Saving the Farm or Giving Away the Farm: A Critical Analysis of the Capital Gains Tax Preferences

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"*We can have democracy in this country, or we can have great wealth concentrated in the hands of a few, but we can't have both.*"[1]

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1. Though this quote is commonly attributed to Louis D. Brandeis, there is evidence that it actually comes from an obituary of Brandeis written by Edward Keating, a Colorado congressman and admirer of the late justice. *See* Peter Scott Campbell, *Democracy v. Concentrated Wealth: In Search of a Louis D. Brandeis Quote*, 16 GREEN BAG 251, 255 56 (2013). Regardless, "[i]f it is not a Brandeis quote, it is at least a Brandeisian one." *Id.* at 256; *cf.* Louis D. Brandeis, *The Opportunity in the Law*, 39 AM. L. REV. 555, 562 (1905) ("[T]here is felt today very widely the inconsistency in this condition of political democracy and industrial absolutism. The people are beginning to doubt whether in the long run democracy and absolutism can co-exist in the same community; beginning to doubt whether there is a justification for the great inequalities in the distribution of wealth, for the rapid creation of fortunes, more mysterious than the deeds of Aladdin's lamp.").

TABLE OF CONTENTS

I. INTRODUCTION

Tax policies that have shaped our tax structure and economic climate overwhelmingly favor the wealthy, propertied taxpayers.[2] These tax policies are currently configured to shift wealth and the benefits of wealth in one direction: To the wealthier taxpayers. As such, these policies contribute to the wealth and income inequality that disadvantages the poor and middle class in favor of the wealthy.

Over the years, the topic of capital gains preferences has been the fodder for much debate regarding the best way to deal with capital gains taxes.[3] Discussions have fluctuated between raising, reducing, and repealing capital gains taxes.[4] Other discussions have centered on whether capital gains have an effect on the economy, and if so, how the research supports those

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2. THOMAS L. HUNGERFORD, CONG. RESEARCH SERV., R40411, THE ECONOMIC EFFECTS OF CAPITAL GAINS TAXATION (2010) ("Higher income households are substantially more likely to own assets that can generate taxable gains than lower income households. Additionally, high income households own most of these assets, realize most of the capital gains, and pay most of the capital gains taxes at preferential rates.").

3. *Id.* ("Some argue that reducing capital gains tax rates will increase tax revenues by dramatically increasing capital gains realizations. While the effect of changes in the capital gains tax rate continue to be debated and researched, the bulk of the evidence suggests that reducing the capital gains tax rate reduces tax revenues."); *see also* Gerald E. Auten & Joseph J. Cordes, *Policy Watch: Cutting Capital Gains Taxes*, J. ECON. PERSP. 181, 182 (1991) ("While taxing capital gains at the same rates as other income has been hailed by some as a major accomplishment of tax reform, it has been criticized by others as one of its main flaws. As a result, there have been proposals each year since 1986 to restore some type of capital gains preference.").

4. *See* John W. Lee, *Critique of Current Congressional Capital Gains Contentions*, 15 VA. TAX REV. 1, 2–5, 3 n.8, 23 n.88 (1995).

assertions.[5] It would be difficult to cover all aspects of the issues associated with capital gains taxes in one article; therefore, this discussion will focus on preferential rates on capital gains as applied to individual income taxes.[6]

Tax policies, when viewed in the aggregate, reveal that the capital gains tax has been a mechanism to shift wealth to the wealthiest taxpayers.[7] This shift is evident through tax preferences and subsidization to reduce or eliminate tax burdens for the wealthy. This Article will add to the discourse by examining how capital gains preferences have failed to accomplish the initial goals of Congress—to encourage disposition of capital property and to generate revenue.[8]

While there is existing literature on wealth and income inequality, and there are discussions of multiple causes of wealth and income inequality, this Article is unique in that it will explore the failures of various historical justifications for the capital gains tax preferences and how these preferences contribute to wealth and income equality.

This Article addresses some of the inequities and offers a multi-faceted proposal to raise revenue and incentivize preferences for a more balanced approached to tax policy. First, I advance a proposal that offers solutions to shift certain aspects of the capital gains tax preferences toward the middle and lower class. To balance the costs, I then propose an option to phase

5. *See generally* AM. COUNCIL FOR CAPITAL FORMATION, STATE AND FEDERAL INDIVIDUAL CAPITAL GAINS TAX RATES (Mar. 2012), http://accf.org/wp-content/uploads/2012/04/1204-15-ACCF-Special-Report-on-Capital-Gains_FINAL.pdf [https://perma.cc/P35W-94VW].

6. Jason L. Hortenstine, Comment, *Use of the Family Limited Partnership to Protect Illinois Family Farms During a Period of Uncertainty: Proceed with Caution*, 37 S. Ill. U. L.J. 195, 204–06 (2012); *see also* Brian Raub & Melissa Belvedere, *New Data on Family Limited Partnerships Reported on Estate Tax Returns*, *in* 2 INTERNAL REVENUE CO., COMPENDIUM OF FEDERAL TRANSFER TAX AND PERSONAL WEALTH STUDIES 374 (2005).

7. Thomas Piketty & Emmanuel Saez, *How Progressive is the U.S. Federal Tax System? A Historical and International Perspective* 1 (Nat'l Bureau of Econ. Research, Working Paper No. 12404, 2006) ("However, the conclusion that these three changes have reduced the progressivity of the federal tax system [sic] less obvious than it may at first appear. For example, in the case of the individual income tax, the numerous deductions and exemptions mean that the tax rates listed in the tax tables might be a poor measure of the actual tax burden faced by each income group. In addition, some forms of income, such as capital gains, have traditionally faced lower tax rates, which benefits disproportionately high income taxpayers.").

8. *Economics of Taxation*, U.S. Dep't of Treasury, https://www.treasury.gov/resource-center/faqs/Taxes/Pages/economics.aspx [https://perma.cc/NLC2-GT93] (last updated Dec. 5, 2010) ("To meet their expenses, government [sic] need income, called 'revenue,' which it raises through taxes.").

out or eliminate other preferences that primarily benefit the wealthiest taxpayers. This balanced approach will allow the government to raise revenue and change the capital gains tax preferences from a rewards to an incentive-based system.

Part II of this Article focuses on the capital gains tax and provides an abbreviated historical background about the preferential rates for capital gains taxes. This discussion includes research supporting the assertion that the wealthiest taxpayers have predominantly benefitted from the capital gains preferential rate, and suggestions to limit the preferential rates based on income levels.

Part II also analyzes tax preferences of capital income and demonstrates how policies have failed to encourage the disposition of property to generate revenue. This Part includes reforms necessary to encourage taxpayers to dispose of capital property by proposing policies that remove the benefits associated with holding property for long periods of time. This Part also discusses widening income and wealth inequalities and how the capital gains tax has contributed to these inequalities.

Part III begins with a discussion of the income tax implications of the capital gains tax when property passes through the estate. The discussion will conclude with the gross inequities associated with capital property that passes through an estate to a beneficiary.

Part IV analyzes the best solutions for reforming capital gain tax policies through the estate. The proposed reforms will create horizontal equity between taxpayers who receive capital property via lifetime transfers and taxpayers who receive capital property via death transfers. This section also discusses the impact of capital gains preferences and analyze how tax preferences on capital income have failed to encourage disposition of property and reforms necessary to encourage taxpayers to dispose of capital property.

Part V provides a conclusion.

II. TAX TREATMENT OF CAPITAL GAIN INCOME[9]

A. Historical Treatment of Capital Gain Property

Tax preferences, such as capital gains, contribute the income disparity in America.[10] Capital gain income is generally defined as income derived

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9. The discussion in this section focuses on the preferential rates of capital gains and dividend income and intentionally excluded deductions associated with capital property.

10. John Lee, *Class Warfare 1988-2005 Over Top Individual Income Tax Rates: Teeter-Totter from Soak-The-Rich to Robin-Hood-In-Reverse*, 2 HASTINGS BUS. L.J. 47, 51 (2006) ("The distribution per percentiles of individual income classes of individual taxpayers of such capital gains tax preference benefit has always been skewed sharply to

from the sale or exchange of a capital asset.[11] In *Eisner v. Macomber*, the court defined income as "gain derived from capital, from labor, or from both combined."[12] At the time when *Macomber* and related tax cases were decided, courts did not distinguish between the tax rates on income.[13]

The Court needed to determine the proper timing for taxing capital income, and it ruled that a realization event must occur before the IRS could tax the appreciation on capital assets.[14] With this ruling, *Macomber* validated the deferral of income for capital gains property for taxpayers. This provides a tax benefit because the taxpayer controls when the realization event occurs and therefore when the tax payment is due.

Before the Supreme Court decided *Macomber*, and under the original Revenue Act of 1913, there was no distinction between the tax treatments for different types of income.[15] All income was taxed at the ordinary rate.[16] It was not until the Revenue Act of 1921 that capital gains income received favorable tax treatment.[17] In 1921, when ordinary income was taxed at a rate of almost 70%, the long-term capital gains preferential rate was reduced to 12.5% for property held for more than two years, and remained at this rate for many years.[18]

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the top income reporters." (citing J.F. WITTE, THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX 88 (1985))).

11. *See* I.R.C. § 1222 (2012) (providing terms and definitions for short and long-term capital gains and losses). For the purpose of simplicity and ease of discussion, unless otherwise specified, capital gains property refers to property treated as long-term capital gain property as defined by I.R.C. § 1222(3). Long-term capital gains qualify for preferential rates in accordance with I.R.C. § 1(h).

12. Eisner v. Macomber, 252 U.S. 189, 207 (1920) (quoting Stratton's Indep., Ltd. v. Howbert, 231 U.S. 399, 415 (1913)).

13. *See Macomber*, 252 U.S. at 189.

14. *Id*. at 209.

15. GREGG A. ESENWEIN, CONG. RESEARCH SERV. 98-473, INDIVIDUAL CAPITAL GAINS INCOME: LEGISLATIVE HISTORY 3 (2006).

16. *Id.*

17. *Id.* ("The Revenue Act of 1921 marked a significant change in the tax treatment of capital gains income. For the first time, capital assets were specifically defined in the individual income tax code and were separated into long and short term assets[.] Gains on short-term assets were included in income and taxed at normal tax rates. Losses on short-term assets were deductible against ordinary income.").

18. John Lee, *The Capital Gains "Sieve" and the "Farce" of Progressivity 1921–1986*, 1 HASTINGS BUS. L.J. 1, 7 (2005). For a detailed discussion of how the holding period may also contribute to the income disparity because inherent gain is not taxed until a realization event occurs, see Beverly Moran, *infra* note 134.

This rate reduction represented a significant change because the stock market was doing very well and capital gains comprised the majority of certain taxpayers' income.[19] Based on the fact that the wealthiest taxpayers owned a substantial portion of the capital gains property taxed at the ordinary rate, high tax rates were did not deter ownership of capital gains property. As a result of the Revenue Act of 1921, those taxpayers whose income consisted primarily of capital gains property experienced a significant decrease in their tax bill.[20]

It is not difficult to determine what may have been the true congressional motive for the capital gains tax. For instance, Professor Lee exposes one such motive with his analysis of those early years leading up to implementation.[21] Specifically, he discusses the "bait and switch" tactic Congress used to gain initial support for the capital gains preference.[22] When Congress initially presented capital gains income for preferential treatment, it used the bait of "saving the farm" to gain support for preferential rates, which they knew would also apply to other capital property such as privately owned stock.[23]

Congress justified preferential rates on the premise that reduced rates were necessary to counter the "lock-in effect" that taxpayers caused when they held capital property to avoid paying the taxes that realization events triggered.[24] Specifically, Congress used farmers as an example to sell the idea that preferential rates were necessary for capital property because the high tax rates were deterring the sale of farmland.[25] In other words, Congress

19. *See* Lee, *supra* note 18, at 8 ("During the Roaring Twenties' boom stock market years, capital gains amounted to almost 50 percent of individual sector taxable income. In the 1925 boom stock market year, the 12 1/2 percent flat rate capital gains preference benefitted only individuals with more than $30,000 of taxable income ($313,910 in 2004 dollars) where an ordinary income rate greater than the flat capital gains rate first applied." (citations omitted)).

20. *See id.* at 7, n.37. The data indicates the top regular rate between 1917 and 1921 averaged in the 70% range. In 1922, the top rate on wages and other income was 58% and the capital gains rage maxed at 12.5%. *Id.*

21. *Id.* at 10.

22. *Id.*

23. *Id.* ("The legislative history reveals that from the beginning, capital gains proponents cloaked the true object of their bounty (public stock concentrated in high income taxpayers) with more popular symbols. For instance, the House floor debate on the Revenue Act of 1921 generally spoke first of high rates blocking sales of farm land before discussing their blocking sales of securities. A decade later the Chair of the House Ways and Means Committee, recalling that the 1921 introduction of a capital gains rate had been presented as having a tendency to permit the break up of large farms, asked what percentage of capital gains sales was attributable to such real estate." (citation omitted)).

24. Richard L. Schmalbeck, *The Uneasy Case for a Lower Capital Gains Tax: Why Not the Second Best?*, 48 TAX NOTES 195, 200 (1990) ("The principle distortion created by the combined effects of a realization requirement and a relatively high tax on relative gains has to do with the tax-induced reluctance to dispose of assets. This is sometimes referred to as the 'lock-in' effect.").

25. Lee, *supra* note 18, at 10.

suggested that, to make it easier for farmers to sell their land, it needed to lower tax rates on the profits from sales. However, if saving the farm was truly the focus of the capital gains preferential rates, then Congress would have limited preferential rates to the sale of farm lands. There was no such limitation. Instead, Congress extended the preferential rates to securities, specifically publicly traded stock, and then further expanded the definition to include even more property.[26]

In short, Congress justified enacting preferential rates for capital gains by encouraging the sale of capital assets like farmlands and making it less costly to sell them.[27] Instead, the property that primarily benefitted from capital treatment was publicly traded stock.[28] If Congress had a valid concern for the lock-in effect of capital property, it should have expected that the voluntary sales of capital property would increase and generate additional revenue for the government.[29] That did not happen.

Even though the government did not gain any significant revenue, the Revenue Act of 1924 further expanded the definition of capital assets by eliminating the requirement for the asset to be held for profit or investment.[30] This expansion made more property eligible for capital treatment, and the wealthy, propertied taxpayers had an even greater reduction in their tax liability, which resulted in less revenue for the government.[31]

26. *Id.* at 15 ("More significantly, in 1942 and 1943 Congress extended the preference beyond the public stock and real estate investments of high income individuals to benefit a wide range of middle class taxpayers who were often the Democrats' constituent groups, such as taxpayers with timber royalties, revenue from the sales of used equipment and livestock and lump-sum distributions from qualified retirement plans." (citations omitted)).

27. *See id.* at 9 ("Congress' articulated rationale for the initial capital gains preference was that 'bunching' of gain accrued over many years into a single year subject to progressive rates 'blocked' voluntary transactions such as sales of capital assets." (citation omitted)).

28. *Id.* at 10.

29. During the hearings for the Revenue Revision Act of 1932, the Under Secretary of the Treasury, when asked whether the Revenue Act of 1921 actually led to large landowners breaking up their land to sell to smaller private owners, responded that "the principal gains that have been realized in the last few years have been in the security markets." *General Statements: Hearings on Revenue Revision Act of 1932 Before the H. Comm. on Ways and Means*, 77d Cong. 42 (1932) (statement of Hon. Ogden Mills, Under Secretary of the Treasury).

30. ESENWEIN, *supra* note 15, at 4 (explaining that with the expanded definition, any gains or losses on residential properties would thereafter be treated as capital gains or losses).

31. *See Hearings on Revenue Revision Act of 1932, supra* note 29, at 37 (tracing the reduction of the government's total tax revenue after the capital assets were given preferential tax treatment).

With continued reductions to their tax liability, the wealthy had more disposable income to save or invest in other income-producing property. On the other hand, the lower-to-middle-income taxpayers saw no commensurate reduction in their tax bills.[32] As a result, the benefits of greater property ownership did not result in the burden of more tax liability. At this point, the stage was securely set to continue the income shifting in favor of the wealthier taxpayers.

By 1938, additional changes affected the rates and holding periods. The Revenue Act of 1921 required a two-year holding period to invoke long-term status and the Revenue Act of 1938 reduced the long-term holding period to eighteen months.[33] The Revenue Act of 1938 also provided two alternative methods for taxing long-term gains and losses. The first method provided for including a percentage of the long-term gains or losses in taxable income at a normal rate.[34] If a taxpayer held those assets for more than eighteen but less than twenty-four months, then those assets were subject to 66.66% of the gain or loss recognized and included in taxable income at the ordinary rate.[35] If a taxpayer held the assets for longer than twenty-four months, then 50% of the gain or loss was recognized and included in taxable income at the ordinary rate.[36]

The second method of taxing long-term capital gains and losses provided for a 30% flat tax on the net long-term capital gain.[37] As a result, this method would apply a maximum rate of 20% to assets held for more than eighteen months but less than twenty-four months, and a maximum of fifteen percent

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32. Lee, *supra* note 10, at 49–50 ("During the first modern capital gains tax preference era from 1921-1986, the federal tax law dipped deeply in large incomes through *nominally* progressive income tax rates, but for large incomes consisting mostly of capital gains (taxed at *effective* rates substantially below the maximum individual ordinary income rate) such dipping was done with a very coarse grained sieve. Highest income taxpayers with substantial capital gains realization enjoyed a Federal tax effective rate lower than that of taxpayers with less income but where the income was wholly or mostly ordinary. Vertical equity or progressivity was a farce during this era." (citations omitted)); *see also id.* at 9 ("Undersecretary of Treasury Ogden Mills, who had been a Wall Street tax lawyer and member of the House Ways and Means Committee in the early 1920's, pointed out in the 1932 Senate Finance Committee Hearings that the real tax burden were state and local taxes borne by small and moderate income taxpayers." (citation omitted)).

33. ESENWEIN, *supra* note 15, at 3, 5 (comparing the Revenue Act of 1921, under which assets had to be held for longer than two years to be considered long term for purposes of the 12.5 percent flat rate, with the Revenue Act of 1938, which reduced the holding period for long-term treatment to eighteen months).

34. *Id.*

35. *Id.*; Gerald Colm, *The Revenue Act of 1938*, 5 SOC. RES. 255, 257 (1938).

36. ESENWEIN, *supra* note 15, at 3, 5; Roy G. Blakey & Gladys C. Blakey, *The Revenue Act of 1938*, 28 AM. ECON. REV. 447, 452 (1938).

37. ESENWEIN, *supra* note 15, at 3, 5.

to assets held for longer than twenty-four months.[38] Of the two methods, the tax that resulted in the lower amount of taxes payable by the taxpayer would apply.[39] During the same period, other unearned income and earned income for the wealthiest income group was taxed at an average rate of 80%.[40] Accordingly, the tax savings for the wealthiest taxpayers was significant.

By creating these two methods to reduce taxes on capital gain income, Congress again demonstrated a pattern of creating income preferences that primarily benefitted the wealthy. In addition, these policies contradicted the stated purpose of capital gains—encouraging the sale of capital property.[41] Instead, Congress facilitated the lock-in effect by permitting the lowest tax rates for taxpayers who held capital property for longer periods.[42]

By continuing to enact tax policies that rewarded taxpayers for holding property longer, it was apparent that Congress had other motives for affording preferential treatment to capital property. By making it easier to qualify for capital gains treatment, and providing preferential rates, Congress continued to shift assets to the wealthiest at the expense of other taxpayers.

A few years later, the Revenue Act of 1942 made it even easier to qualify for the preferential treatment offered to capital gain income. This act further reduced the holding period to six months but attempted to balance the reduced holding period by increasing the maximum tax rate on long-term gain from 15% to 25%.[43] Congress justified these changes based on the decline in capital gain revenue.[44] It was predictable, however, that capital gains

38. *Id.* Assets held longer than eighteen months but fewer than twenty-four months were subject to taxation on 66.66 percent of the gain. When 30 percent is applied to the 66.66% of capital gains subject to tax, a maximum rate of 20% is the result. When the 30% is applied to assets held longer than twenty-four months, the maximum tax rate would be 15%. *Id.*

39. *Id.*

40. *Top Federal Income Tax Rates Since 1913*, CITIZENS FOR TAX JUSTICE (Nov. 2011), http://ctj.org/pdf/regcg.pdf [https://perma.cc/E5RA-637N].

41. *See* Lee, *supra* note 18, at 9.

42. HUNGERFORD, *supra* note 2, at 4 ("The capital gains tax discourages capital gains realizations because capital gains are only taxed when realized. Consequently, taxpayers tend to hold on to appreciated assets they would otherwise sell.").

43. ESENWEIN, *supra* note 15, at 6.

44. Lee, *supra* note 18, at 14–15 ("In developing the Revenue Act of 1942, the House and Senate tax-writing committees reconsidered the treatment of capital gains for the third time in a decade. Citing declining capital gains revenue, they strengthened the capital gains preference by shortening the holding period to six months, and provided a single 50 percent *deduction* for the small taxpayer while increasing the alternative 15 percent *flat rate*

revenue would decline when there was nothing in the tax policies to encourage or trigger a sale or any other realization event.

While it may seem that an increase in the long-term rate would be a step toward minimizing the preferential treatment, this adjustment was really a deceptive tactic because the holding period was significantly reduced, which made it cheaper to buy and sell stock in the short term. Without the reduced holding period, the short-term stock would have been subject to a tax of up to 88%, the top marginal rate on other unearned and earned income during that same time period.[45] With these provisions, the taxpayer owning capital property had the ability to either hold the property for a short period, or hold it for a long period and receive a tax benefit.

Over the course of years, through various other revenue acts, Congress has expanded capital gains treatment to other properties such as timber, land with unharvested crops, livestock, coal royalties, and iron ore, thereby expanding the concept of capital property.[46] By expanding the pool of property receiving preferential treatment, the government has chosen to subsidize certain taxpayers without a commensurate or measurable benefit to society at large.

Subsequent revenue acts continued to provide tax preferences to a larger pool of property. Yet, while Congress has continued to expand the accessibility of capital treatment, it has failed to adequately demonstrate whether these preferences work, why it was necessary to continue preferential rates indefinitely, and why it expanded the pool of property that qualified for capital treatment. Up to this point in history, it is difficult to ascertain whether these justifications aligned with the results.

For instance, Professor Lee describes the unsuccessful efforts by the Treasury's Special Tax Advisor, Randolph Paul, to challenge the tax policies that provided special tax preferences in the 1942 Act.[47] Professor Lee illustrates how Paul's efforts to challenge the proponents of the preferential treatment were exacerbated by other tax proposals, including a notable effort to institute a flat tax.[48]

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from the Revenue Act of 1938 to a single 25 percent maximum rate for the high income taxpayer." (citations omitted)).

45. JOINT COMM'N ON TAXATION, PRESENT LAW AND BACKGROUND INFORMATION RELATED TO THE TAXATION OF CAPITAL GAINS 24 (2012), https://www.jct.gov/publications.html?func=startdown&id=4485 [https://perma.cc/7JED-U3FC].

46. *See* ESENWEIN, *supra* note 15, at 6–7. In the Revenue Act of 1943, capital gains treatment was expanded to include timber. *Id.* at 6. The Revenue Act of 1951 further expanded preferential tax treatment to sales of unharvested crops, sales of livestock and coal royalties. *Id.* at 7. The Revenue Act of 1964 extended treatment to ire ore royalties. *Id.* at 7.

47. *See* Lee, *supra* note 18, at 17–18.

48. *Id.* at 17.

> In the 1942 Hearings, Randolph Paul provided the most thoughtful analysis of the capital gains policy to date backed by extensive historical data. He debunked a long-time favorite rationalization for the preference, that the treatment of capital gains and losses had a major impact on the stock market, and addressed the inflation rationale. He presented data, including charts, showing the historical fluctuations in revenues from capital transactions reflected market conditions rather than capital gains tax rates. Nevertheless, conservative Republican capital gains cuts proponents continued to assert that decreases in the capital gains rate were necessary to increase revenues by unblocking transactions.[49]

Paul provided analysis to the Ways and Means Committee contradicting the claim that preferential tax treatment for capital gains positively impacted the stock market and addressed erosions caused by inflation.[50] Instead, Paul's data supported the idea that fluctuations in capital revenue were more attributable to market conditions than the preferential capital gain rates.[51] Based on Paul's research, the primary purpose of the preferential rates was to provide a tax advantage that primarily benefitted the wealthier taxpayers.[52]

In spite of this evidence, the proponents of capital gains offered the same justification they used in the past—that lower rates discouraged taxpayers from holding on to capital assets.[53] Professor Lee also depicts Paul's efforts to demonstrate that the disproportionate benefits received by the wealthiest taxpayers came at the expense of the lower-income taxpayers.[54]

In the end, the preferential tax rates for capital gains prevailed and Congress sustained the reduced holding period. As this brief look into the

49. *Id.*

50. *Id*. at 17–18 ("In the 1942 Hearings, Randolph Paul provided the most thoughtful analysis of the capital gains policy to date backed by extensive historical data. He debunked a long-time favorite rationalization for the preference, that the treatment of capital gains and losses had a major impact on the stock market, and addressed the inflation rationale. He presented data, including charts, showing the historical fluctuations in revenues from capital transactions reflected market conditions rather than capital gains tax rates. Nevertheless, conservative Republican capital gains cuts proponents continued to assert that decreases in the capital gains rate were necessary to increase revenues by unblocking transactions." (citations omitted)).

51. *Id.*

52. *Id.* at 18. Paul's most noteworthy contribution at the 1942 Hearings may have been his "equity argument," in which he proffered distributional statistics showing that wealthy taxpayers were receiving disproportional benefits. *Id.*

53. *Id.* at 18.

54. *Id*. Paul claimed that "the Bland bill would reduce the taxes of not more than one-tenth of the taxpayers with the probable result that the other nine-tenths of taxpayers would be called upon to pay what the one-tenth saved. . . . From these facts, it is inescapable that the highest income individuals had effective rates far below the top ordinary income rates." *Id.*

early history of capital gains income demonstrates, the stage for income inequality was set. Proponents of preferential treatment for capital gain income continue to support these preferences despite evidence of rising income inequality.[55] As a result, these tax policies have contributed to income inequality as well and overall wealth inequality.

The record reflects that the wealthiest taxpayers have received the majority of the benefits from capital gains for over ninety years.[56] The wealthier taxpayers, those who received capital gains as their primary source of income, have experienced a "freeing of assets," but not in the way Congress originally imagined. These taxpayers had the opportunity to invest and save with the funds that would have otherwise been required as tax payments. Meanwhile, the burden of raising revenue remained with lower-income taxpayers who paid a greater percentage of tax on their earned income because tax rates on ordinary income did not decrease.[57]

First, this Article proposes to limit preferential rates on capital property to taxpayers earning $100,000 or less. Once a taxpayer's income surpasses $100,000, capital property would be taxed at ordinary rates. By limiting tax preferences for taxpayers who would not traditionally invest in the market, the preference would truly serve as an incentive to bring new investors to the market. Taxpayers who earn more than $100,000 probably do not need incentives to invest because this group has historically owned a high percentage of capital property.[58]

One of the reasons the capital gains tax has not generated more revenue is because Congress has created, and continues to create, policies that encourage holding capital property for long periods of time.[59] One of the

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55. LINDA LEVINE, CONG. RESEARCH SERV., R42400, THE U.S. INCOME DISTRIBUTION AND MOBILITY: TRENDS AND INTERNATIONAL COMPARISONS 4 (2012).

56. JOEL FRIEDMAN & KATHARINE RICHARDS, CTR. ON BUDGET & POL'Y PRIORITIES, CAPITAL GAINS AND DIVIDEND TAX CUTS: DATA MAKE CLEAR THAT HIGH-INCOME HOUSEHOLDS BENEFIT THE MOST 3 (Jan. 30, 2006), http://www.cbpp.org/files/1-30-06tax2.pdf [https://perma.cc/KZZ5-P7GE]. In 2005, more than seventy-eight percent of the capital gains and dividend income were attributed to households with incomes of more than $200,000 which represents the top three percent of all households. *Id.*

57. Lee, *supra* note 18, at 31.

58. CONG. BUDGET OFFICE, HOW CAPITAL GAINS TAX RATES AFFECT REVENUES: THE HISTORICAL EVIDENCE 21–22 (1988). ("Taxpayers with AGI of $100,000 or more (the top percentile of returns) accounted for 54 percent of gains and about 9 percent of other AGI."); *see also* HUNGERFORD, *supra* note 2, at 9. The data shows that when you isolate stock from other capital gains property, it becomes even more concentrated with the top income levels owning virtually all of this property. *Id.*

59. CONG. BUDGET OFFICE, *supra* note 58, at 49 ("It can be shown mathematically that even a substantial reduction in turnover (or a substantial increase in the average holding period) will have a relatively small negative impact on the long-run ratio of realizations to accruals, although it has a considerable first-year effect and also lowers the present value of realizations.").

most compelling reasons to hold capital property is codified in § 1014, commonly referred to as the "step-up provision."[60] Under this provision, the recipient of property passed from a decedent takes the property with a stepped-up basis equal to the "fair market value of the property at the date of the decedent's death."[61] As a result, taxpayers who might otherwise gift certain assets are instead incentivized to hold onto those assets and bequeath them. When taxpayers hold onto capital property, they delay or altogether prevent the federal government from receiving revenue.[62] History has demonstrated that taxpayers who own capital property tend to hold that property for longer periods of time, rather than disposing of it right away.[63] Therefore, it is counterproductive to provide preferential rates for capital property because the capital itself, and the income from it, remains out of the stream of commerce.

In a sense, the deferral treatment afforded to capital property discourages the disposition of property because a taxpayer owes nothing until a realization event occurs.[64] In most instances, taxpayers would prefer not to accelerate tax payments. Even when a realization event does eventually occur, the taxpayer will be taxed at a reduced rate if they hold the asset for longer than a year, so there is no disincentive to hold the property for extended periods.[65]

Congress can further limit preferential rates by implementing a maximum holding time for them. By doing so, Congress can encourage taxpayers to dispose of capital property sooner rather than later. At a time when the economy is still in recovery and the government needs additional revenue, capital gains preferences offer an area ripe for reform. The government should implement a sliding scale for reduced rates to encourage the disposition of capital property within five years.

Under this proposal, to receive long-term capital treatment, a taxpayer must hold property for at least one year. At the one-year mark, and up until

60. *Id.* at 49–50 ("A much larger permanent tax effect can be attributed to the step-up in basis at death. A high tax rate on gains realized during a taxpayer's lifetime provides a large incentive to avoid consumption out of assets with accumulated gains and to hold onto those assets to leave as bequests."). For a more detailed analysis of the step-up provision, see *infra* note 131 and accompanying text.

61. I.R.C. § 1014(a)(1) (2012).

62. CONG. BUDGET OFFICE, *supra* note 58, at 1.

63. *Id.* at 49.

64. *Id.* at 1.

65. I.R.C. § 1222(3) (2012) (defining long-term gain as that derived from sale or exchange of a capital asset held for more than one year); I.R.C. § 1(h) (2012) (outlining maximum tax on capital gains).

the end of year three, the capital property would enjoy a maximum tax rate of 20%. For the fourth and fifth year, the maximum tax rate would be 25%. Beyond the fifth year, the capital property would be taxed at the ordinary rate. This proposal would incentivize the disposition of capital property, thereby increasing the potential for government revenue.

B. Impact of Capital Gains Property on the Economy

As previously mentioned, there is conflicting research on whether capital gains rates have a positive effect on investment choices.[66] On the one hand, some research indicates that capital gains rates have no impact on the economy.[67] On the other hand, however, different research suggests that the increase in tax rates on capital gain income coincides with reductions in wealth gaps.[68] Either way, tax policies provide wealthier taxpayers the opportunity to increase wealth by reducing their effective tax rates and thereby reducing their tax liability.[69] Reduced rates on capital gains, coupled with the pattern of long-term holding periods, have the effect of reducing overall tax revenue.[70]

Because the IRS does not collect capital gains taxes until a realization event occurs, historical data should provide sufficient information to determine what impact, if any, the capital gains tax has on the economy. Research shows that the revenue from capital gains has been a steady 5.2% of the total income tax revenue.[71] Historical data also reveals that capital gains realizations and overall tax revenue have not been steady.[72] Between 1954 and 2010, the capital gains realizations have been as low as 2% of the gross domestic product (GDP) and peaked at over seven percent of the GDP.[73]

The major peaks in capital gains realizations occurred in 1986, 2000, and 2007.[74] If there is a common thread between those years, it might inform a decision for how to motivate taxpayers to dispose of capital property. Hungerford noted that the realization increases corresponded with actual

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66. Auten & Cordes, *supra* note 3, at 189–90.

67. Len Burman, *Capital Gains Tax Rates and Economic Growth (or not)*, FORBES (Mar. 15, 2012, 1:25 PM), www.forbes.com/sites/leonardburman/2012/03/15/capital-gains-tax- rates-and-economic-growth-or-not/ [https://perma.cc/BM7V-EHWK].

68. Jillian Berman, *Raising Taxes on the Rich Would Reduce Income Inequality: Larry Summers*, HUFFINGTON POST (Feb. 17, 2014, 3:07 PM), http://www.huffingtonpost.com/2014/02/17/taxes-rich-larry-summers_n_4804285.html [https://perma.cc/X9ZS-AHCC].

69. HUNGERFORD, *supra* note 2, at 7–8.

70. *Id.*

71. *Id.* at 3.

72. *Id.* at 4.

73. *Id*.

74. *Id.*

or anticipated changes in the tax rate.[75] His report also noted that realizations returned to normal levels after the transition periods.[76]

Because of the conflicting research on the effect of capital gains rates on the economy, it has been difficult to craft solutions for the economically unbalanced playing field set by Congress. The justification for tax preferences for capital gains property may be better applied to justify tax preferences for labor income over capital property. In other words, by extending preferential rates to labor income and ordinary rates to capital income, the majority of taxpayers would have more disposable income to spend or invest. Increased spending would stimulate the economy and contribute to the national economic recovery. However, Congress has not passed such a law, and it probably never will. Therefore, this Article will not focus on eliminating capital income preferences; rather, I make proposals that will justify why capital income preferential rates should be limited to a targeted group of taxpayers.

C. Who Benefits from Tax Preference Property?

Whereas the discussion has previously focused on the preferential treatment afforded to capital property, this Article shall shift its focus to determining the true beneficiaries of the capital gains tax. In 2003, data showed that capital gain and dividend income averaged 1.4% of income in households with less than $100,000.[77] In addition, the data also showed that capital gain and dividend income averaged 12.2% of the total income for households with those making over $100,000.[78] For households with incomes over $1 million, the average capital gains income was 31% of overall income.[79]

By 2011, the households in the highest income quintile were receiving 92% of all tax savings through capital gain and dividend income.[80] In 2011, the effective tax rate for the average taxpayer making over $1 million was approximately 19%.[81] The numbers are even more distorted for taxpayers in the highest income quintile who also received at least two-thirds of their

75. *Id.*
76. *Id.*
77. *See* FRIEDMAN & RICHARDS, *supra* note 56, at 3.
78. *Id.*
79. *Id.*
80. DANIEL BANEMAN ET AL., TAX POLICY CTR. URBAN INST. & BROOKINGS INST., CURBING TAX EXPENDITURES 10 (Jan. 2012).
81. *Id.*

income from capital gains; in that case, the effective tax rate was an astounding 11.9%.[82]

Congress applies the highest marginal tax rates to taxpayers in the highest income quintiles.[83] Capital gains and dividend income are taxed at substantially lower rates.[84] Ownership of capital property, therefore, reduces the effective rate of top income earners.[85] As a consequence, preferential tax treatment of capital gain and other property frustrates the progressive tax structure. The effective rates that the wealthiest taxpayers enjoy are approximately the same or less than the marginal rate imposed on the middle and lower quintile taxpayers.[86] Because of this distortion, the marginal rate schedule does not accurately reflect the actual tax responsibility for the wealthiest taxpayers.

These tax expenditures cost the government billions in revenue.[87] The figures become even more distorted when considering capital income as a whole.[88] Proponents of the favorable tax treatment argue that such treatment

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82. *Id.* at 10–11.

83. Internal Revenue Serv., Tax Guide 2013 263 (2013), http://www.irs.gov/pub/irs-pdf/p17.pdf [https://perma.cc/H68T-6XSW] ("The tax rate for a single person is 10 percent for taxable income between $0 and $8,925, 15 percent for taxable income between $8,925 and $36,250, 25 percent for taxable income between $36,250 and $87,850, 28 percent for taxable income between $87,850 and $183,250, 33 percent for taxable income between $183,250 and $398,350, 35 percent for taxable income between $398,350 and $400,000, and 39.6 for taxable income over $400,000. For a married couple filing jointly or a qualifying widow(er) the tax rate is 10 percent on taxable income between $0 and $17,850, 15 percent on taxable income between $17,850 and $72,500, 25 percent on taxable income between $72,500 and $146,400, 28 percent on taxable income between $146,400 and $223,050, 33 percent on taxable income between $223,050 and $398,350, 35 percent on taxable income between $398,350 and $450,000 and 39.6 percent on taxable income over $450,000").

84. *Id.* at 118 tbl.16-1.

85. Black's Law Dictionary (9th ed. 2009). A taxpayer's effective rate, also referred to as the average tax rate, is a taxpayer's tax liability divided by the amount of taxable income. *Id.*

86. *See* Christopher Ingraham, *As the Rich Become Super-Rich, They Pay Lower Taxes. For Real.*, WASH. POST (June 4, 2015), https://www.washingtonpost.com/news/wonk/wp/2015/06/04/as-the-rich-become-super-rich-they-pay-lower-taxes-for-real/?utm_term=.cd9c991746e2 [https://perma.cc/4ZQM-PA9U] ("[T]he progressivity of the federal income tax starts to fall apart at the upper reaches of the income distribution.").

87. JOINT COMM. ON TAXATION, NO. 78-317, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2012–2017 tbl. 1 (2013) Tax expenditures are defined as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of liability." *Id.* at 2 (citation omitted).

88. CONG. BUDGET OFFICE, Pub. No. 4130, TRENDS IN THE DISTRIBUTION OF HOUSEHOLD INCOME BETWEEN 1979 AND 2007, at ii (2011) ("Capital income (excluding capital gains) comprises taxable and tax-exempt interest, dividends paid by corporations (but not dividends from S corporations, which are considered part of business income), positive rental income, and corporate income taxes. Capital gains are considered separately and not included in this measure of capital income. The Congressional Budget Office assumes in this analysis that corporate income taxes are borne by owners of capital in proportion to their income from

contributes to economic growth because it encourages investment in capital assets and boosts the stock market.[89] However, research does not clearly demonstrate a correlation between favorable tax treatment of capital income and stock market values.[90] In addition, research does not support the assertion that favorable tax treatment encourages disposition of capital property. On the other hand, the following discussion will demonstrate a correlation between the preferential tax rates on capital income and income inequality.

In 1979, the top one percent benefitted from the greatest share of after-tax income, and their share has increased substantially over time.[91] The top one percent received approximately 38% of all capital income in 1979; by 2003, the top one percent received approximately 58% of all capital income.[92] During this time period, the bottom eighty percent's share of capital income decreased substantially.[93] In 1979, the bottom eighty percent received approximately 23% of all capital income, and by 2003 the same income demographic received approximately 12.6% of all capital income.[94]

The numbers are even more slanted when computed using the top ten percent of income earners. The top ten percent received approximately 67% of capital income in 1979 and 79% by 2003.[95] As the research shows, the top ten percent has consistently commanded the vast majority of the capital income. By 2007, the income disparity between top income earners compared to the lower income earners was substantially more unequal than it was in 1979.[96]

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capital; therefore, the amount of the corporate tax is included in household income measured before taxes.").

89. FRIEDMAN & RICHARDS, *supra* note 56, at 2.

90. *Id.*

91. CONG. BUDGET OFF., *supra* note 88, at ix. The report indicates that "[f]rom 1979 to 2007, real (inflation-adjusted) average household income, measured after government transfers and federal taxes, grew by 62 percent." *Id.*

92. *Id.* at 4. This percentage held by the top one percent was the largest since 1979 in the years examined by the CBO. The top one percent consisted of households with after tax incomes averaging $700,000.

93. *Id.*

94. *Id.*

95. *Id.* at 3.

96. *Id.* at ix. The CBO examined the years 1979–2007 because the endpoints in those years had a similar overall economic activity because both 1979 and 2007 were years preceding a recession.

Although the United States' taxing structure purports to be progressive, as applied the system is regressive.[97] In fact, over a forty-year span the tax rates for the wealthiest have decreased by forty percent while the average taxpayer's rates have remained approximately the same or have increased slightly.[98] This is important because earned income became more concentrated during this time.[99] Therefore, the taxpayers who recieved the largest wage income growth also received the greatest tax reductions, while Congress shifted the tax burden to lower income taxpayers either through tax increases or by no corresponding tax reduction.[100]

The data from Congressional Budget Office reports between 1979 and 2007 shows that the average after-tax income, adjusted for inflation, of the top one percent rose 275%.[101] During the same period, the sixty percent of earners

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97. Beverly Moran, *Wealth Redistribution and the Income Tax*, 53 HOW. L.J. 319, 324 (2010) ("On paper, progressive rates can appear dramatic. At times, the highest marginal rate has risen to 90% of taxable income. Working solely from the statute as written, progressive rates seem ideal for downward wealth redistribution; but the dramatic appearance of rates on paper are just part of the story. Progressive rates are applied to ordinary income, including income from wages, but a lower rate applies to income from the sale of capital assets, such as stocks, bonds, and real estate. Progressive rates are more public than real because as income and wealth rises, sources of taxable income shift from wages to capital gains. This shift in the source of income moves most wealthy people out of the high progressive rates on ordinary income and into the lower tax rates on capital gains. The result is that, as income rises, tax rates actually fall." (citations omitted)).

98. Michael Greenstone & Adam Looney, *Just How Progressive is the U.S. Tax Code*, BROOKINGS (Apr. 13, 2012), http://www.hamiltonproject.org/assets/legacy/files/downloads_and_links/0413_tax.pdf [https://perma.cc/Z43X-VPQF]. The chart provided demonstrates that for the wealthiest one percent, their rates peaked at around seventy percent in the early 1970s and after 2000 and dropped below forty percent. *Id.* On the other hand, the taxpayers in the 80–99 percentile range saw their taxes increase from just under twenty percent to twenty-five percent during the same timeframe, while the lowest percentile, the 0–80 percentile range, stayed approximately the same. *Id.*

99. *Id.*

100. *See id.* ("In 1979, the top 1 percent of Americans earned 9.3 percent of all income in the United States and paid 15.4 percent of all federal taxes. While the share of income earned by the top 1 percent had more than doubled by 2007—to 19.4 percent—the share of federal tax liability paid by that group only increased by about 80 percent, to 28.1 percent. The share of taxes increased less for this group because high-income tax rates fell by more than the tax rates for everyone else—reductions that made the system less progressive.").

101. *See* CONG. BUDGET OFFICE, *supra* note 88, at 3 ("Average real after-tax household income for the one percent of the population with the highest income grew by 275 percent between 1979 and 2007. Average real after-tax income for that group has been quite volatile: It spiked in 1986 and fell in 1987, reflecting an acceleration of capital gains realizations into 1986 in anticipation of the scheduled increase in tax rates the following year."). Moreover, "[a]fter-tax income is equal to market income plus transfer income minus federal taxes paid. In assessing the impact of various taxes, individual income taxes are allocated directly to households paying those taxes. Social insurance, or payroll, taxes are allocated to households paying those taxes directly or paying them indirectly through their employers. Corporate income taxes are allocated to households according to their share of capital income. Federal excise

in the middle saw only a 37% increase, and income for those in the bottom twenty percent grew by a mere 19%.[102] It is difficult to pinpoint the exact cause or causes of the significant wealth disparity that exists in the United States; however, this Article argues that data supports the idea that favorable tax treatment afforded to capital income exacerbates income disparity. Tax policy affects wealth disparity in the United States in a number of ways. As the wealth gap between the upper income and the lowest income taxpayers continues to widen, the impact of this phenomenon concerns society as a whole.[103]

I have previously stated that taxing wealth at death can combat wealth concentration.[104] However, because of the significant disparity in wealth that currently exists, there is no magic bullet that will diminish its effect. In order to effectively challenge the concentrated masses of wealth, a multi-level attack is necessary. In addition to lowering the exemption levels and raising rates on life and death time transfers, Congress must also implement changes with respect to other tax policies that shift wealth to the wealthier taxpayers.

There are numerous factors that contribute to increasing income inequality, so it is difficult to pinpoint specific changes to reverse the phenomenon. Scholars and economists do agree, however, that two factors in particular contribute to income inequality: concentration of market income and tax policy.[105]

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taxes are allocated to households according to their consumption of the taxed good or service." *Id.* at iii.

102. *Id.* at 3 ("For the sixty percent of the population in the middle of the income scale (the 21st through 80th percentiles), average after-tax household income grew thirty seven percent between 1979 and 2007[.] Average after-tax household income in the lowest income quintile (the 1st through 20th percentiles) was eighteen percent higher in 2007 than in 1979.").

103. ISAAC SHAPIRO & JOEL FRIEDMAN, CTR. ON BUDGET & POLICY PRIORITIES, NEW, UNNOTICED CBO DATA SHOW CAPITAL INCOME HAS BECOME MUCH MORE CONCENTRATED AT THE TOP (Jan. 26, 2006), http://www.cbpp.org/research/new-unnoticed-cbo-data-show-capital-income-has-become-much-more-concentrated-at-the-top [https://perma.cc/JTM3-WPU7] ("Adding to concerns over the increasingly regressive effects of extending lower taxes on capital gains and dividend income, the CBO data also show a dramatic widening in overall income disparities during the past two and one half decades.").

104. Phyllis C. Smith, *Change We Can't Believe In . . . Or Afford: Why the Timing Is Wrong To Reduce the Estate Tax for the Wealthiest Americans*, 42 U. MEM. L. REV. 493, 547 (2012).

105. *See* CONG. BUDGET OFFICE, *supra* note 88, at ix–xiii. Market income is income measured before government transfers and taxes and includes labor, business, capital gains, capital income and other income such as retirement income for past services and any other sources of income. *Id.* Even though an increasing concentration of market income was

Various income sources affect market income, but labor income accounted for more than seventy percent of market income between 1979 and 2007.[106] For the bottom eighty percent of income earners, their share of labor income dropped significantly between 1979 and 2007.[107] Furthermore, the bottom eighty percent also experienced a decrease in their income share of capital gains, as well as income from other capital property.[108] Between 1979 and 2007, the share of after-tax household average income received by the top one percent increased by nine percentage points, while the household income from the three middle income quintiles decreased by seven percentage points and the lowest income households decreased by two percentage points.[109]

Because the wealthiest derive income from the stock market, there are periods of volatility, but overall there has been a substantial increase in after-tax income.[110] The volatility may also be linked to tax policy; as this Article suggests, it is no coincidence that major swings in income occurred directly after major tax policy changes. For instance, income of the wealthiest one percent peaked in 1986 and dropped dramatically in the following

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the primary force behind the growing dispersion in after-tax household income between 1979 and 2007, shifts in the distribution of government transfer payments and federal taxes also contributed to the increase in after-tax income inequality. *Id.* at ii.

106. *Id.* at 10.

107. *Id.*

> In 1979, the bottom 80 percent of the population in the income spectrum received nearly 60 percent of total labor income, about 33 percent of income from capital and business, and about 8 percent from capital gains[.] By 2007, the share of labor income going to the bottom 80 percent had dropped to less than 50 percent, their percentage of business income and income from capital had decreased to 20 percent, and their share of capital gains was about 5 percent.

Id.

108. *Id.*

109. *See* CONG. BUDGET OFFICE, *supra* note 88, at 3. Furthermore,

> the share of total after-tax income received by the 1 percent of the population in households with the highest income more than doubled between 1979 and 2007, whereas the share received by low-and middle-income households declined. The share of income received by the top 1 percent grew from about 8 percent in 1979 to over 17 percent in 2007. The share received by other households in the highest income quintile was fairly flat over the same period, edging up from 35 percent to 36 percent. In contrast, the share of after-tax income received by the 60 percent of the population in the three middle-income quintiles fell by 7 percentage points between 1979 and 2007, from 50 percent to 43 percent of total after-tax household income, and the share of after-tax income accruing to the lowest-income quintile decreased from 7 percent to 5 percent.

Id. at 3.

110. *See id*. The average real income, adjusted for inflation, peaked in 1986 for the 1 percent of the population with the highest income, and dropped the following year. *Id.* By 1988, the income began to rise again but decreased again between 1990 and 1991 due to the recession. *Id.* By 1994, the income was on the rise again and in 1995 there was a spike and increases in income until 2000. *Id.* In 2001, there was a sharp decline in income growth due to the recession; however, incomes. *Id.*

year.[111] The Tax Reform Act of 1986 (TRA 1986) may have contributed to the dramatic decrease because it repealed the net capital gains deductions for individuals and repealed the favorable tax rates for capital gains, thereby taxing capital gains at the ordinary rate.[112]

Proponents of preferential treatment for capital gains and dividends may continue to argue that society benefits because it encourages investments and economic growth. These proponents have made this assertion for years with little to no evidence supporting it.[113] Because there is no dispositive factor that causes economic growth or decline, it is difficult to pinpoint the impact preferential tax treatment has on investments and economic growth.[114] On the other hand, there is evidence of income inequality that has adversely impacted middle-to low-wealth earners, and the evidence reveals that these income demographics have not seen a positive income boost from such capital gains property.[115]

The primary purpose of taxation is to raise revenue; yet, tax preferences reduce revenue.[116] For that reason, policymakers should base any justification for maintaining a tax preference on the benefit to the majority, not a select few. Moreover, if tax preferences are meant to incentivize behavior, then preferences should be extended only as necessary to influence the desired behavior. Finally, tax incentives based on public policy should balance the benefits of policy with the burden of the expense. In the case of capital

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111. *Id.* at 3.

112. ESENWEIN, *supra* note 15, at 10 ("The Tax Reform Act of 1986 repealed the net capital gain deduction for individuals. Both short-term and long-term capital gains income were included in taxable income and taxed in full at regular income tax rates. Statutory rates under the act were reduced from a maximum of 50% to 33% (28% statutory rate plus 5% surcharge).").

113. *See* HUNGERFORD, *supra* note 2, at 6 ("While the effect of changes in the capital gains tax rate continue to be debated and researched, the bulk of the evidence suggests that reducing the capital gains tax rate reduces tax revenues.").

114. *Id.*

115. SHAPIRO & FRIEDMAN, *supra* note 103 ("In 2003, the bottom 80 percent of the population received only 12.6 percent of such capital income, the lowest share on record (with data back to 1979). As recently as 1989, for instance, the bottom 80 percent of the population received 23.5 percent of capital income subject to taxation, a share nearly twice as high.").

116. *See* CONG. BUDGET OFFICE, *supra* note 58, at 5 ("This behavioral response is considered the key to the revenue effect. If taxpayers change their realizations little in response to a tax rate change, then an increase in tax rates will raise revenue and a decrease will lose revenue.").

gains income, the benefit to society at large does not equal or outweigh the burden of the foregone revenue.[117]

The current tax treatment of capital property fails at both raising revenue and incentivizing new investors.[118] One potential solution is to reassign the burden of generating revenue to the wealthiest taxpayers, because this income demographic has benefitted the most from tax policies for over ninety years.[119] In order to reallocate the burden of raising revenue, Congress should tax certain capital assets of taxpayers earning $100,000 or more at the same marginal rate as the taxpayer's ordinary income.

The second proposal is to set maximum holding periods for capital gain rates for taxpayers who own certain capital property for at least twelve months but not longer than sixty months. After sixty months, capital income from stock should be taxed and treated as ordinary income for any taxpayer. This approach balances the need for revenue with the need for stability in the market.

While eliminating all capital gains preferences could potentially raise more revenue, a policy such as this would not suffice to discourage the lock-in effect.[120] In order for the tax incentive to have its desired effect, there must be a specific deterrent to holding the property in perpetuity because only a realization event can trigger the tax on inherent gain.[121] By providing a window for preferential tax treatment, Congress could incentivize taxpayers to dispose

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117. HUNGERFORD, *supra* note 2, at 3 ("Overall, capital gains tax revenues have been a fairly small, but not trivial, source of government revenue. Since 1954, revenue from the capital gains tax as a share of total income tax revenue has averaged 5.2%. It reached a peak of 12.8% in 1986 and a low of 2.0% in 1957. Nonetheless, the 2007 capital gains tax revenue of $123 billion was equal to 75% of the FY2007 budget deficit.").

118. THOMAS L. HUNGERFORD, CONG. RESEARCH SERV., 7-5700, TAXES AND THE ECONOMY: AN ECONOMIC ANALYSIS OF THE TOP RATES SINCE 1945 (2012) (first citing Eric Engen & Jonathan Skinner, *Taxation and Economic Growth*, 49 NAT'L TAX J. 617–42 (1996); then citing Charles W. Calomiris & Kevin A. Hassett, *Marginal Tax Rate Cuts and the Public Tax Debate*, 55 NAT'L TAX J. 119–31 (2002); and then citing Martin Feldstein & Douglas W. Elmendorf, *Budget Deficits, Tax Incentives, and Inflation: A Surprising Lesson from the 1983-1984 Recovery*, *in* TAX POLICY AND THE ECONOMY 1–23 (Lawrence H. Summers ed., 1989)); William G. Gale & Samara R. Potter, *An Economic Evaluation of the Economic Growth and Tax Relief Reconciliation Act of 2001*, 55 NAT'L TAX J. 133–86 (2002); William G. Gale & Peter R. Orszag, *Economic Effects of Making the 2001 and 2003 Tax Cuts Permanent*, 12 INT'L TAX & PUB. FIN. 193–232 (2005) ("Some studies find that a broad based tax rate reduction has a small to modest, positive effect on economic growth. Other studies have found that a broad based tax reduction, such as the Bush tax cuts, has no effect on economic growth. It would be reasonable to assume that a tax rate change limited to a small group of taxpayers at the top of the income distribution would have a negligible effect on economic growth.").

119. *See supra* notes 45–56 and accompanying text.

120. *See* Schmalbeck, *supra* note 24, at 200.

121. *See* discussion *infra* Part II.B.

of property within a reasonable time, as opposed to holding the property indefinitely.

Also, the government could benefit from the additional revenue it would raise by increasing rates on the sale of capital property. In order to receive the added benefit of the increased rates, however, there must be an incentive to sell the property and a disincentive to holding the property until a death-time transfer. This leads to the following discussion of the capital gains tax and estates.

III. THE ESTATE TAX AND THE CAPITAL GAINS TAX

A. Introduction

In addition to the income tax preferences for lifetime transactions, there are a number of estate tax policies that impact wealth and income inequality.[122] This section of the Article will focus on the intersection between the capital gains tax and estate property. Specifically, transfer taxes affect wealth and income inequality through § 1014 of the Internal Revenue Code (IRC), which permits any pre-death appreciation on property to go untaxed.[123]

This windfall to certain taxpayers lacks horizontal equity because a taxpayer receiving the same type of gift in an inter vivos transfer would receive carryover basis through IRC § 1015, deferring the tax.[124] The appropriate

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122. Chuck Collins, *Fixing and Expanding the Estate Tax: Intervening to Reduce Wealth Inequality*, INST. FOR POLICY STUD. (Apr. 15, 2014), http://www.ips-dc.org/fixing_expanding_the_estate_tax/ [https://perma.cc/Q7MM-P8FQ].

123. I.R.C. § 1014(a)(1) (2012). This section provides, in pertinent part,

> Except as otherwise provided in this section, 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 shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be—(1) the fair market value of the property at the date of the decedent's death . . . .

Id. While this section is widely known as the step-up basis provision, it is possible for property to suffer a loss, or a "step down." For ease of illustration and providing examples, the term "step-up" provision will be used to reference this section.

124. I.R.C. § 1015(a) (2012). This section provides, in pertinent part,

> [i]f the property was acquired by gift after December 31, 1920, the basis shall be the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift, except that if such basis (adjusted for the period before the date of the gift as provided in section 1016) is greater than the fair market value of the property at the time of the gift, then for the purpose of determining loss the basis shall be such fair market value[.]

Id.

way to achieve horizontal equity is by providing similar tax treatment for inherent gains on death-time transfers.

The final proposal for this paper addresses the tax treatment of capital property transferred through an estate. For the previous reform proposals to be effective, it is necessary to remove the final incentive for those who hold capital property as a means of reaping the benefits of a death-time transfer under § 1014.[125] Unless there are tax reforms to § 1014, then all other reforms previously discussed would be neutralized because the taxpayer would simply hold the property to make a death-time transfer and eliminate the inherent gain associated with the property. The first option is to eliminate the § 1014 step-up provision for estates with less than $5.5 million because this would eliminate the concern for double taxation.[126] The second option is to convert the current step-up basis to a carryover basis. This Article discusses both of these options in greater detail later in this section.[127]

B. Estate Tax

When a decedent passes away and leaves property, they have the ability to transfer that property to whomever they choose. For the sake of simplicity, this Article will refer to descendants as recipients because they are the most common recipients. There is nothing inherently wrong with the notion of providing for one's children or setting up the next generation. All the same, transferring property—whether through an estate or lifetime transfer—is a property interest the government has chosen to tax in certain instances.[128]

Congress originally implemented the estate tax as a temporary measure to raise revenue to finance the nation's military conflict against France in the late eighteenth century.[129] In 1916, however, the estate tax became a permanent part of the revenue-generating measures, in large part due to World War I.[130] Other scholars have attributed the permanent nature of the estate tax to the progressive movement and its desire to combat wealth concentration.[131]

125. I.R.C. § 1014 (2012).

126. For a detailed discussion about the step-up provisions, see *infra* note 159 and accompanying text.

127. *See infra* notes 159, 183 and accompanying text.

128. *See* I.R.C. §§ 2001(a), 2501(a) (2012).

129. *See* Smith, *supra* note 104, at 498.

130. *Id.* at 499–500.

131. *Id.* at 501; *see also* Nancy M. Annick, *The Gaping Loophole of the Step-Up Basis at Death: A Proposal to Apply Carryover Basis to Excess Property*, 8 PITT. TAX REV. 75, 81 (2011) ("The justification for the estate tax as a tool of social policy was first employed in the White House in the early 1900s, when President Theodore Roosevelt called for a tax on the transfer of wealth in order to break up large fortunes. The torch was taken up by President Franklin D. Roosevelt during the Great Depression, who stated in 1935 that '[t]he transmission

Since 1921, the estate tax exemption levels have consistently risen to include fewer estates while the corresponding tax rates have consistently dropped.[132] In the last decade, the estate tax exemption has increased from \$1.5 million to over \$5 million.[133] By increasing the exemption levels and reducing rates, the government has permitted more wealth concentration for families in the highest wealth echelon. The United States must generate the revenue lost as a result of these policies through other methods.

To make up for these shortfalls, Congress will look to middle- and low- income taxpayers. Congress will either raise income tax rates or will choose not to reduce tax rates for these taxpayers, even though higher income taxpayers may use various tax reductions via preferences. The revenue shortfall may also lead the government to reduce funding for programs that primarily benefit middle- to lower- income classes.[134] In order to maintain a semblance of equity, Congress should put measures in place to counterbalance the benefits received by the wealthy.[135]

While the data is unclear as to whether there is any particular remedy to effectively curtail wealth concentration, one can look to certain tax policies to determine whether those policies have contributed to wealth concentration and inequality. For instance, the estate tax was designed to raise revenue and subsequently mitigate wealth concentration.[136] In more recent years, however, the estate tax has become less effective on both accounts because of the increasing exemption levels and reduced rates.[137]

For example, David Joulfaian's research shows that the permanent estate tax began with a maximum tax rate of 10% and an applicable exclusion

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from generation to generation of vast fortunes by will, inheritance, or gift is not consistent with the ideals and sentiments of the American people.'" (citations omitted)).

132. Darien B. Jacobson, Brian G. Raub & Barry W. Johnson, IRS, *The Estate Tax: Ninety Years and Counting* 122, www.irs.gov/pub/irs-soi/ninetyestate.pdf [https://perma.cc/6P2F-JDN8] (last visited Oct. 15, 2016).

133. *Id.*; *see also* I.R.C. § 2010(c)(3)(A) (2012).

134. Rebecca Safford, *Information Asymmetry, Race, and the "Death Tax,"* 13 WASH. & LEE J. C.R. & SOC. JUST. 117, 131 (2006) (discussing why and how wealth inequalities would be exaggerated by the repeal of estate tax and the effect such a repeal would have on minorities).

135. See discussion *infra* Part III for specific proposals to make tax burdens more equitable.

136. *See generally* James R. Repetti & Paul L. Caron, *Occupy the Tax Code: Using the Estate Tax to Reduce Inequality and Spur Economic Growth*, 40 PEPP. L. REV. 1255 (2013) (arguing that the estate tax is a powerful reform mechanism because inherited assets are a significant source of income for the wealthy).

137. *See* Jacobson et al., *supra* note 132; *see also* I.R.C. § 2010(c)(3)(A) (2012).

amount of $50,000 in 1916.[138] By 1926, the estate tax exclusion amount had doubled and the maximum tax rate was 20%.[139] Between 1935 and 1941, the maximum tax rate was as high as 77%.[140] The Joulfaian report further reveals that between 1932 and 1940 the exclusion amount was reduced to $40,000, which allowed the government to collect revenue from a greater number of estates.[141]

The tide shifted dramatically with the implementation of the Tax Reform Act of 1976 (TRA 1976) and other similar tax acts.[142] Beginning in 1977, the maximum marginal tax rate declined and continued to decline for many years to come.[143] Between 1977 and 2001, the exclusion amount continued to rise from $120,667 to as high as $1,000,000; as a result, fewer estates paid taxes.[144] Over time, while the tax liability on the wealthiest has decreased, the tax liability for lower wealth classes has not decreased at the same rate.

Understandably, there appears to be a correlation between the exclusion amounts and the number of estate tax returns filed. As the exclusion amounts increased, the number of tax returns filed decreased significantly.[145] Furthermore, in the years following TRA 1976, the number of transfer tax returns filed decreased by 45%.[146] In the years following the implementation

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138. David Joulfaian, The Federal Estate Tax: History, Law, and Economics 2-6 (June 2013) (unpublished manuscript), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1579829 [https://perma.cc/X5SQ-G5GG] [hereinafter Joulfaian Report].

139. *Id.* Between 1916 and 1926 the tax rate increased in increments with a maximum tax rate as high as 40% before the big reduction in 1926. *Id.* At first glance it would appear the rate had increased, but the actual data demonstrates there was a significant reduction in rates and exclusion amount. *Id.*

140. *Id*.

141. *Id*.

142. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2005, 90 Stat. 1520, 1872, repealed by Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-223, § 401(a), 94 Stat. 229. In relevant part, the Tax Reform Act of 1976 increased the holding period from nine months to one year for tax years beginning after 1977, increased the capital gains rate from ten to fifteen percent, and eliminated the step-up basis in favor of carryover basis.

143. Joulfaian Report, *supra* note 138, at 2-6. The maximum rate in 1977 was reduced to 70%, and by 1982 was further reduced to 65%. *Id.* By 1984, the maximum rate was reduced to 55%. *Id.*; *see also* Economic Growth and Tax Reconciliation Relief Act of 2001 (EGTRRA), Pub. L. No. 107-16, 115 Stat. 38 (codified as amended in scattered sections of 26 U.S.C.). EGTRRA phased out the estate tax and ultimately eliminated it in 2010 through annual reductions, but the tax was automatically reinstated in 2011. *See id.* § 901(a)(2), 115 Stat. 38, 150 ("[T]his Act shall not apply . . . to estates of decedents dying, gifts made, or generation skipping transfers, after December 31, 2010."); *see also* Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 Pub. L. No. 111-312, § 302, 124 Stat. 3296 (further reduced the maximum rate to thirty-five percent).

144. Joulfaian Report, *supra* note 138, at 2-6.

145. *See id.* at 2-6, 4-4.

146. PATRICK FLEENOR, TAX FOUND., A HISTORY AND OVERVIEW OF ESTATE TAXES IN THE UNITED STATES 9 (1994), http://taxfoundation.org/sites/taxfoundation.org/files/docs/f7c34848582a114133f90711b50b9a3a.pdf [https://perma.cc/37PA-94SY].

of the Economic Recovery Tax Act of 1981 (ERTA), the number of estate tax returns decreased by more than 50%.[147] These reductions in filings shrunk the government's revenue stream.[148]

The reduction in tax rates has had a similar effect on the number of returns filed. Between 2002 and 2010, the maximum annual tax rates decreased from 50% to 45%, and remained at 45% until 2009.[149] The increased exclusion amount and decreased tax rates resulted in a dramatic decrease in estate tax filings. For instance, in 2002, there were approximately 121,000 estate tax filings.[150] By 2008, the number of estate tax filings had decreased to an estimated 46,000; as a result, the estate tax exemption produced its lowest number of filings since 1956.[151]

Finally, Congress passed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, which provided a five million dollar exclusion for estates and established a 35% flat rate for the gift tax.[152] This Act represented the largest tax breaks yet, with the exception of the temporary repeal in 2010, in the history of the transfer tax.[153] These huge tax breaks came at a time when the nation was operating under a deficit.[154] The reduction in rates, the increase in the exemption amount, and the temporary repeal all contradicted the original intent of the estate tax—raising revenue. These tax breaks also shifted significant amounts of wealth to the wealthiest

147. *See* Joulfaian Report, *supra* note 138, at 2-6. The chart reveals that between 1981 and 1986, the number of estate tax returns filed were reduced from approximately 145,600 to approximately 71,500. *Id.*

148. *Id.* at 6-2.

149. *See id.* In 2002, the maximum rate was set at fifty percent, down from fifty-five percent in previous years. *Federal Estate and Gift Tax Rates, Exemptions, and Exclusions, 1916–2014*, TAX. FOUND. (Feb. 4, 2014), http://taxfoundation.org/article/federal-estate-and-gift-tax-rates-exemptions-and-exclusions-1916-2014 [https://perma.cc/8CFL-5PQP]. By 2003 the maximum rate was 49%, there was an annual 1% decrease every until 2007 when the maximum rate was reduced to 45%. *Id.* The maximum rate remained at 45% until sunset in December of 2009. Economic Growth and Tax Reconciliation Relief Act of 2001 (EGTRRA), Pub. L. No. 107-16, 115 Stat. 38 (codified as amended in scattered sections of 26 U.S.C.).

150. Joulfaian Report, *supra* note 138, at 4-4.

151. *Id.*

152. Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 Pub. L. No. 111-312, § 302, 124 Stat. 3296.

153. Joulfaian Report, *supra* note 138, at 2-9. The lowest gift tax rate prior to the Job Creation Act was 33.5 percent in 1932. *Id.* at 2-7.

154. CONG. BUDGET OFFICE, THE FEDERAL BUDGET DEFICIT FOR 2010 (2010), http://www.cbo.gov/publication/25107 [https://perma.cc/C4ZC-CWZE]. The 2010 federal budget deficiency was a little less than $1.3 trillion dollars. *Id.*

taxpayers, at the expense of government revenue, thereby further contributing to wealth inequality.[155]

When Congress initially increased the exclusion amount to $1 million in 2002, it marked the highest exclusion amount in history.[156] The primary difference between the 2001 and 2010 tax acts is that in 2001 the national debt was not so substantial.[157] Even in 2001, the vast majority of estates did not owe an estate tax, so there would seem to be little justification for extending the exemption and providing further tax breaks for estates.[158]

C. Step-Up Basis

Section 1014(a)(1) of the Internal Revenue Code provides that property passing through a decedent's estate shall receive a step-up basis equal to the fair market value of the property at the time of the decedent's death.[159] As a result, property that passes through an estate may escape income taxation—to the extent of the property's appreciation—when the recipient later disposes of that property. For example, if property purchased in 2000 for $100,000 was later transferred to a beneficiary through the decedent's estate, the basis would adjust to the fair market value of the property at the death of the decedent.[160] If the transfer occurred in 2013 and the property value had increased to $500,000, the $400,000 appreciation would never be subject to income tax.

The purpose of establishing a taxpayer's basis in property is not to permit permanent tax relief. Rather, the purpose is to recover the capital invested in property before taxing any gain.[161] The step-up in basis allowed under

155. *Id.*

156. *Id.* at 2-9.

157. Office of Mgmt. & Budget, Exec. Office of the President, FEDERAL DEBT AT THE END OF YEAR: 1940–2019, http://www.whitehouse.gov/omb/budget/Historicals [https://perma.cc/H2CA-L9ZB].

158. Joulfaian Report, *supra* note 138, at 4-4. In 2001, a total of 121,715 estate tax returns were filed. *Id.*

159. I.R.C. § 1014(a)(1) (2013). While this tax provision is commonly known as the step-up provision, § 1014 requires the basis of the property to adjust to the fair market value, which could step up or step down. Because of the tax advantage associated with this provision, most scholars simply refer to this provision as the step-up provision and for the purpose of this paper, this author will similarly refer to § 1014(a)(1) as the step-up provision.

160. I.R.C. § 1014(a) (2013).

161. Treas. Reg. § 1.1001-1 (as amended in 2015) states, in relevant part,

> [t]he general method of computing such gain or loss is prescribed by section 1001 (a) through (d) which contemplates that from the amount realized upon the sale or exchange there shall be withdrawn a sum sufficient to restore the adjusted basis prescribed by section 1011 and the regulations thereunder (i.e., the cost or other basis adjusted for receipts, expenditures, losses, allowances, and other items chargeable against and applicable to such cost or other basis). The amount which remains after the adjusted basis has been restored to the taxpayer constitutes the realized

§ 1014 conflicts with this purpose. Moreover, the primary purpose of both the estate tax and income tax is to raise revenue.[162] The step-up basis provision is also inconsistent with this purpose.[163]

One justification used to support the step-up provisions is the difficulty associated with recordkeeping.[164] Advocates for the step-up provisions claim that taxpayers do not keep good records and point out that the decedent would not be available to assist with determining the basis of property at the time of transfer. If there were no records or inadequate records it would be difficult—if not impossible—to determine the basis of property. Therefore, these provisions make it easier to establish basis when the property is later disposed.[165]

The problem with that argument, however, is that the same may be said even if the transferor were alive and had transferred the same property by gift. Although the option to ask the transferor to provide information remains, there is simply no guarantee he or she would be able to do so. Even if the problem were limited to the case of bequests, the Internal Revenue Code already has a remedy for such a situation. If there is insufficient evidence to determine the basis of property, the secretary substitutes the fair market value of the property at the time of the original purchase as the basis for the property.[166] In addition, technological advances that track property values and transfers make these rationales less plausible over time.

Proponents of the step-up basis provisions also suggest that § 1014(a)(1) is necessary because the government would tax the property twice, income

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> gain. If the amount realized upon the sale or exchange is insufficient to restore to the taxpayer the adjusted basis of the property, a loss is sustained to the extent of the difference between such adjusted basis and the amount realized.

162. *See generally* Smith, *supra* note 104, at 512–13 (explaining how the government could potentially generate trillions of dollars in revenue through more efficient taxation processes).

163. The unlimited step-up in basis at death has been a *cause celebre* for tax reformers for decades. Referring to it as a "gaping loophole," they highlight several negative consequences of this treatment. *See* Annick, *supra* note 131.

164. *Id.* at 96–97.

165. *Id.*

166. I.R.C. § 1015(a) (2012) ("If the facts necessary to determine the basis in the hands of the donor or the last preceding owner are unknown to the donee, the Secretary shall, if possible, obtain such facts from such donor or last preceding owner, or any other person cognizant thereof. If the Secretary finds it impossible to obtain such facts, the basis in the hands of such donor or last preceding owner shall be the fair market value of such property as found by the Secretary as of the date or approximate date at which, according to the best information that the Secretary is able to obtain, such property was acquired by such donor or last preceding owner.").

and estate, if the provisions of § 1014 were not in place.[167] In his Note, Marvin Blum encapsulates this argument and some of the popular justifications for maintaining the step-up provisions.[168] Blum's arguments were timely because Congress had recently enacted TRA 1976, which eliminated the step-up provisions in favor of carryover basis provisions.[169] With modified carryover provision election, enacted pursuant to EGTRRA, to address the temporary estate tax repeal, there is room for a healthy debate as to the feasibility of carryover basis.[170]

First, Blum argues that step-up provisions are necessary because death is involuntary—it is not subject to abuse, it occurs only once, and it is available to everyone.[171] While death is, in most cases, involuntary, that does not justify a total tax exclusion attributed to capital property. Just because a taxpayer receives property in a death-time transfer instead of a lifetime transfer does not make it more or less subject to abuse. It is true that death happens once and the transfer itself may be free of fraud, but there are other ways for the decedent to manipulate this tax provision for the sake of their beneficiaries.

For instance, the decedent could receive gifts of various low-basis properties from family members, hold the properties until death, and then devise the properties back to those original family members. The only restriction on the transfer back to the original owner is that the decedent must live longer than one year after the initial transfer.[172]

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167. These proponents suggest that if the decedent paid estate taxes on such property and the beneficiary subsequently sold that property with carryover basis, and the beneficiary sold the property for a gain, then the inherent gain on the property would be twice subjected to taxation.

168. Marvin E. Blum, Note, *Carryover Basis: The Case for Repeal*, 57 TEX. L. REV. 204, 205 (1979).

169. *See* ESENWEIN, *supra* note 15. The Tax Reform Act of 1976 repealed the step-up provisions. Until that point, the property passing through the estate of a decedent received a basis of the fair market value at the time of the decedent's death. The 1976 act required the basis of property passed through the estate to carry the basis the property had in the hands of the decedent. Ultimately, the 1978 act postponed the implementation to apply property transferred after December 31, 1979. In 1980 the carryover provisions were repealed. *Id.*

170. *See* Blum, *supra* note 168, at 205.

171. *Id.* "First, death is normally an involuntary occurrence and, unlike lifetime gifts, is not as susceptible to abuse for the purpose of saving taxes. Moreover, the step-up device is available to all persons and each taxpayer may use it only once. Congress would therefore be justified in treating lifetime gifts differently from deathtime transfers." *Id.*

172. This look back requirement is outlined in I.R.C. § 1014(e) (2012) which states:

> Appreciated property acquired by decedent by gift within 1 year of death
>
> (1) In general
>
> In the case of a decedent dying after December 31, 1981, if—
>
> (A) appreciated property was acquired by the decedent by gift during the 1-year period ending on the date of the decedent's death, and

There are risks associated with such an arrangement, but they are minimal. The property, now owned by the decedent, may be devised as he sees fit with little to no recourse for the original owner.[173] However, a taxpayer would likely not make a transfer unless they trusted the decedent, and so this risk is low. Because the timing of death is unknown in most cases, there is also a risk that the decedent may not survive the year; in that case, however, the original transferor will be in the same position they would have been had the gift not been made.[174]

The look-back period is even less risky when the decedent could make the transfer to the child of the original transferor without the restrictions of § 1014(e). If the decedent completes the transfer before their death and devises the property to the original transferor's child, the property receives a step-up basis—even if the decedent dies in the same year.[175] Blum's argument is also flawed in that the step-up provisions are not in fact available to everyone.[176] In theory, step-up provisions are available to every taxpayer. Yet, as research has demonstrated, members of the higher income classes tend to hold capital gain property, and those are the class of taxpayers with such property in their estates.[177] As a result, this tax subsidy is available primarily for the higher income taxpayers.[178] Even if we concede that the step-up provision is available to everyone, the government subsidy is still unjustified for the reasons articulated in previous sections of this Article.

(B) such property is acquired from the decedent by (or passes from the decedent to) the donor of such property (or the spouse of such donor), the basis of such property in the hands of such donor (or spouse) shall be the adjusted basis of such property in the hands of the decedent immediately before the death of the decedent.

173. The original owner may have unclean hands if the transfer was for the sole purpose of tax avoidance. In such a case a judge may not be willing to reverse the transfer particularly if the sole evidence regarding the motivations for transfer is from the original owner. The unclean hands doctrine indicates that a person may be precluded from an equitable remedy if he was complicit in the disputed conduct. *See, e.g.*, Precision Instrument Mfg. Co. v. Automotive Maintenance Machinery Co., 324 U.S. 806 (1945).

174. I.R.C. § 1014(e) provides that if the decedent does not survive the transfer by one year, then the appreciated property would have a basis equal to that of the original donor before the transfer.

175. The limitations under I.R.C. § 1014(e) do not have the attribution provisions that would trigger the carryover basis provision if the property is devised to any beneficiary other than the original transferor, or their spouse.

176. Blum, *supra* note 168, at 210.

177. BANEMAN, ET AL., *supra* note 80, at 10–11.

178. Blum, *supra* note 168, at 210; *see also* BANEMAN, ET AL., *supra* note 80, at 10–11.

Another justification Blum identifies for maintaining § 1014(a) is that the Government will tax property will be taxed through the estate tax at the death.[179] Because fair market value determines the value of the property included in the gross estate at death, the estate tax would capture the inherent gain. If an estate tax was paid on an estate that included the capital gain property, then Blum's point would be right because, in a sense, there would be double taxation on the subject property if § 1014 did not exist. His argument, however, is unjustified because taxpayers who receive property through inter vivos transfers must pay for the income tax due on the inherent gain upon the sale or exchange of capital property.[180]

On the other hand, only the top one percent of estates actually must pay the estate tax; therefore, the inherent gain is rarely taxed and the windfall inures to the profit of beneficiaries of the estate.[181] If an estate does not actually pay any estate taxes, then the capital property should, at a minimum, be transferred with carryover basis. There is no risk of double taxation in these cases—only a risk of no taxation—which creates further vertical and horizontal inequities.[182] Accordingly, if the estate is subject to taxation and it actually pays an estate tax, the estate's executor may apply a credit to the income tax return for the amount of the tax paid, thereby eliminating the risk of both double taxation and no taxation.

D. Carryover Basis

Carryover basis is an alternative to the step-up provision. Carryover basis requires the recipient of the property to take the donor's basis for the purpose of determining gain.[183] In 2010, with the repeal of the estate tax, the modified carryover basis provisions applied for certain capital property.[184] Under

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179. Blum, *supra* note 168, at 204–05.

180. I.R.C. § 1015 (2012).

181. *See* Joulfaian Report, *supra* note 138, at 4-1.

182. Mark L. Louie, *Realizing Appreciation Without Sale: Accrual Taxation of Capital Gains on Marketable Securities*, 34 STAN. L. REV. 857, 864 (1982). "The principle of vertical equity requires that individuals be taxed according to their ability to pay." *Id.* at 863.

183. I.R.C. § 1015 ("In the case of property acquired by gift after December 31, 1920 (whether by a transfer in trust or otherwise), the basis of the property for the purpose of determining gain is the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift.").

184. *See* I.R.C. § 1022 (2013); *see also* Economic Growth and Tax Reconciliation Relief Act of 2001 (EGTRRA), Pub. L. No. 107-16, 115 Stat. 38 (codified as amended in scattered sections of 26 U.S.C.) (authorizing the estate repeal in the year 2010 and authorizing the modified carryover provisions). EGTRRA sunset at the end of 2010 and was repealed by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (TRA 2010), Pub. L. No. 111-312, 124 Stat. 3296 (codified in scattered sections of 26 U.S.C.). TRA 2010 granted executors for decedents dying in 2010 the option to elect no estate tax and modified carryover basis. *Id.* § 301(c).

the modified carryover basis rules, the decedent's basis carried over to the recipient, who had the option to allocate additional bases up to $3,000,000 for property passing to the surviving spouse and $1,300,000 to property passing to other beneficiaries.[185]

Except for these modified rules, the Code requires carryover basis only for inter vivos gifts.[186] If the Internal Revenue Code applied carry over basis to the estate property, it would place the beneficiary in the same tax position whether they received the property inter vivos or through an estate. Furthermore, the government could still collect the inherent gain as revenue when there is a realization event.[187]

Although TRA 1976 failed to replace the step-up provision with carryover basis, there are some lessons to be learned. Some scholars criticized the difficulty in determining basis and the low exclusion amount.[188] Since that time, technological advancements have made it substantially easier to track records, and the exclusion amount is now significantly higher. Even if the prior attempt was a disaster, the old arguments will likely fail garner the same level of support in the face of these developments.[189]

E. Deemed Realization

An alternative to both the step-up and carryover basis provisions is to treat a death-time transfer as a deemed realization event. As previously discussed, a realization event is necessary in order to trigger a tax on the inherent gains.[190] Deemed realization is a concept in taxation whereby a certain event or act that would not ordinarily trigger a realization event is deemed to have triggered one.[191] Under the current rules, death is not a realization event that triggers income tax payable on capital gains property. Instead, inherent capital gains in estate property receive permanent exclusions

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185. I.R.C. § 1022. The additional basis increase may not exceed the fair market value of the property pursuant to I.R.C. § 1022 (d)(2).

186. I.R.C. § 1015.

187. Eisner v. Macomber, 252 U.S. 189, 211 (1920).

188. Annick, *supra* note 131, at 81.

189. *Id*.

190. *See Macomber*, 252 U.S. at 211.

191. Rodney P. Mock & Jeffrey Tolin, *Realization and Its Evil Twin Deemed Realization*, 31 VA. TAX REV. 573, 609 (2012) ("The realization requirement generally requires some sort of identifiable event prior to gain or loss recognition. Under certain limited circumstances in the Internal Revenue Code . . . realization is 'deemed' to have occurred even though no actual transfer, exchange, sale, or other disposition of the asset has transpired.").

pursuant to § 1014(a). If death were a deemed realization event, the decedent's death would subject the transferred property to income taxation when the property has inherent gain.

Professor Joseph M. Dodge has defended this proposal.[192] He argues that deemed realization is the better approach because subjecting property to the one-time income tax payment is not dissimilar to what happens with the transfer taxes.[193] Professor Dodge notes that by permitting the permanent exclusion of the capital gains tax under § 1014, transfers at death create the type of tax avoidance that people cannot achieve through inter vivos gift transfers.[194]

IV. BEST SOLUTIONS?

So far, this Article has focused on various ways the preferential treatment of capital gains income creates inequities amongst taxpayers and has offered several proposals to address this problem. Without carryover basis provisions or deemed realizations, taxpayers have every incentive to retain their capital gain property until death.[195] By providing incentives to hold the property until death, tax policy encourages the lock-in effect.[196] While each proposal has some positive consequences, each approach also has negative factors. How then, can we find solutions in the midst of these conflicting tax policies?

In some cases, the deemed realization approach offers the best solution to achieve horizontal equity between similarly situated beneficiary taxpayers receiving similar types of gratuitous transfers. If beneficiaries receive capital property as a gift, they take a carryover basis and would be subject the taxation

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192. Joseph M. Dodge, *A Deemed Realization Approach Is Superior to Carryover Basis (and Avoids Most of the Problems of the Estate and Gift Tax)*, 54 TAX L. REV. 421, 423 (2001) (citation omitted).

193. *Id.* at 434 ("Deeming realization to occur at death (or upon gift) would pose a one-time valuation and liquidity problem, as opposed to annual valuations, and in that respect would be similar to the federal transfer taxes.").

194. *Id.* at 438. ("The tax avoidance would derive not from procuring or accelerating one's own death, but rather from the act of *holding onto property* until one's death, which act washes the built-in gain out of the income tax forever. This permanent exclusion of gain constitutes a far more serious tax-avoidance result than can be obtained by the making of gifts of appreciated property to low-bracket donees.").

195. *See* Lee, *supra* note 18 and accompanying text.

196. Louie, *supra* note 182, at 864 ("The realization requirement and the stepped-up basis at death combine to lock investors into their investment portfolios. Because taxpayers do not have to pay taxes on the increase in value of an asset until they sell or exchange it, taxpayers will resist selling appreciated property even though they may have better available investments, or are in need of cash. The investors are said to be 'locked in' because of the tax penalty that they would incur if they were to sell their property and realize the gains. If the investor is well-to-do and elderly, the lock-in problem becomes even more acute: The incentives to hold an asset until death so that the basis can be increased to market value—allowing the unrealized gain to escape taxation entirely—become even greater." (citations omitted)).

on the inherent gain upon a realization event.[197] At the same time, beneficiaries who receive the same type of property from an estate transfer would still receive property with inherent gain, but would be entitled to a stepped-up basis.[198] The only distinction between these two scenarios is the outcome. When the beneficiary sells the gift immediately, the taxpayer will pay taxes on the inherent gain. This same beneficiary may well be in a financial hardship at the time of disposition and there is little relief for this taxpayer. For the beneficiary who receives a death-time transfer, they would owe no tax upon the immediate sale of the property. With rate reductions, tax deferrals and now tax elimination, it seems that capital gains preferences are "giving away the farm."

This stands in stark contrast to current policies, under which the recipient beneficiary of a death time transfer may have no tax due upon the immediate sale of the property because the step-up provision may extinguish the inherent gain. There is little justification for these drastically different tax outcomes. Requiring deemed realization for estate property would treat inter vivos and death-time property transfers similarly, thereby creating some horizontal equity.[199]

Deemed realization is not without its problems. If death is a deemed realization event, then family members who receive property may face a tax that they are not prepared to pay without selling the property. Congress anticipated this problem in other situations and enacted the § 6166 election.[200] This provision permits taxpayers in certain circumstances to elect to pay the estate tax over a period of years through installment payments.[201] If Congress opted for deemed realization at death, it could handle this issue by extending the § 6166 election to taxpayers who inherit properties with inherent gains.[202]

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197. I.R.C. § 1015 (2012).

198. I.R.C. § 1014 (2012).

199. Richard Musgrave, *Horizontal Equity Once More*, 43 NAT'L TAX J. 113, 113–22 (1990). Horizontal equity is one of the most widely accepted principles used to judge the fairness of taxes which indicates that people in equal positions should be treated, for tax purposes, equally. *Id.* at 113.

200. I.R.C. § 6166(a)(1) (2013).

201. *Id.*

202. I.R.C. § 6166 (2013). Under § 6166, an estate that meets all the requirements of the statute may elect to pay the estate tax attributable to the decedent's interest in a closely held business in up to ten equal, annual installments. *Id.* The first of those annual payments must be made by the fifth anniversary of the due date (determined without regard to any extension) of the estate tax liability that is not deferred under § 6166. *Id.* An estate qualifies for a § 6166 election if the value of the decedent's interest in the closely held business

Carryover basis also provides a certain level of horizontal equity. As previously mentioned, Congress does not tax lifetime transfers because these transfers are not treated as realization events. These recipients receive a tax benefit in the form of tax deferral because the government assesses no income tax liability until the taxpayer disposes of the property. Conversely, if Congress adopted the deemed realization proposal, then beneficiaries who receive property by death-time transfers—which are also gratuitous—would arrive in a worse tax position than the recipients of inter vivos gifts because they would be taxed immediately. In these cases, carryover basis would place these beneficiary taxpayers in similar tax positions with similar tax liabilities that would arise when they sell or exchange the property.

If instead Congress continues to utilize carryover basis without adopting the deemed realization proposal, then the beneficiary would not pay a tax upon the death of the decedent. Implementing carryover basis as a possible solution also carries a fundamental challenge. How long should we allow a taxpayer to hold gratuitously received property, with inherent gain, without triggering an income tax? An indirect solution to this problem is to eliminate the step-up provisions. By eliminating the step-up provisions, Congress can disincentivize holding property until death because a property owner would not extinguish inherent gain upon their death. Still, this solution alone is not sufficient; there should be a point at which the property is subject to taxation.

Because carryover basis is a form of tax deferral—and yet another type of tax preference on property transactions conducted primarily by the wealthy—Congress should limit it to one transfer. Specifically, I propose that carryover basis only apply to the first transfer of the property both for gift and estate purposes. This limitation would extinguish the risk of perpetual tax avoidance and mitigate the risk of revenue loss.

With the estate and income tax systems operating under existing rules, wealth continues to shift to the wealthy. By retaining the status quo with regard to transfer liability, the government again demonstrates that its priority is to show preference to wealth-based income over labor-based income. There is no reasonable rationalization for continuing to operate under the current tax laws when more equitable options are readily available.

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exceeds 35% of the adjusted gross estate, the decedent was a United States citizen or resident at the time of his or her death, and the estate made the election by attaching a full and complete notice of election with a timely filed federal estate tax return. *Id.* §§ 6166(a), (d). If the estate qualifies for the election, the estate pays a reduced rate of interest on the portion of estate tax deferred under § 6166; that interest is payable annually during the entire deferral period, and in most instances, interest only is paid during the first four years of the deferral period. I.R.C. §§ 6166(f), 6601(j). The deferred tax is payable in no more than ten equal annual installments, beginning on a date that is not more than five years after the due date of the Federal estate tax return, which is generally nine months from the date of death. *Id.*

The final justification in Blum's Note is that death is a time of grieving; therefore, subjecting this property to carryover basis is "more vindictive than equitable."[203] This may well be the weakest of all arguments. There is no shortage of taxpayers who suffer financially because they are called upon to pay a debt, including income taxes for other income in the estate. Yet, such collection is not deemed to be a vindictive act in those other circumstances.[204]

Under this theory, then, an estate would owe no tax during the time of grieving because carryover is still a form of tax deferral.[205] The beneficiary could sell the property years after the death of the decedent, which eliminates this particular concern. On the other hand, if Congress adopts the deemed realization principle, capital gain property that an estate sells in the course of its administration should be no more traumatic than any other property sold in an estate administration.

Supporters of the step-up basis provisions essentially attempt to make the case that the government should not tax capital property received in a death-time transfer without providing adequate justification for why the two similar transactions should be treated differently. In fact, if the step-up provisions did not provide such a significant tax break, the original holder of the property may not have such an incentive to hold the property until death.

If the primary concern is based in fear that families will lose their farms, then a possible remedy is to use § 6166. Taxpayers could elect to pay the taxes by installment over a period of ten years. That would provide a form of tax relief under which both the government and the taxpayer would benefit.

V. CONCLUSION

Years of economic policies that favor the top wealth earners at the expense of low-income earners have caused wealth and income inequalities. This

203. Blum, *supra* note 168, at 210.

204. *See, e.g.*, I.R.C. § 691 (2012). Income owed to the decedent at death is taxable to the recipient of the income. *Id.*

205. Under the current rules, death is not treated as a realization event for income tax purposes. However, there are scholars making the case that death should be a realization event. For an in-depth discussion about realizing inherent appreciation in capital assets, see Louie, *supra* note 182, and Jeffrey L. Kwall, *When Should Asset Appreciation Be Taxed?: The Case for a Disposition Standard of Realization*, 86 IND. L.J. 77, 111–12 (2011) ("Although death has not historically been treated as a realization event, Congress could establish that result *by* enacting the disposition standard proposed *by* this Article. The Constitution does not impede the treatment of death as a realization event.") (emphasis added).

evaluation of our tax policies, as a whole, has revealed that our current system is grossly imbalanced. Even though we label the structure of the tax system as a progressive system, the reality is that our system, in operation, is a regressive taxing system. The benefits and treasures of society flow to those of greater wealth, while the burdens of revenue-raising fall to those with less wealth.

Tax policies have shaped the tax structure and economic climate and have historically, overwhelmingly favored the wealthy, propertied taxpayers. To that end, our taxing system has failed. This paper discussed specific tax policies that work in collusion to systematically shift wealth to the wealthiest taxpayers.

By shifting the focus of capital gain tax preferences away from households with income in excess of $100,000 and adopting policies that provide preferences to households with less than $100,000, tax policy shifts from a reward to an incentive-based system. Using tax as a method to address income and wealth inequality is particularly appropriate because tax policy contributes to wealth and income inequality.

In addition, placing time limits on the capital property by removing incentives to hold property allows preferences for certain taxpayers, and provides an incentive to sell the property—thereby triggering a realization event. Finally, if Congress converted the step-up basis to a carryover basis provision, the final step to encourage a realization event, it would seal the last opportunity to avoid the tax altogether. In the end, there are a number of ways to reach justice by *saving the farm* without *giving away the farm*.