress added a penalty applicable to appraisers who prepare appraisals that result in a substantial valuation misstatement, a substantial estate or gift tax valuation misstatement, or a gross value misstatement.[45] The penalty amount is equal to the lesser of the following: (1)

[35]For example, the taxpayers in *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), *Doc 98-31128*, *98 TNT 202-7*, *cert. denied*, 526 U.S. 1017 (1999), constructed a tax shelter strategy around the fact that the installment sales accounting rules in reg. section 15a.453-1(c)(3) prevent inappropriate accelerated recovery of basis in installment sales but do not prevent inappropriate deferral of recovery of basis in those sales.

[36]Historically, in the realm of transfer taxes, the primary thrust of the penalty rules has been to try to prevent taxpayers who, in an attempt to reduce their transfer tax burdens, submit a substantial estate or gift tax *valuation misstatement* related to the value of a decedent's assets. *See* section 6662(g) (a 20 percent penalty applies in instances when the value of any property claimed on a transfer tax return is 65 percent or less of the amount determined to be the correct value); section 6662(h)(2)(C) (the penalty is raised to 40 percent when the value of any property claimed on a transfer tax return is 25 percent or less of the correct amount).

[37]*See supra* note 3.

[38]Sections 167 and 168.

[39]The amount allowed as a charitable deduction for contributed assets is often the FMV of the asset; however, there are many situations in which a taxpayer's deduction may be limited to the basis of the contributed asset. *See* section 170(e).

[40]Section 6662(e)(1)(A).

[41]Section 6662(a). Note that insofar as accuracy-related penalties are concerned, Congress also has provided a reasonable cause exception. That exception applies if it is shown that there was a reasonable cause for the underpayment and that the taxpayer acted in good faith. Section 6664(c).

[42]Section 6662(h)(2)(A)(i).

[43]Section 6662(h)(1).

[44]The Pension Protection Act of 2006, P.L. 109-280, 120 Stat. 780.

[45]For definitions of the foregoing terms, see *supra* text accompanying notes 40-43.

the greater of $1,000 or 10 percent of the understatement of tax resulting from the misstatement, or (2) 125 percent of the gross income received from the preparation of the appraisal.[46]

**3. Tax return preparers' exposure to the section 6694 penalty.** A tax return preparer, including an attorney, accountant, or enrolled agent, faces a penalty if any part of an understatement on a tax return or refund claim is because of an unreasonable position — that is, one that lacks substantial authority — and the return preparer knew or should have known that to be the case.[47] The penalty has two tiers. For the first tier, the penalty is equal to the greater of $1,000 or 50 percent of the income derived (or to be derived) by the preparer regarding the return or claim.[48] The second-tier penalty is more onerous: When the understatement is attributable to the preparer's willful conduct or a reckless or intentional disregard of the rules or regulations, the penalty is the greater of $5,000 or 50 percent of the income derived (or to be derived) by the preparer regarding the return or claim.[49]

Unless the submitted tax return information appears incorrect or incomplete on its face, a tax return preparer in good faith can generally rely on the information a taxpayer supplies.[50] The tax return preparer thus generally has no independent duty to verify submitted information.[51]

The valuation of assets is generally an area of expertise beyond that of most tax return preparers. Tax return preparers therefore generally rely on taxpayers to supply asset valuations, thereby making the tax return preparer penalty imposition in this context highly unlikely. Indeed, the only time tax return preparers risk penalty exposure would be in the unlikely event they counsel or instruct their clients to use unreasonable asset values.

**4. Ethical issues associated with the reporting of assets with an inflated tax basis.** Tax return preparers are subject to the ethical rules promulgated under Circular 230.[52] Under Circular 230, a tax return preparer must exercise due diligence in the preparation of tax returns, including determining the accuracy of information supplied by a client if that information on its face appears incorrect.[53] (A tax return preparer generally, however, can rely on the work product of others, such as an appraiser.[54])

If the tax return preparer fails to fulfill her responsibilities, she can be subject to disciplinary action, such as censure, suspension, or disbarment.[55]

**5. Effects of the penalties and disciplinary rules.** In the prior subsections, we set forth the penalty framework applicable to taxpayers, appraisers, and tax practitioners who overvalue a decedent's assets and thereby artificially inflate the underlying tax bases of a decedent's assets. But consider the limitations of that framework using the building that was depicted in the Section B example, worth between $3 million to $4.5 million.

If the taxpayers simply valued the building at the high end of the valuation continuum ($4.5 million), they would have no risk of enduring a tax deficiency. Further, there would be a risk of a substantial valuation misstatement only if the taxpayers valued the building at or more than $6.75 million ($4.5 million x 150 percent), and a risk of a gross valuation misstatement only if the taxpayers valued the building at or more than $9 million ($4.5 x 200 percent). If the taxpayers secured the expertise of an appraiser to value the building, the appraiser would have no penalty exposure unless the appraisal produced reflected a value at or more than $6.75 million ($4.5 million x 150 percent). Finally, the tax return preparer would have no penalty exposure if she simply accepted the taxpayers' supplied value unless she knew or should have known that that value was incorrect or she herself supplied the unreasonable value. If a penalty were imposed on the tax return preparer, the Office of Professional Responsibility might conduct an investigation, resulting in her censure, suspension, or disbarment.

As evidenced by those five subsections, taxpayers, appraisers, and tax practitioners all have some risk of penalty exposure if, on a client taxpayer's death, they aggressively value his assets beyond their legitimate FMVs. Having said this, as a practical matter, we question whether the IRS has adequate resources to police the current valuation process, whether existing penalties are severe enough to dissuade participants in the valuation process from overinflating tax bases, if adjudicating valuation disputes are truly cost-efficient, and, finally, whether there might be a more effective policy approach to address how death should bear on the tax bases of assets owned by a decedent.

## F. Conclusion

This article is not intended primarily to offer arguments for retention of a broad-based estate tax, although in truth we would support maintaining the

[46]Section 6695A(b).
[47]Section 6694((a)(2)(A).
[48]Section 6694(a)(1).
[49]Section 6694(b).
[50]Reg. section 1.6694-1(e).
[51]Reg. section 1.6694-1(e)(3), Example 2.
[52]Circular 230, section 10.3.
[53]Circular 230, section 10.22(a).
[54]Circular 230, section 10.22(b).

[55]Circular 230, sections 10.50, 10.51, and 10.52.

permanent $1 million exemption on the policy grounds that initially led Congress to institute this tax in the first place.[56] What we argue instead is that a broad-based estate tax provides an ancillary income tax benefit in the form of curtailing the abusive use of section 1014. When Congress next considers the appropriate exemption level for years following 2012, we hope that it will consider that effect, as well as the substantive arguments for a broad-based estate tax. Section 1014 lacks theoretical justification, but its administrative attractiveness to members of Congress has proven nothing short of intoxicating. When the estate tax exemption amounts were relatively low, the corrosive impact of section 1014 was mitigated. With the significant increase of the applicable exclusion amount, section 1014 and its application will largely go unchecked. If most large wealth holdings that pass by inheritance must go through the mill of an estate tax valuation, however, there is some mitigation of section 1014's shortcomings provided by the strong incentive to minimize valuations for estate tax purposes. Those valuations then presumptively become the heirs' bases in the assets they inherit, and abuse of section 1014's rule is substantially abated. A major, but largely unexamined, problem of reducing the scope of the estate tax to only a fraction of 1 percent of all estates is that most assets would thenceforth not go through the estate tax valuation mill, and section 1014 abuse would go unmonitored.

So our first recommendation would be that Congress simply let the temporary provisions expire. Even a $1 million exemption is relatively large by historic standards.[57] The federal budget deficit is widely regarded as unsustainably large, which would seem to make this a poor time to exempt a category of taxpayers — those leaving estates between $1 million and $5 million — that has historically been subject to an estate tax and that occupied roughly the 97th through 99.8th percentiles of the wealth distribution. If Congress doesn't recover that revenue from another source, it makes the deficit that much worse; if Congress *does* recover that revenue from another source, it will certainly be from those less able to bear additional tax burdens.

If a $1 million exemption is unrealistic under current political conditions, the arguments in this article still offer support for any exemption level between $1 million and $5 million, and the closer to the former benchmark, the better. A compromise at $3.5 million, for example, was discussed in the run-up to the 2010 legislation and could certainly be revived. A $2 million or $2.5 million exemption would be better, but the point is that anything below $5 million will not only augment the estate tax revenue but also reduce the income tax losses associated with abuse of the stepped-up basis rules by heirs of decedents whose estates were not subject to the estate tax.

While maintenance of an estate tax exemption that is as close to $1 million as possible is the best solution for the abuse of the stepped-up basis rules, there are other approaches that would be helpful even if Congress chooses to adopt a very high threshold of estate taxability. First among them would be to consider requiring that estates file estate tax returns even when the gross estate is less than the exemption amount. Under current law, the obligation to file an estate tax return is tied to the exemption amount in effect in the year of the decedent's death.[58] That is presumably because it seems pointless to require an executor to complete a return that cannot possibly show a positive estate tax liability. However, as we have shown, the return is not in fact pointless in those cases: It can help establish the basis of assets for later income tax purposes. Executors may be willing to err on the high side in valuing assets for a return they know will not be taxable, but at least some estates will be close enough to the line that executors will have reason to be cautious not to so favor the interests of the heirs that the estate valuations come in from the appraisers at levels that turn out to cross the taxability threshold.

Finally, in light of the particularly problematic basis rules of section 1014, Congress could consider a harsher penalty regime that would impose both larger penalties on overvaluations and narrow the range within which valuations could avoid the penalties. For example, under current law, an overvaluation that is not more than 150 percent of what a court finds to be the true value will not be subject to a penalty. That penalty safe harbor could be reduced to 125 percent of the true valuation.

There may be other solutions as well. But our hope is that Congress does not make permanent changes to the estate tax without full consideration of the income tax revenue losses that are also at stake. Lost revenue of $80 billion over a 10-year scoring period is not a huge number in terms of our recent budget deficits, but it is not a trivial number, either. When Congress hastened to pass the greatly increased temporary exemption, it ignored that revenue loss. But when Congress next considers this question, it should not replicate that error.

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[56]*See supra* note 1.

[57]The 1954 Internal Revenue Code allowed an exemption of only $60,000 (see section 2052 (1954)), and as recently as 2001 the exemption was only $675,000 (see section 2010).

[58]Section 6075(a).