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## **On Constructively Realizing Constructive Realization: Building the Case for Death and Taxes**

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# The University of Kansas Law Review

## On Constructively Realizing Constructive Realization: Building the Case for Death and Taxes

*Dan Subotnik\**

### I. INTRODUCTION

Like Christian theologians,<sup>1</sup> tax theoreticians have long argued that death is an event of realization.<sup>2</sup> Accordingly, they claim, new decedents should be treated by the tax system as if they had sold each of their assets (at the moment before death) for a fair market price, that is, earning a final reward or punishment depending on whether, overall, their property had appreciated or depreciated in value.<sup>3</sup>

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\* Professor of Law at Touro College, Jacob D. Fuchsberg Law Center. The author is grateful to Professors John Creed, Guy Fortin, and Stephanie Willbanks, and to Jeanne Compitello, Don Daly, Suzanne Napolitano, and Michael Waterston for their help. Special thanks go to Professor John Durnsford of McGill for his professional advice, encouragement, and warm hospitality. Finally, the author gratefully acknowledges the invaluable assistance of his Law Review editor, Joan Bowen.

1. See *John* 3:16, 36, 11:25-26.

2. See *infra* notes 10, 13.

3. From a statutory standpoint, as Boris Bittker has pointed out, the machinery is already in place to produce tax consequences upon death. The reason for this is that § 1001 of the Internal Revenue Code comes into play upon "sale or other disposition," and "a lexicographer would almost certainly say" that the second term "includes a gift or bequest of property." B. BITTKER & M. MCMAHON, *FEDERAL INCOME TAXATION OF INDIVIDUALS* ¶ 25.3 (1988). Bittker concedes that fixing an "amount realized" is difficult here (because the taxpayer is not literally receiving property of value), but he observes, the taxpayers in this situation "could be viewed as receiving noneconomic satisfactions equal to the value of the transferred property. Indeed, this rationale is the foundation of many cases in the assignment-of-income area, which received its classic expression in Mr. Justice Stone's opinion in *Helvering v. Horst* [311 U.S. 112 (1940)] . . . ." *Id.*

Unlike Christian theologians, however, tax theoreticians have made or found few believers. As a result, death triggers no income tax liability and operates as a gaping loophole in the internal revenue system.<sup>4</sup>

Consider, for example, a taxpayer who purchased shares of stock for \$10,000. Through good fortune they are now worth \$1,000,000. If the taxpayer sells the shares before death, the tax (assuming a 28% rate) comes to \$277,000, and if the estate tax does not apply (for instance, because of the marital deduction),<sup>5</sup> the beneficiary pockets \$723,000.<sup>6</sup> If, on the other hand, the taxpayer keeps the shares, death extinguishes the decedent's income tax potential, and the beneficiary receives the \$1,000,000 inheritance intact. In brief, although not necessarily forgiving their debtors, the decedents have their own "debts" forgiven.

Equally significant, after the decedent's death the government makes a "contribution" to the legatee in the decedent's memory because the basis in the stock becomes its fair market value, in this case \$1,000,000.<sup>7</sup> Thus, no tax is ever payable on the appreciation that accrued to the decedent. "Death," as a social worker friend of the author insists, "can [indeed] be a positive experience."

Nonrealization, of course, is not a one-way ticket. Taxpayers' losses at death are not recognized either. This point, however, should not be overstated. At least with regard to property not held by taxpayers for personal consumption, the fair market value, for a variety of reasons, generally exceeds the basis.<sup>8</sup>

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4. See *infra* pt. II.

5. See I.R.C. § 2056 (West 1989). For a discussion of the equity issue where the estate tax does apply, see *infra* notes 42-44 and accompanying text.

A 28% rate is assumed notwithstanding that some income is taxed at a rate of 15% and some at a 33% rate. I.R.C. § 1 (West Supp. 1989); Rev. Proc. 88-56, 1988-2 C.B. 726, 726-27. The assumption is not inappropriate because to effectively eliminate the 15% bracket, § 1(g) provides that the rate drops back to 28% at the \$155,320 level of income (for married couples). This amount is adjusted upward by \$11,200 for each personal exemption claimed. Thus, the effective rate of tax for married big-earners is 28%.

6. All figures are rounded to the nearest thousand.

7. See I.R.C. § 1014 (1982).

8. The inflation factor affects fair market values but not basis. Moreover, insofar as buildings are concerned, for most of our recent past they have appreciated in value while depreciating for tax purposes. With respect to other depreciable assets, since the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172, no attempt has been made to tie depreciation schedules to useful lives of assets. Rather, congressional intent has been to stimulate acquisitions of such assets through accelerated depreciation. Finally, where the fair market values drop below the adjusted bases of assets, the taxpayer has an incentive to sell in order to recognize the potential loss (assuming transaction costs are not prohibitive).

None of the taxpayer gain described here has been lost on tax academics or the Treasury. As far back as the 1930s, tax luminary Henry Simons was strongly urging the adoption of constructive realization ("CR") at death.<sup>9</sup> The 1940s and 1950s witnessed many appeals by prominent critics of the tax system for CR or, at least, for repeal of the tax-free step-up in basis rule.<sup>10</sup>

The first concrete proposal for CR was submitted by the Kennedy administration in 1963.<sup>11</sup> A half-dozen other proposals were submitted to Congress in the 1960s and early 1970s.<sup>12</sup> Authors of law review articles found the area particularly fruitful in those years.<sup>13</sup> Perhaps the plan that met with greatest success during this period was that submitted by the American Bankers Association.<sup>14</sup> In the end, however, because of the forceful opposition mounted by practitioners,<sup>15</sup> and in spite of the very strong support of the academic community, CR went nowhere.

Yet CR dies hard. Although over the years every legislative effort on CR has been killed, at least some have perceived the

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9. See H. SIMONS, *PERSONAL INCOME TAXATION* 162-68 (1938).

10. See Waterbury, *A Case for Realizing Gains at Death in Terms of Family Interests*, 52 MINN. L. REV. 1, 5 n.n.29-30 (1967). In 1976 Congress enacted § 1023 of the Internal Revenue Code, a complex provision that would not have allowed a step-up in basis, calling for a carryover basis instead. See Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520, 1872-77. Because of perceived administrative problems, however, the effective date of the legislation was postponed to January 1, 1980. See Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763, 2884. Finally, as part of the Crude Oil Windfall Profit Tax Act of 1980, § 1023 was repealed retroactively. See Crude Oil Windfall Profits Tax Act of 1980, Pub. L. No. 96-223, 94 Stat. 229, 299. See Lustgarten, Book Review, 78 COLUM. L. REV. 679 (1978) for a concise analysis of the carryover basis problem.

11. See Waterbury, *supra* note 10, at 1.

12. See *infra* notes 32-34 and accompanying text.

13. See Anthoine, *Tax Reduction and Reform: A Lawyer's View*, 63 COLUM. L. REV. 808, 815-16 (1963); Castruccio, *Becoming More Inevitable? Death and Taxes . . . and Taxes*, 17 UCLA L. REV. 459 (1970); Covey, Surrey & Westfall, *Perspectives on Suggested Revisions in Federal Estate and Gift Taxation*, 28 REC. A.B. CITY N.Y. 42, 49-55 (1973) (Third Mortimer H. Hess Memorial Lecture); Graetz, *Taxation of Unrealized Gains at Death—An Evaluation of the Current Proposals*, 59 VA. L. REV. 830 (1973); Kurtz & Surrey, *Reform of Death and Gift Taxes: The 1969 Treasury Proposals, the Criticisms, and a Rebuttal*, 70 COLUM. L. REV. 1365, 1381-89 (1970); Waterbury, *supra* note 10; Comment, *Taxing Appreciated Property at Death: The Case for Reform*, 51 OR. L. REV. 364 (1972); Note, *Alternative Gains Tax Treatments of Decedents' Appreciated Capital Assets*, 27 VAND. L. REV. 493 (1974). A number of important articles geared to practitioners appeared during this period. See Covey, *Possible Change in the Basis Rule for Property Transferred by Gift or at Death*, 50 TAXES 831 (1972) [hereinafter Covey I]; Covey, *Estate and Gift Tax Revision (Part I)*, 1973 TAX ADVISER 218 [hereinafter Covey II]; Hoffman, *Stepped-up Basis at Death: The Defense*, 1973 TAX ADVISER 466.

14. See Covey I, *supra* note 13 for a description and analysis of the American Bankers Association plan.

15. See, e.g., Hoffman, *supra* note 13.

underlying evil to be so great that CR has been regularly resurrected.

Thus, although it is true that law professors (and students) have essentially given up on CR in the 1980s, other critics have kept the faith. A CR bill was introduced in the House Ways and Means Committee (though not adopted) on the road to the Revenue Act of 1987.<sup>16</sup> During the last presidential campaign, Lawrence Summers, a professor at Harvard and chief economic consultant to Michael Dukakis, formally placed CR on the national agenda.<sup>17</sup> Most recently, the *New York Times* recommended CR as a way of financing a cut in the capital gains rate.<sup>18</sup>

The Bush administration's position is unknown at the moment. What is known is one of our principal economic problems: cutting the budget deficit without raising taxes. It may well be only a matter of time before some staff member decides that CR is a loophole-closing device and thus not a "new tax" within the meaning of "No New Taxes."

If CR is to be seriously considered for adoption, as it should be both on budgetary and equity grounds, the legal literature must, for a number of reasons, be re-examined. First, there have been enormous changes in the tax law in the fifteen years since CR was last considered. The most obvious examples include: the unification of the gift and estate taxes,<sup>19</sup> the introduction of the unified credit (which shelters the first \$600,000 from estate and gift tax)<sup>20</sup> and the unlimited gift and estate tax marital deduction,<sup>21</sup> and the lowering of the maximum estate and gift tax rate from 77% to 55%<sup>22</sup> and the maximum income tax rate from 70% to 33%.<sup>23</sup> Because of the nature of the prior debate on CR, these legislative changes have rendered much of the discussion obsolete.

Furthermore, CR proponents never reached a consensus on such difficult problems as what to do about property passing to a spouse, whether gains accruing on property up to the time of enactment of CR legislation should be sheltered, and whether inter vivos transfers should be subject to CR in the same way as transfers by inheritance. Nor could they convince decision-makers that CR

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16. See *infra* notes 35-36 and accompanying text.

17. See Wechsler, *Tax Hike of '89: Uncle Sam Wants Your Money*, *Newsday*, July 3, 1988, at 160, col. 1.

18. See *The New Voodoo, Made Fairer*, *N.Y. Times*, Jan. 18, 1989, at A22, col. 1.

19. See I.R.C. § 2001 (1982 & Supp. V 1987).

20. See *id.* §§ 2010, 2505 (1982).

21. See *id.* §§ 2056, 2523 (West 1989).

22. See *id.* § 2001(c)(2)(D) (Supp. V 1987).

23. See *id.* § 1 (West Supp. 1989).

was workable in light of the difficulties that CR would bring about, such as valuing property and determining basis at the decedent's death.

Many of these matters have now been removed from the realm of the speculative and problematic; some fully tested and successful responses to these questions are currently available for our evaluation. Canada has had a CR rule in effect for over fifteen years.<sup>24</sup> Although Canada has not applied CR in its pure form, the Canadian CR system overall seems to have run so smoothly that careful consideration of that experience is appropriate. As far as the author has been able to determine, no one has attempted to interpret this experience for an American audience.

The body of this Article is organized in three parts. Part II provides a historical summary of the effort to sell CR both in theory and in concrete form while presenting and evaluating the principal arguments for and against CR.<sup>25</sup> Part III describes and analyzes the CR scheme adopted by Canada. Finally, Part IV examines the prior proposals in light of the Canadian experience and offers a number of recommendations.

## II. HISTORY OF CR

Death has been a problem for the income tax system from the beginning. From 1913 to 1921, there was no statutory provision dealing with determining the basis of property acquired through inheritance; nevertheless, it was IRS practice to allow taxpayers holding property a step-up in basis to fair market value.<sup>26</sup> In 1921 the predecessor to the modern statute codified this practice.<sup>27</sup> During these early years, there is no evidence of any IRS interest in treating decedents as if they had cashed in.

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24. See *infra* pt. III.

25. A brief word about the nature of the CR debate is in order before proceeding. At an estate planning seminar in 1987, just a week or so after a CR bill was discussed in House Ways and Means, see *infra* notes 35-36 and accompanying text, a distinguished speaker interrupted his remarks to strongly urge each member of the audience to contact his or her Congressperson to protest the CR initiative. At no other point in his presentation did the speaker editorialize, nor did he offer any reason for his position. Potential benefits from CR, such as making it possible for the rate structure to be reduced, were completely ignored. Such almost visceral hostility toward CR is not unusual. The author hopes that, among other things, this Article will serve to counter the alarmism surrounding the issue so that the debate can proceed along more rational lines.

26. For a brief history of the capital gains tax and basis rules, see Castruccio, *supra* note 13, at 460-68; Waterbury, *supra* note 10, at 4 n.21; Wells, *Legislative History of Capital Gains under the Federal Income Tax*, 2 NAT'L TAX J. 12, 16 (1949).

27. See Revenue Act of 1921, ch. 136, § 202, 42 Stat. 227, 229-31.

### A. *Brief History of CR Proposals*

Twenty-five years passed before tax scholars took a comprehensive and critical look at what had been wrought. With the publication in 1938 of Henry Simons' magnum opus, *Personal Income Taxation*,<sup>28</sup> large segments of the population could discern basic problems of fairness in the tax system and the impact of that system on American economic life.

Simons issued a strong call for CR<sup>29</sup> (also proposing other radical changes such as recognition of gifts and inheritances as income to recipients).<sup>30</sup> Simons' primary argument was that a tax imposed at the time of death, in addition to bringing needed revenue, was least likely to cause disturbances of incentives to work and save. Notwithstanding the pressure for reform from Simons and later influential writers and teachers in this area,<sup>31</sup> another twenty-five years passed before legislative action began to develop.

In 1963 the Kennedy administration recommended a CR proposal consisting essentially of the following:<sup>32</sup> (1) constructive realization for inter vivos and death-time transfers (although special transition rules were provided to mitigate some of the hardship to people caught off guard in the first few years of effectiveness); (2) an estate tax deduction for the income tax thus imposed; (3) an automatic and overall \$15,000 exemption of gain for all taxpayers; (4) an exemption for household items; (5) an exemption of up to 50% of the gain if 50% of the estate passed to a spouse; (6) a complete exemption for a residence passing to a surviving spouse, although again with a carryover basis; (7) an income averaging feature to alleviate the burden of recognizing large amounts of income in the year of death; (8) a carryback rule for capital losses to prior years if there was inadequate income to offset in the year of death; and (9) under some circumstances, a right of election by the taxpayer to defer payment of the tax produced by CR.

The Kennedy plan never made it out of Committee. Nevertheless, in an important sense, it was not a failure because since that proposal, the battle has continued to be joined.

Attempting to overcome objections to the Kennedy plan, the Treasury made some modifications in 1969.<sup>33</sup> Under the adjusted

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28. See H. SIMONS, *supra* note 9.

29. See *id.* at 162-68.

30. See *id.* at 125-47.

31. See *supra* notes 10, 13.

32. See *President's 1963 Tax Message: Hearings Before the Comm. on Ways and Means House of Representatives*, 88th Cong., 1st Sess. pt. 1 at 128-40 (1963) [hereinafter *Hearings*]; see also Waterbury, *supra* note 10, at 1-3; Comment, *supra* note 13, at 368-71.

33. See HOUSE COMM. ON WAYS AND MEANS & SENATE COMM. ON FINANCE, 91ST

plan, there would be an *unlimited* marital deduction for all property passing to a spouse. There would be no averaging provision. Only gains from property accruing after the effective date of the legislation would be subject to the tax. Finally, \$60,000 of gain would be excused (through a minimum deemed-basis rule) rather than \$15,000. This proposal, however, had no greater success than the earlier one.

Although also ultimately rejected in committee, perhaps the best received plan was that submitted by the American Bankers Association in 1972 under the name of the Additional Estate Tax ("AET").<sup>34</sup> The proposal provided for the following: (1) imposition of a 14% tax on the unrealized gains of an individual at death and on appreciation of property gifted by a decedent within two years of death; (2) a carryover basis on other inter vivos transfers; (3) exemption of gains accruing before a valuation day to be determined; (4) denial of exemptions for transfers to spouses and charitable organizations; (5) denial of deductions for capital gains taxes payable under CR; and (6) prohibition of the use of losses by decedents. This plan was made contingent upon a change in the estate tax rate schedule, under which the highest bracket would not exceed 60%. (The top rate was then 77%.)

In 1987 two proposals were submitted for the consideration of the House Ways and Means Committee. The first,<sup>35</sup> only a slight variant from previous proposals, would have subjected net appreciation at death to the income tax. To prevent taxation of small estates, provision would have been made for either an exemption or a credit in the amount of the unused portion of the unified credit. Transfers of property to spouses (and to charities) would not have been subject to tax. On such transfers, the spouse would have received a carryover basis.

The second proposal<sup>36</sup> was somewhat related to the AET plan discussed above. The net appreciation of property in the estate would have been subject to a flat tax rate of 10%, although an

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CONG., 1ST SESS., TAX REFORM STUDIES AND PROPOSALS U.S. TREASURY DEP'T pt. 3 at 331-51 (Comm. Print 1969) [hereinafter TREASURY PROPOSAL]. For discussion of the Treasury proposals see Castruccio, *supra* note 13; Covey I, *supra* note 13, at 837-43; Covey II, *supra* note 13; Covey, Surrey & Westfall, *supra* note 13; Graetz, *supra* note 13; Hoffman, *supra* note 13; Kurtz & Surrey, *supra* note 13; Comment, *supra* note 13; Note, *supra* note 13.

34. The most comprehensive treatment of the ABA plan can be found in Covey I, *supra* note 13. See also Graetz, *supra* note 13.

35. See *Joint Tax Committee Releases Overview of Tax Proposals for Consideration in Revenue Reconciliation*, Tax Notes Today, Oct. 14, 1987, at pt. I.B.2. (LEXIS, Fedtax library, TNT file).

36. See *id.*

exemption was contemplated for the first \$1,000,000 of appreciation. Jointly held property, including community property, would have been added to the estate to determine the exemption amount. Once again, interspousal transfers would have been fully exempt.

Underlying the above proposals—which met with no success—are some fundamental tax issues.

### *B. The Debate over Theory and Practice*

#### 1. Arguments in Favor of CR

At the heart of the case for reform is the principle of horizontal equity.<sup>37</sup> Consider again the example of the taxpayer who sells an appreciated asset before death. This taxpayer pays \$277,000 more in taxes than the similarly situated taxpayer who holds the asset until death (and pays nothing).<sup>38</sup> Defenders of the existing system have never provided sound reasoning for the tax system's discrimination in favor of the taxpayer who dies before selling the appreciated asset.

Indeed, there is no such reason; the equity argument offered in support of the status quo is a flimsy one. In essence, it can be reduced to this: Because estate tax rates are considerably higher than income tax rates, any income tax savings would be taxed at the relatively high estate tax rates, thus equalizing the results in the two situations.<sup>39</sup>

The problem with this explanation is that because of the unified credit and marital deduction, the vast majority of estates do not pay tax.<sup>40</sup> Thus, there is no back-up to the income tax, except where the wealthiest taxpayers are concerned.

Even if the estate tax does apply, there is no equity, rough or otherwise. Consider the foregoing illustration in which the taxpayer paid \$10,000 for an investment that is now worth \$1,000,000. Assume this time that the taxpayer has other assets and income—and that there is no estate tax marital deduction available<sup>41</sup>—so that the taxpayer is in the highest estate tax and income tax brackets. Under these circumstances, a taxpayer selling immediately

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37. Under the principle of horizontal equity, taxpayers in the same economic position should be treated equally by the tax system. For a fuller discussion of this canon of taxation, see W. KLEIN, *POLICY ANALYSIS OF THE FEDERAL INCOME TAX* 114-21 (1976).

38. See *supra* pt. I.

39. See Hoffman, *supra* note 13, at 469-72.

40. In 1987 it was estimated that one-third of 1% of decedents each year were subjected to the estate tax. See J. McNULTY, *FEDERAL ESTATE AND GIFT TAXATION IN A NUTSHELL* 12 (4th ed. 1989).

41. See I.R.C. § 2056 (West Supp. 1989).

before death incurs the same income tax of \$277,000, thus reducing the estate by that amount. The remaining \$723,000 would be subject to a 50% tax rate,<sup>42</sup> the tax would amount to \$361,000, and this same amount, of course, would be left for distribution to beneficiaries.

By contrast, under current law, if this same taxpayer retains the investment until death, there is no income tax, and the estate tax comes to \$500,000.<sup>43</sup> This would leave \$500,000 for beneficiaries.

The tax differential in the two cases is \$138,000. The taxpayer selling an investment prior to death is subject to an additional 28% tax. Returning to the original thesis that the estate tax equalizes the two situations,<sup>44</sup> it is apparent that although the estate tax *mitigates* the tax penalty of selling appreciated assets before death, that penalty is hardly eliminated.

The inequity of nonrealization can also be seen in a slightly different but equally common setting. Consider A and B, who are in the highest income and estate tax brackets. A works, earning an annual salary of \$100,000, while B owns property worth \$1,000,000 that is appreciating (untaxed) at the rate of 10% per year. (Both A and B, it can be assumed, derive their spendable income from certificates of deposit that they own.) This pattern continues for twenty years, at which point A and B die.

A will accumulate \$72,000 per year, which, assuming a 10% annual growth rate, will be worth \$4,124,000 at the end of the twenty-year period before the estate tax and \$2,062,000 after the estate tax.<sup>45</sup> A's total tax bill will come to \$2,622,000. In contrast, B accumulates \$100,000 per year and \$5,728,000 at the end of the

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42. The current (1989) maximum transfer tax rate (for estates valued in excess of \$2,500,000) is 55%. See *id.* § 2001(c)(2)(D) (1982 & Supp. V 1987). A 50% rate is being used here for the sake of simplification and because 50% is expected to be the "permanent" maximum rate beginning in 1993. See *id.* § 2001(c)(1). The estate tax schedule is, of course, graduated so that not all dollars in the estate will be subject to that rate. Nevertheless, because the estate tax rates effectively begin at 37% (due to the \$192,800 unified credit), the 50% assumption will not be materially misleading.

43. See *supra* note 42.

44. See Hoffman, *supra* note 13, at 469-72. The equalization argument was made when the maximum estate tax rate was 77%, and thus there was more equalization then than there is today. Nevertheless, "equality," it will be noted from casual observation, hardly describes the situation.

45. A 28% income tax rate and a 50% estate tax rate are assumed. See *supra* notes 5, 42. An argument could be made that a growth rate of 7.2% should be used because the accumulation of income on the \$72,000 annual receipt will be taxable. For simplicity, however, it is assumed that the income is tax sheltered in some way, and thus the portfolio also increases at a 10% rate. This assumption does not affect the conclusion derived from these calculations.

twenty-year period, assuming again a 10% annual growth rate. The resulting estate tax in this case is \$2,864,000, and the same amount is left for beneficiaries.

It has been argued that this kind of computation demonstrates that, far from being advantaged by the system, holders of (untaxed) appreciated property actually pay more in total taxes than taxpayers who pay income tax during the course of their lives and an estate tax at death, \$2,864,000 versus \$2,622,000.<sup>46</sup> The observation is correct, but only marginally relevant.

Present value analysis, of course, explains what really is happening here. The present value of the tax payments in the second case (where the total tax payments are higher) is \$426,000 compared to \$545,000 in the first case.<sup>47</sup> Thus, in today's dollar terms, the Treasury is significantly less well off in the second case. Here, again, the estate tax mitigates the discrimination in favor of holders of appreciated assets but by no means eliminates it.

That CR will even the score should be evident. A CR tax at death will create tax liability of \$1,604,000 (28% of \$5,728,000), which will lead to a taxable estate of \$4,124,000. The estate tax on this estate will be \$2,062,000, and the same amount will be left for beneficiaries. The present value of the total taxes payable at death will be \$545,000, which is the present value of A's tax payments in the prior example.

The sums of tax dollars at issue with respect to CR are not trivial. For 1963 the Treasury estimated that a CR rule would have produced \$300,000,000 in tax revenue.<sup>48</sup> For 1968 that estimate rose to between \$2.5 and \$3.1 billion annually.<sup>49</sup> The projected revenue under the first of the 1987 proposals was about \$5 billion per year.<sup>50</sup>

Arguments based on equity and loss of revenue have not been the only ones advanced in favor of CR. One of the oldest arguments is "lock-in,"<sup>51</sup> which runs as follows: Under current tax law, taxpayers, particularly the elderly, have a disincentive to liquidate their holdings because of the income tax. The resulting stagnation in capital flows damages the economy. CR would reduce

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46. See Hoffman, *supra* note 13, at 470; see also *supra* note 45.

47. For discounting purposes, again a 10% rate is used.

48. See Castruccio, *supra* note 13, at 477.

49. See 116 CONG. REC. 225 (1970) (statement of Rep. Reuss). A 1972 article estimated the increase in the potential revenue at \$4 billion by 1975. See Graetz, *Reflections on the Tax Legislative Process: Prelude to Reform*, 58 VA. L. REV. 1389, 1416 (1972).

50. See *supra* note 35.

51. See discussion in Note, *supra* note 13, at 495-97.

this incentive to keep assets because the tax would be harvested in any event by the grim reaper.

The evidence on this point, however, seems to be in conflict. On the one hand, a number of contemporary supply-side studies show that some recent decreases in capital gains rates (such as the ones between 1981-1984) have actually stimulated realization of gains.<sup>52</sup> On the other hand, earlier investigations into the problem led to the opposite conclusion.<sup>53</sup> Perhaps a fair summary from all of the evidence is that although raising tax rates provides some incentive in favor of holding, as opposed to selling, that factor is not as significant in the marketplace as has been represented.<sup>54</sup>

In sum, arguments in favor of CR have, for the most part, been cogent. We turn now to arguments against CR. These—to preview the conclusion—will be found to be highly problematic.

## 2. Arguments against CR

### a. Constitutional and Conceptual Problems

CR proposals have stirred strong opposition. Many questions have been raised including those concerning the constitutional status of CR, as well as the related matter of whether it is appropriate to weaken the realization requirement, which is a fundamental feature of the income tax. The constitutional argument proceeds along the following lines:<sup>55</sup> The sixteenth amendment authorizes Congress to impose a tax on income. The realization requirement, however, has been held—by no less authority than the Supreme Court—to be of constitutional significance, and realization has been interpreted as requiring some kind of conversion of one asset into another. Because a rule of constructive realization would tax decedents in the absence of such a conversion (the argument continues), CR is unconstitutional.

As Boris Bittker has recently reminded us, however, the Supreme Court itself has downgraded the realization principle to one “founded on administrative convenience,” and its constitutional status is now “badly eroded.”<sup>56</sup>

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52. See, e.g., Toder & Ozane, *CBO Works on Capital Gains*, 39 TAX NOTES 1441 (1988) for an excellent summary of contemporary research on this very important issue.

53. See, e.g., Castruccio, *supra* note 13, at 459-68.

54. See, e.g., Waterbury, *supra*, note 10, at 48-49. His conclusion, however, predates some of the modern empirical work. See *supra* note 52 and accompanying text.

55. See, e.g., Castruccio, *supra* note 13, at 492-97; Waterbury, *supra* note 10, at 8-15; Comment, *supra* note 13, at 371-75.

56. See B. BITTKER & M. McMAHON, *supra* note 3, ¶ 3.2.

The constitutional issue has been fully aired over the last twenty years,<sup>57</sup> and because the courts have added little to the debate during this period, the matter will not be further addressed here. Most academics writing in this area (and this author) have concluded that notwithstanding some contrary language in earlier cases, CR could not be successfully challenged today on constitutional grounds.<sup>58</sup>

The conceptual (to say nothing of the political) side of this issue is not so easily resolved. An elegant John Dewey aphorism seems apt: "The mind of man is taken captive by the spoils of its prior victories."<sup>59</sup> Although the unthinking application of this wisdom to our humble tax problem—that is, a knee-jerk rejection of the status quo—might itself illustrate the unfortunate human tendency Dewey writes about, the observation nevertheless seems especially germane to understanding the place of realization in our consciousness.

The realization requirement is a cornerstone of our tax system, and it is hard to imagine (although some have been able to do so)<sup>60</sup> that we could have a viable tax system where, for example, gains and losses are accrued. The realization requirement, however, was never meant to give taxpayers *final* absolution from liability for gains that they earned while holding property; it was meant only to postpone recognition until an appropriate time for taxation. Because in the case of death, time has run out for the taxpayer, the tax should be applied then. If in the higher interests of equity, the argument goes, this means that the realization requirement must be suspended once in every taxpayer's life and the estate must be valued, so be it.

#### b. Liquidity

The foregoing discussion leads naturally to the issue raised by opponents of CR as to whether the time of death is indeed the

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57. See Kurtz & Surrey, *supra* note 13, at 1387; Waterbury, *supra* note 10, at 8-15. See also Heckerling, *The Death of the "Stepped-Up" Basis at Death*, 37 S. CAL. L. REV. 247, 265-72 (1964) (discussion of colloquy among G. Griswold, B. Bittker, S. Surrey, and R. Miller).

58. See, e.g., Castruccio, *supra* note 13, at 492-97; Kurtz & Surrey, *supra* note 13, at 1387; Waterbury, *supra* note 10, at 1387; Comment, *supra* note 13, at 371-75. For a contrary position, see *Hearings*, *supra* note 32, pt. 5 at 2808-09, 2839.

59. Gummere, *He's Back*, COLUMBIA, Apr. 1988, at 22, 25. With only modest liberties taken, the phrase can be understood to mean that a kind of Peter Principle applies to ideas; that is, ideas also rise to their level of "incompetence." (The original statement of the principle held that people in organizations tend to be promoted beyond the level at which they can perform competently.) The common wisdom that generals tend to prepare for the last war is an illustration of the problem.

60. See Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111 (1986).

appropriate time to collect the tax, considering that often there are no funds with which to pay the tax absent a sale of property or collection of insurance on the decedent's life. The response to this question, however, lies in its very formulation. If taxpayers anticipate some form of CR, they will likely make provision for it by creating a market for assets (for example, through a buy-sell agreement) or by purchasing insurance. The same strategies are used to deal with the estate tax, which also raises the liquidity problem.

Of course, these techniques will not always be available, or the protection they offer will prove insufficient. This is especially so where wealth takes the form of an interest in a small business. Opponents of CR have argued that in these cases both individual sellers and society will be harmed—the former because they will be forced to sell for less than fair market value, and the latter because the situation will inevitably lead to the concentration of economic power in the hands of the major corporations, the only buyers, practically speaking, of successful privately-held businesses.

There is a ready solution to this problem, however. The estate tax rules already provide relief to owners of small businesses and farms. Section 2032A of the Internal Revenue Code helps reduce estate tax valuation of these assets,<sup>61</sup> while Code section 6166 allows the owners of such businesses to stretch out estate tax payments at favorable interest rates.<sup>62</sup> An income tax rule helps in another way. Under Code section 303, the one holding stock may treat redemptions as sales, rather than dividends, to the extent of debts and estate tax payable.<sup>63</sup> There seems to be no reason that these provisions, liberalized if necessary, could not be made applicable to cases where the capital gains tax presents a major liquidity problem for the estate.

It should be noted that the liquidity squeeze has eased somewhat since the first half of the 1970s, when CR was last seriously entertained. At that time, estate tax rates had reached a high of 77%, while capital gains rates had risen to 35%. Under these conditions, a taxpayer could have been wiped out by the one-two punch of the capital gains tax (which would frequently have applied) and the estate tax, even if relief were given in the form of an estate tax deduction for the capital gains tax payable on the transaction. Our taxpayer, for example, with stock purchased for \$10,000 and appreciation of \$990,000 by the time of death, would

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61. See I.R.C. § 2032A (West 1989).

62. See *id.* § 6166 (1982 & Supp. V 1987).

63. See *id.* § 303 (1982 & Supp. V 1987).

have had only \$150,000 to show for skill (or luck) in escaping the gravity of efficient markets.<sup>64</sup>

Although that outcome seems harsh, it is, of course, identical to the tax that would have been paid by taxpayers who sold their assets before death. Therefore, there is no real basis for complaint. Some would find this consideration persuasive in and of itself. The point here, however, is that with the decline of both income and estate tax rates, the combination of the taxes is no longer quite so onerous. Using the hypothetical numbers above, the taxpayer today would be left with \$361,000 after taxes.<sup>65</sup>

### c. Valuation and Basis Problems

CR opponents point to the difficult valuation problems that would attend any CR system because the CR-based tax can only be determined by reference to a valuation of property at death. There is some merit to this contention, but current law requires most of the same valuations. All property of decedents with gross estates in excess of \$600,000 must be valued as of the time of death.<sup>66</sup> Similarly, taxpayers who wish to sell or depreciate inherited property must establish a date-of-death valuation.

Even if legatees or devisees wish to keep inherited property, say, a residence, for personal consumption, they would be well-advised to have the property appraised, in case they later wish to sell it. The only situation in which CR would require valuation, where current law would not, is when the taxpayer uses inherited property for personal purposes (so there is no depreciation) and subsequently suffers a (nondeductible) loss. In short, CR should not materially increase the valuation burden on taxpayers, even if it occasionally would force them to bear the brunt of that burden earlier than they might like.

There is another problem: how will decedents' bases be determined if their records are incomplete? First, if a CR rule becomes the law of the land, taxpayers will have a strong incentive to maintain adequate records to protect their estates from the risk of overtaxation.

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64. Here again, other income and assets are assumed so that only the highest marginal rates apply.

65. This result is identical to the one arrived at above. See *supra* note 42 and accompanying text.

66. See I.R.C. § 2031 (1982); *id.* § 6018 (West 1989). In Canada, valuation problems can be even more serious than in the United States because the Canadian tax system grandfathered gains prior to Valuation Day, December 31, 1971. See *infra* note 129 and accompanying text. Thus, even on cash sales of property purchased prior to that date, a valuation is necessary to establish the basis.

This, of course, does not solve the basis problem of "old" property, that is, property purchased before CR might come into effect. Professor Michael Graetz has expressed concern about this problem. The reform proposals, he writes, "require that the decedent have adequate records of basis, but ignore the fact that at present persons cannot be expected to have such records since they are not required under current law for assets held until death. Their failure to deal with this problem is clearly a major inadequacy."<sup>67</sup> For this reason, Graetz opposes a backward-looking CR tax.

The problem of poor record keeping is overstated because it is only if taxpayers hold on to property until death that they may not have to know their basis in property. Yet the rational taxpayer cannot completely exclude the possibility that before death an offer will be forthcoming that simply cannot be refused. Even if the taxpayer does refuse, how will the depreciation deductions taken be supported?

Certainly, in some cases documentation will not be available to establish a decedent's basis. In these situations, however, the system might simply adopt a rule that the fair market value of the property when acquired by the decedent governs. Such a rule would parallel the one applicable where purchases of property take place long before sale and records have been lost and where a donee of an inter vivos gift cannot determine the transferor's basis.<sup>68</sup>

There is a second anti-CR argument with respect to basis. Understanding this point requires some background information. As implied in the sketch of the various CR proposals offered during the last twenty years, one of the major controversies has been over the position of the spouse; specifically, should property transferred to the spouse be subject to CR?

The 1963<sup>69</sup> and 1969<sup>70</sup> proposals would have deferred some or all of the gain on transfers to spouses, whereas the ABA plan would have accorded no special status to the spouse in these matters.<sup>71</sup> If the spouse is treated favorably, the question then arises as to the appropriate basis of the property in the surviving spouse's hands. Carryover basis, of course, is the only workable answer. Otherwise, in a family where all of the property was

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67. Graetz, *supra* note 13, at 854.

68. See *Cinelli v. Commissioner*, 502 F.2d 695 (6th Cir. 1974); *Jones v. Commissioner*,

24 T.C. 525 (1955); see also I.R.C. § 1015(a) (1982).

69. See *supra* note 32 and accompanying text.

70. See *supra* note 33 and accompanying text.

71. See *supra* note 34 and accompanying text.

owned by spouse A, potentially enormous tax consequences would hinge on whether spouse A or spouse B were the first to die. If spouse A died first, CR would ordinarily be avoided entirely, but this would not be the case if spouse B died first. Obviously, no rational tax system could be built on a foundation of this kind.

A decision would then have to be made about what to do in cases where some property goes to the surviving spouse and some goes to others. When the Treasury first examined this matter, the consensus was that it could be unfortunate for all concerned if spouses took a carryover basis and others took a fair market value basis, depending upon the specific assets they inherited.<sup>72</sup> The government could be disadvantaged by taxpayers assigning low-basis assets to their spouses and the rest to other beneficiaries, thereby minimizing their capital gains tax, and taxpayers might face the problem of being "forced" by tax circumstances into following this plan, when for nontax reasons, they would not want to do so. The widely accepted solution suggested for the problem, which effects a kind of compromise, was to require that the taxpayer allocate the total basis of the property to each of the individual assets in proportion to their fair market value.

How would the procedure just outlined work in practice?<sup>73</sup> Because in many cases the executor cannot transfer property to individual beneficiaries until all claims and taxes are known, the system must provide for determining basis (for purposes of determining gain or loss) when assets are sold during the interim period to pay such claims and taxes. Solutions to this problem are not easy to develop. Probably the best that we can do, having no practical experience or concrete data of our own to work with in this area, is to analyze Canada's treatment of the problem.

#### d. The Regression Argument

Richard Covey has developed the regression argument most clearly.<sup>74</sup> At its heart is the truism that there can be no real reform if the tax system becomes more unfair in some significant way. Thus, Covey argues: A deduction must be allowable from the gross estate for the taxes that are owing as a result of the application of any CR rule. Otherwise, the tax system would treat taxpayers who sell property in an inter vivos transfer more favorably than it would those who are subject to CR because they did

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72. See TREASURY PROPOSAL, *supra* note 33, at 338.

73. Covey focuses clearly on this issue. See Covey I, *supra* note 13, at 839-40.

74. See *id.* at 838-39.

not sell. This would be a full reversal of nonneutralities. CR, however, was designed only to equalize the tax treatment of those who keep appreciated property with those who sell prior to death, not to penalize the former.

According to Covey, the deduction for CR taxes is the beginning of the problem:

This approach removes from the estate tax base a portion of the estate assets which would otherwise be taxed at the highest, or marginal, rate or rates. Thus the actual rate of tax on the net appreciation is the complement of the marginal rate or rates at which the deducted capital gains tax would otherwise be taxed in the estate. To illustrate, an estate whose appreciation would be taxed under current [1972] estate tax law at the highest rate of 77% would be subject to an effective capital gains tax at only 23% of the actual capital gains tax that is paid. On the other hand, the effective rate of capital gains tax on an estate whose highest marginal estate tax rate was 25% would be 75% of the actual amount of capital gains tax that is paid.<sup>75</sup>

To illustrate his point, Covey takes the case of two taxpaying estates: one holding property worth \$450,000 with a basis of \$150,000 and the other holding property worth \$4,500,000 with a basis of \$1,500,000.<sup>76</sup> Applying both maximum capital gains tax rates in effect when the Treasury proposals were made and Covey's proposed (and lower) transfer tax rates, Covey concludes that CR would yield the bizarre result of increased taxes of \$7,700 (or 0.4%) in the latter estate and \$30,650 (or 28%) in the former, smaller estate. This consideration became a principal basis for his rejection of the basic CR proposals.

Covey's analysis, although insightful, is conceptually problematic and mathematically incomplete. The conceptual problem that he is really defining, as the late Professor Surrey has pointed out,<sup>77</sup> is a structural one that exists in the relationship between the income tax and the estate tax. If there is a deduction available against the estate tax for income taxes paid, any flat-rate income tax system<sup>78</sup> combined with a progressive estate tax structure will favor the wealthy in the sense that the Government will be picking up a larger fraction of the cost of the CR tax. Indeed, any estate tax

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75. *Id.* at 838.

76. *See id.* at 839.

77. *See* Covey, Surrey & Westfall, *supra* note 13, at 50-51.

78. For this purpose, the CR tax can be thought of as essentially flat-rate. The reason for this is that in 1989 the 28% bracket starts at \$30,950 for married couples and at \$18,550 for singles, *see* I.R.C. § 1(a),(c) (West Supp. 1989), Rev. Proc. 88-56, 1988-2 C.B. 726, whereas taxpayers with incomes below this do not have appreciable amounts of investment property.

deduction allowed, not just one for income tax paid, has this regressive effect on the estate tax structure.

The easiest way to cure the problem would be to eliminate the progressivity of the estate tax or to eliminate the tax itself. Presumably because he found these solutions unrealistic, Covey's preference among the alternative CR proposals was the flat-rate Additional Estate Tax, which is not deductible against the estate tax.<sup>79</sup>

Another problem with Covey's analysis is the existence of a zero bracket range, that is, an exemption amount. As long as an estate tax has such a feature, one should expect some measure of regressiveness in a CR system. The reason for this is that even a nominal flat-rate estate tax operates as a progressive one if it has an exemption amount. Thus, as just demonstrated, a flat-rate income tax joined to an *effectively* progressive estate tax will impose a greater relative burden on the less wealthy taxpayer, that is, it will be regressive.

To illustrate this second factor shaping regressivity, consider the impact of CR on a taxpayer whose property at death has appreciated by the same \$300,000 as above but whose total estate amounts to less than the \$600,000 exemption amount. Tax academics are frequent and natural targets for tiresome and self-serving taxpayer grouching about the income tax, but here, at long last, is a taxpayer who merits our sympathy. Under CR, this taxpayer's tax rate goes up astronomically.<sup>80</sup>

This situation raises an interesting issue in tax policy: Does the existence of a tax concession that effectively reduces the rate of one tax mean that the tax system should go easy with such a taxpayer with regard to other taxes? There is a good argument, at least, that it does not.

We can probably make more progress on the regressivity issue, however, by considering the dramatic changes in rates effected by recent legislation. In essence, since 1972, when Covey's article was written, the lowest estate tax rate bracket has increased from 3% (on amounts in excess of a \$60,000 exemption level) to (effectively) 37% (on taxable estates of over \$600,000), while the highest rate has dropped from 77% to 50%.<sup>81</sup> Under these circumstances, the regressivity in moving to CR would no longer be as dramatic as it would have been in 1972, and the bizarre results, such as the

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79. See Covey I, *supra* note 13, at 843-48.

80. More precisely, the tax rate increases from zero, and thus infinitely.

81. See Internal Revenue Code of 1954, 68A Stat. 1, 373-74; I.R.C. § 2001(c) (1982 & Supp. V 1987). The 50% rate takes effect in 1993. See *supra* note 42.

ones in Covey's hypothetical, would no longer obtain. The exemption issue aside, narrowing the estate tax rate structure has yielded a tax that, practically speaking, has the same effect as Covey's AET.

e. The "Moral" or "Aesthetic" Argument

For all of the elaborate arguments made in connection with CR, it is difficult to avoid the suspicion that a yet unarticulated factor is at work here blocking CR. This factor, which is best characterized as "moral" or "aesthetic," is related to the conceptual one referred to above, and yet there is a difference. This slippery, mysterious and powerful factor is perhaps the key to understanding why, notwithstanding the academic support it has received for over a generation, CR has never made it to the floor of Congress.

When considering the realization principle, one can readily conclude that absent a sale or similar event, we are not taxed—and should not be taxed—because *we have not done anything* to warrant such treatment by the tax system. Under this view, individuals have a fundamental right not to be participants in the income tax system. That system is seen as almost penal in nature, requiring some kind of overt act combined with a requisite mental state before a taxpayer can properly be "penalized."<sup>82</sup>

Section 109 of the Internal Revenue Code provides an example of this "moral" or "aesthetic" factor.<sup>83</sup> It protects the landlord who one day wakes up to find that a tenant had erected a building on the property, which because of the termination of the lease period, has now reverted to him.

More generally, this factor can explain why no income is imputed to an individual who keeps land that appreciates in value, or who puts his money under a mattress rather than in a bank. The classical explanation offered for these results is that it is too difficult or disruptive to measure the appreciation, to force a sale through imposition of a tax, or to start determining tax consequences based upon what individuals might have done instead of

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82. In the estate and gift tax area, the disclaimer rules, *see* I.R.C. § 2518 (1982), are premised on the same idea. The tax system does not allow an individual to be forced into becoming a taxpayer (perhaps even pushing the taxpayer into a higher transfer tax bracket) by treating the disclaimer as if it were a transfer to the taker in default. In economic terms, of course, that is precisely what the taxpayer is doing.

83. Section 109 provides that "[g]ross income does not include income (other than rent) derived by a lessor of real property on the termination of a lease, representing the value of such property attributable to buildings erected or other improvements made by the lessee." *Id.* § 109 (1982).

what they actually did. The classical explanation is not wrong; the problem is that it does not begin to capture the shock that most taxpayers would feel if a tax were imposed in these circumstances.

This line of argument could be called "moral" or "aesthetic," rather than "economic," because it involves culturally established priorities rather than inexorable economic principles. With the exercise of only a small amount of imagination, one notes that in the first two examples above, the taxpayers could have anticipated that the events in question *might* take place when they purchased property. In the third example, the taxpayer's refusal to invest the money is tantamount to investing it and throwing away the interest. This is not to suggest that the rule of law in these cases is wrong; it only highlights that there are limits to the extent that taxpayers would be justified in feeling abused if a tax were imposed here.

All of this discussion leads to the expression of the argument directly against CR: Even if it might be appropriate during their lifetimes to tax sellers of appreciated assets, the same does not hold for those retaining property at death, the quintessential involuntary act. There is a now familiar response to this, even if by itself it may not be altogether convincing in this context. This response is that the fact of death, if not the time, comes as no surprise; for we are warned from the very outset, *memento mori*, "remember that [we] must die."

Finally, at least one congressional witness over the years has argued that it is unseemly to raise the cost of dying.<sup>84</sup> Here we come to the crux of the entire matter.

The idea is that it is inappropriate for Congress to add a financial injury to an emotional one. The argument has more than surface appeal, and thus the tax system should certainly try to avoid having a more favorable rule for pre-death transfers than for post-death transfers. It would be grossly unfair, for example, if individuals killed suddenly in automobile accidents were disadvantaged relative to long-term cancer victims because the former could not plan properly. (Also, the system should not be encouraging tax advisors to share vigils with priests to make sure that taxpayers are not caught at the moment of death holding appreciated assets.) Beyond this consideration, however, the "moral" or "aesthetic" objection has really already been answered. CR is a tax on lifetime events that is only *deferred* until death. Thus, notwithstanding our

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84. He described the estate tax as "harvest[ing] . . . [d]ollars from the graves of dead Americans." *Public Hearings Before the Comm. on Ways and Means House of Representatives*, 93d Cong., 1st Sess. pt. 10 at 4183 (1973) (statement of Phillip S. Fry, Executive Director, National Council to Eliminate Death Taxes).

temptation by the "moral" and "aesthetic" arguments, the existence of the estate tax and the gross inequity of applying the income tax only to those rendering service for compensation and to inter vivos sellers of assets really foreclose this line of reasoning.<sup>85</sup>

### III. THE CANADIAN EXPERIENCE

If, as has been shown, CR seems mandated by considerations of equity and revenue and there are no countervailing theoretical factors, the only question left is can it work? As indicated at the outset, CR (referred to as "deemed disposition" in Canada) has been an important and highly visible part of the system in Canada for over fifteen years.<sup>86</sup> Thus, it seems appropriate to look for any

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85. H. Ross Perot is a genuine American Hero. See K. FOLLET, *ON WINGS OF EAGLES* (1983). For all of Perot's wealth, can anyone deny that if his level of wealth can be truly earned, he has earned it? Ross Perot initially invested only \$1,000 in EDS, see *id.* at 45, which after reorganization took the form of hundreds of millions of dollars of General Motors stock. It is not clear whether Mr. Perot has since paid tax on his gain, but let us assume that he has not. Should Joe Sixpack pay tax on every dollar he makes while Chivas Regal Ross gets a free ride? Only because the subject is Perot is the question not rhetorical.

86. See Act Respecting Income Taxes, CAN. REV. STAT. ch. 148 (1952), *amended by* Act of Dec. 23, 1971, ch. 63, 1970-72 Can. Stat. 1311; Act of Mar. 29, 1972, ch. 9, 1972 Can. Stat. 97; Act of Apr. 18, 1973, ch. 14, 1973-74 Can. Stat. 121; Act of July 27, 1973, ch. 29, 1973-74 Can. Stat. 435; Act of July 27, 1973, ch. 30, 1973-74 Can. Stat. 441; Act of Dec. 12, 1973, ch. 44, 1973-74 Can. Stat. 591; Act of Dec. 12, 1973, ch. 45, 1973-74 Can. Stat. 613; Act of Dec. 21, 1973, ch. 49, 1973-74 Can. Stat. 693; Act of Jan. 14, 1974, ch. 51, 1973-74 Can. Stat. 739; Act of Mar. 13, 1975, ch. 26, 1974-76 Can. Stat. 389; Act of June 19, 1975, ch. 50, 1974-76 Can. Stat. 1155; Act of June 26, 1975, ch. 58, 1974-76 Can. Stat. 1285; Act of Dec. 2, 1975, ch. 71, 1974-76 Can. Stat. 1411; Act of Feb. 25, 1976, ch. 87, 1974-76 Can. Stat. 1741; Act of Feb. 25, 1976, ch. 88, 1974-76 Can. Stat. 1783; Act of May 5, 1976, ch. 95, 1974-76 Can. Stat. 1929; Act of Feb. 24, 1977, ch. 4, 1976-77 Can. Stat. 47; Act of Mar. 31, 1977, ch. 10, 1976-77 Can. Stat. 301; Act of Aug. 5, 1977, ch. 54, 1976-77 Can. Stat. 1369; Act of Dec. 15, 1977, ch. 1, 1977-78 Can. Stat. 1; Act of Feb. 2, 1978, ch. 4, 1977-78 Can. Stat. 387; Act of June 30, 1978, ch. 32, 1977-78 Can. Stat. 759; Act of June 30, 1978, ch. 41, 1977-78 Can. Stat. 889; Act of June 30, 1978, ch. 42, 1977-78 Can. Stat. 975; Act of Dec. 12, 1978, ch. 5, 1978-79 Can. Stat. 17; Act of Dec. 6, 1979, ch. 5, 1979 Can. Stat. 47; Act of Nov. 26, 1980, ch. 40, 1980-83 Can. Stat. 305; Act of Feb. 19, 1981, ch. 47, 1980-83 Can. Stat. 1167; Act of Feb. 26, 1981, ch. 48, 1980-83 Can. Stat. 1275; Act of July 8, 1981, ch. 68, 1980-83 Can. Stat. 2457; Act of June 22, 1982, ch. 102, 1980-83 Can. Stat. 3011; Act of June 29, 1982, ch. 104, 1980-83 Can. Stat. 3087; Act of July 7, 1982, ch. 109, 1980-83 Can. Stat. 3193; Act of Mar. 30, 1983, ch. 140, 1980-83 Can. Stat. 3777; Act of Jan. 19, 1984, ch. 1, 1984 Can. Stat. 1; Act of June 14, 1984, ch. 19, 1984 Can. Stat. 523; Act of June 29, 1984, ch. 31, 1984 Can. Stat. 961; Act of Dec. 20, 1984, ch. 45, 1984 Can. Stat. 1611; Act of Oct. 29, 1985, ch. 45, 1985 Can. Stat. 959; Act of Feb. 13, 1986, ch. 6, 1986 Can. Stat. 221; Act of June 17, 1986, ch. 24, 1986 Can. Stat. 843; Act of June 27, 1986, ch. 40, 1986 Can. Stat. 1269; Act of Nov. 5, 1986, ch. 44, 1986 Can. Stat. 1415; Act of Dec. 19,

bright lights emanating from the north directed at this topic.<sup>87</sup>

### A. Introduction

Canada's federal income tax system is similar to ours. (The same is true of the tax systems in the Provinces.) The rate structure is especially close to ours. At the federal level, the 17% lowest bracket rises to 26% at the \$27,500 income level and to a peak of 29% at \$55,000.<sup>88</sup>

Like the United States, Canada has special rules for capital gains, which are defined similarly to ours.<sup>89</sup> There are some significant advantages, however, to enjoying capital gains in Canada. Canada exempts the first \$100,000 of taxable capital gains earned by taxpayers during their lives (or as a result of the application of CR),<sup>90</sup> and there is no minimum holding period required to qualify for this benefit. Moreover, in 1988 and 1989 taxpayers can exclude one-third of their net capital gains (gross capital gains less gross capital losses); for 1990 and future years the exclusion has been reduced to one-quarter of the gain.<sup>91</sup>

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1986, ch. 55, 1986 Can. Stat. 1631; Act of Dec. 19, 1986, ch. 58, 1986 Can. Stat. 1781; Act of Dec. 17, 1987, ch. 46, 1987 Can. Stat. 1249; Act of July 21, 1988, ch. 28, 1988 Can. Stat.; Act of Sept. 13, 1988, ch. 61, 1988 Can. Stat.; Act of Sept. 13, 1988, ch. 55, 1988 Can. Stat.; Act of Sept. 22, 1988, ch. 61, 1988 Can. Stat. [hereinafter I.T.A.]. (The 1988 Statutes of Canada were unpublished at the time of publication of this Article, but are available through the Canada Gazette, pt. 3.)

87. Before proceeding, a word of caution is in order. As one might expect, CR is very closely integrated with the rest of the Canadian tax system. When writing about the American tax system, we can concentrate on selected topics without concern that we will lose sight of the larger perspective. Of necessity in taking on a project of this kind, there is a great risk of not providing the needed global perspective. Although that risk cannot be eliminated (without making this Article encyclopedic), it will perhaps allay some fear to know that the author is conscious of the peril.

88. See I.T.A., *supra* note 86, § 117(2). Reference to the federal tax rate, without more, may be misleading because of the generally high provincial rates. To illustrate, in 1989 the top combined federal and provincial rate will be approximately 46% in Ontario and 49% in Quebec.

89. Section 39(1)(a) defines property that will produce capital gain or loss upon disposition. See *id.* § 39(1)(a). The definition resembles that provided by § 1221 of the Internal Revenue Code. See I.R.C. § 1221 (1982).

90. See I.T.A., *supra* note 86, § 110.6(3). The exemption is, technically speaking, a deduction of \$75,000 from taxable income. (References to dollar amounts in Canadian tax law are in Canadian dollars, which were worth approximately \$0.85 in American dollars at the time of publication.) This reflects the fact that beginning in 1990 only three-quarters of any capital gain is taxable. See *id.* § 38(a). See *infra* pt. III.E. for historical background to the \$100,000 exemption.

91. See I.T.A., *supra* note 86, § 38(a). In the United States, the capital gains deduction was repealed effective in 1987 by the Tax Reform Act of 1986, Pub. L. No. 99-514, § 301(a), 100 Stat. 2085, 2216-19.

Canada's capital gains benefits are not quite as generous as they appear to be. Backing

Certain transactions, for example sales and other transfers of residences, are completely exempt from tax.<sup>92</sup> Also not subject to tax are transactions between spouses<sup>93</sup> (although an election can be made to have the gain recognized).<sup>94</sup> In addition, there are some limited special exemptions from gain recognition; up to \$500,000 of capital gains are exempt on transfers of qualified farm property and certain defined small business corporation shares.<sup>95</sup>

A few words about depreciation are helpful here. Under Canadian tax law, the same categories of assets qualify for "capital cost allowance" as qualify in the United States.<sup>96</sup> A principal difference between the two systems is that in Canada all depreci-

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up the regular tax structure is an alternative minimum tax ("AMT"), which recognizes the exemption but not the exclusion. The AMT rate of tax is currently 17%. See I.T.A., *supra* note 86, §§ 127.51, 248(1), 117(2). Taking into account the provincial AMT rates, the combined marginal rate is approximately 27% in Ontario and 31% in Quebec.

The capital gains exemption is subject to additional limitations. First, in any one year, the availability of the exemption is reduced by: (1) the capital losses from that year and those from other years deducted in computing taxable income in the year of the loss, see *id.* §§ 110.6(3)(c), 110.6(1); (2) the allowable "business investment losses," see *id.* §§ 110.6(3)(c), 110.6(1); and (3) the "cumulative net investment loss," see *id.* §§ 110.6(3)(b), 110.6(1). A "business investment loss" is essentially a loss on the sale of stock in a private business corporation whose assets are in Canada. See *id.* § 39(1)(c). The "cumulative net investment loss" consists of the excess of investment expense over investment income. See *id.* § 110.6(1) (definition of "cumulative net investment loss"). The latter provision functions as a cross between our investment interest limitations and passive loss restrictions.

Although capital gains are treated more favorably in Canada than in the United States (particularly now because the capital gains deduction of former § 1202 of the Internal Revenue Code has been eliminated), capital losses are treated about the same. On such losses from dispositions of assets (other than those employed for personal use), a taxpayer offsets capital gains from the year of realization and then from "taxation years preceding and the three years immediately following the year." *Id.* § 111(1)(b). Because commencing in 1990 only 75% of the gain is taxable, only 75% of the loss is usable for offset purposes. See *id.* § 38(b). Unlike United States tax law, if capital gains are insufficient to offset capital losses, the latter may not offset ordinary income. An exception to this rule exists for "business investment losses." See preceding paragraph; I.T.A., *supra* note 86, §§ 3(d), 39(1)(c).

A major difference in the Canadian system is that in the year of death, excess capital losses can be used to write off ordinary income from any source, in that year and in the preceding one. See *id.* § 111(2).

92. See *id.* §§ 40(2)(b), 54(g). Section 54(g) applies a strong presumption that the owner of more than one-half hectare of property (1.24 acres) does not hold it for residential purposes. See *id.* § 54(g)(v). Thus, the gain on the excess is not sheltered from tax.

93. See *id.* §§ 70(6), 73(1). Technically, assets transferred to a spouse are deemed to have been disposed of for a price equal to the basis of the property.

94. See *id.* §§ 70(6.2), 73(1).

95. See *id.* §§ 110.6(2), (2.1), (4). See also *infra* notes 152-54 and accompanying text. The \$500,000 exemptions translate into a \$375,000 deduction from taxable gain. See *supra* note 90 and accompanying text.

96. See I.T.A., *supra* note 86, § 20(1).

ation is subject to recapture; no distinction is made between real and personal property.<sup>97</sup> Thus, to the extent that the capital cost allowance rules have allowed too much depreciation (looked at retrospectively, of course), the taxpayer has ordinary income. This cannot be offset by the exemption referred to above, which is explicitly limited to capital gains.<sup>98</sup>

Finally, a perhaps unique feature of the Canadian tax system is that the individual, not the couple, is the basic unit of taxation.<sup>99</sup> As a result, the question of "whose income is it?" is more important than it is in the United States. To ensure that interspousal gifts do not defeat the progressive rate schedules for individuals, income from property transferred and gains on subsequent dispositions by the original transferee are attributed to the original transferor.<sup>100</sup>

Canada's CR rules generally became effective for calendar years beginning in 1972, the year in which tax was first imposed on capital gains.<sup>101</sup> As part of its package of legislative reform, Canada repealed its estate tax<sup>102</sup> (and all of the Provinces have since followed suit). At the end of the discussion of the basic operation of CR in Canada, consideration will be given to the issue of choosing between the two taxes, if a choice must be made. For now it should be clear that although Canada decided for itself that only one "death tax" was appropriate, enactment of one death tax need not, from a conceptual standpoint, be accompanied by repeal of the other. Indeed, in the United States, as has been shown, equity actually requires that *both* taxes be imposed at the taxpayer's death.<sup>103</sup>

### B. *The General Application of CR Rules*

At the heart of the Canadian tax system, for our purposes, is section 70 of the Income Tax Act. Unlike section 691 of the

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97. See *id.* § 13(1).

98. See *id.* § 110.6(3).

99. There are no joint returns in Canada. See *id.* § 150. One rate schedule applies to singles and married individuals alike. See *id.* § 117(2). For a comprehensive discussion of tax consequences of marriage in the United States see Subotnik, *The Marriage Tax Revisited: An Analysis of the Tax Consequences of Marriage*, 90 W. VA. L. REV. 1127 (1988).

100. See I.T.A., *supra* note 86, §§ 74.1(1), 74.2(1).

101. See Act of Dec. 23, 1971, ch. 63, § 9, 1970-72 Can. Stat. 1311, 1916. See also *Report of the Royal Commission On Taxation*, v.3 (Ottawa; Queen's Printer, 1966) at 331-36 for its strong argument in favor of full capital gains taxation. (The report is usually referred to as the Carter Report.) A perfect compromise on this issue was reached with those who favored no capital gains tax; the inclusion rate (from 1972 through 1987) was settled at 50%. See Act of Dec. 23, 1971, ch. 63, § 38, 1970-72 Can. Stat. 1311, 1404.

102. See *id.*, § 2, 1970-72 Can. Stat. 1311, 1910.

103. See *supra*, pt. II.

Internal Revenue Code, which puts the taxpayer on a cash basis at death,<sup>104</sup> subsection 70(1) requires the taxpayer to accrue "periodic payments" such as interest, rents, and salary on a daily basis in the taxpayer's last tax return, which covers the period ending with the date of death.<sup>105</sup> Under subsection 70(2), if the taxpayer leaves "rights" or "things," such as matured bond coupons and dividends declared but not paid, their value is included in full in the taxpayer's last return.<sup>106</sup>

The key provision within section 70 is subsection 70(5).<sup>107</sup> Under paragraph (a), upon death, taxpayers are "deemed to have dis-

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104. See I.R.C. § 691 (West Supp. 1989).

105. See I.T.A., *supra* note 86, § 70(1).

106. See *id.* § 70(2). See also M. CULLING, R. FORBES & C. BROWN, *TAXATION AND ESTATE PLANNING* 64 (1984). Under § 70(2), the executor can elect to include the latter items in a separate return or, under § 70(3), to distribute them, along with the obligation to pay the tax, to estate beneficiaries. See I.T.A., *supra* note 86, §§ 70(2), (3).

107. Section 70(5) reads as follows:

**Depreciable and other capital property of deceased taxpayer.** Where in a taxation year a taxpayer has died, the following rules apply:

(a) the taxpayer shall be deemed to have disposed, immediately before his death, of each property owned by him at that time that was a capital property of the taxpayer (other than depreciable property of a prescribed class) and to have received proceeds of disposition therefor equal to the fair market value of the property at that time;

(b) the taxpayer shall be deemed to have disposed, immediately before his death, of all property of a prescribed class owned by him at that time and to have received proceeds of disposition therefor equal to,

(i) where the fair market value of that property at that time exceeds the undepreciated capital cost thereof to the taxpayer at that time, the amount of that undepreciated cost plus 1/2 of the amount of the excess, and

(ii) in any other case, the fair market value of that property at that time plus 1/2 of the amount, if any, by which the undepreciated capital cost thereof to the taxpayer at that time exceeds that fair market value;

(c) any person who, as a consequence of the death of the taxpayer, has acquired any particular capital property of the taxpayer (other than depreciable property of a prescribed class) that is deemed by paragraph (a) to have been disposed of by him at that time shall be deemed to have acquired it immediately after that time at a cost equal to its fair market value immediately before the death of the taxpayer;

(d) any person who, as a consequence of the death of the taxpayer, has acquired any particular depreciable property of the taxpayer of a prescribed class that is deemed by paragraph (b) to have been disposed of by him at any time shall be deemed to have acquired it immediately after that time at a cost equal to that proportion of the proceeds of disposition of all depreciable property of that class deemed by paragraph (b) to have been received by the taxpayer that the fair market value immediately before the death of the taxpayer of the particular property is of the fair market value at that time of all of that property of that class . . . .

*Id.* § 70(5). Therefore, if the fair market value is less than the undepreciated capital cost,

posed" of their "capital property."<sup>108</sup> Taxpayers are also deemed to have received "the fair market value of the property at that time."<sup>109</sup> Thus, gain or loss would be reported as if the property had been sold for cash. The basis of the property (the term used by the Income Tax Act is "adjusted cost base")<sup>110</sup> to the successor in interest is the same fair market value.<sup>111</sup>

A special rule applies where the decedent holds depreciable property.<sup>112</sup> If the fair market value exceeds the undepreciated capital cost, the deemed proceeds of sale are the undepreciated capital cost plus one-half of the difference between the two values. The deemed sale price would again be the deemed purchase price for purposes of subsequent transactions by the deemed buyer.<sup>113</sup>

Assume, for example, that the decedent holds an asset with an original cost of \$50,000 and that \$15,000 of depreciation has been taken on the asset so that the undepreciated cost is \$35,000. The fair market value is \$45,000. In this case the deemed sale is at the price of \$40,000, and the gain is \$5,000. The successor's basis is also \$40,000.

Why is there a special rule for depreciable property? It would appear that there was some concern about the liquidity problems of estates because on some or all of any recognized gain the taxpayer would be ineligible for the capital gains exemption and exclusion.<sup>114</sup> The solution adopted puts only one-half of the burden of recapture on the decedent.

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the fair market value plus one-half of the excess represents the deemed proceeds of sale. Thus, if a fair market value were \$15,000 and the undepreciated capital cost were \$35,000, the deemed sale would take place at \$25,000, and there would be a loss of \$10,000. Presumably, the purpose for the rule in this case is simply to achieve a kind of symmetry with the case of gain.

108. *Id.* § 70(5)(a).

109. *Id.*

110. *See id.* §§ 54(a), 248(1).

111. *See id.* § 70(5)(c).

112. *See id.* § 70(5)(b).

113. *See id.* § 70(5)(d). If a decedent leaves more than one item of property of the same depreciation class, the successor's basis of property is determined by prorating the basis of all of the items of property in that class to each item in proportion to its fair market value. Thus, carryover basis will not apply with respect to each item in the class. (The undepreciated capital cost is defined in § 13(21)(f). *See id.* § 13(21)(f).)

Section 70(5)(b) provides that if the fair market value is lower than the undepreciated capital cost, the fair market value plus one-half of the excess represents the deemed proceeds of sale. *See id.* § 70(5)(b). If in the example, *supra* note 107, the fair market value were \$15,000, the deemed sale would take place at \$25,000. In this case, there would be a loss of \$10,000.

114. *See supra* note 98 and accompanying text.

Deemed disposition rules apply to inter vivos transfers<sup>115</sup> as well as to transfers by inheritance, a feature inhibiting the gifting of appreciated property (which has been an important part of American estate planning). With its emphasis on neutrality between gifts and bequests, the Canadian system is, in an important way, more rational than ours. Although we openly accept the notion that gifts and bequests are closely related economically—witness the unification of the estate and gift tax systems<sup>116</sup>—the United States tax consequences of these two types of transfers are significantly different. Here although legatees and devisees take a stepped-up basis,<sup>117</sup> donees ordinarily receive a carryover basis.<sup>118</sup> The Canadian deemed disposition rules prevent this kind of distortion.<sup>119</sup>

Actual and deemed dispositions of “personal-use” property<sup>120</sup> in Canada are subject to a de minimis exception. On transfers of these assets, both the minimum basis and disposition price are assumed to be at least \$1,000.<sup>121</sup> This means that no gain will be recognized unless the actual selling price (or in the case of a deemed disposition, the fair market value) exceeds the higher of the basis or \$1,000. Thus, most household items will produce little, if any, tax, and record-keeping burdens are lightened. As in United

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115. See I.T.A., *supra* note 86, § 69(1)(b). The deemed disposition rules can sometimes apply even without a transfer of property. Section 45(1)(a) requires such treatment if the holder of property shifts its use from business to personal and vice versa. See *id.* § 45(1)(a). This rule has the advantage of forcing the taxpayer to come to grips with the problem of valuation immediately while valuation data is available.

116. See I.R.C. § 2001(b) (Supp. V 1987).

117. See *id.* § 1014(a) (1982).

118. See *id.* § 1015(a) (1982).

119. This is not to suggest that there are no special rules for gifts in Canada. For one thing, there is no exception to the general rule for gifts of depreciable property under the Canadian system, see *supra* note 112 and accompanying text; the fair market value is the deemed selling price and basis to the donee, and recapture applies in full. See I.T.A., *supra* note 86, §§ 69(1)(b), 13(1). (Gifts of appreciated property are thus especially painful.) Moreover, if the transfer is part gift and part sale, the donor is deemed to sell for fair market value, see *id.* § 69(1)(b), but apparently (and inexplicably) the donee/buyer takes a basis of the value of the consideration he transferred. Section 69(1)(c) apparently does not apply because the donee acquired the property in part “by purchase.” Thus, there is a strong risk of a double tax in these transactions.

To eliminate hardship resulting from good faith differences in valuations between taxpayers and the tax authorities, it is possible under some circumstances for the parties to revise the proceeds of any gift/sale. See B. ARNOLD, D. MCNAIR & C. YOUNG, *MATERIALS ON CANADIAN INCOME TAX* 653 (1987). Although not frequently used in the United States, the “price-adjustment clause” would seem to be equally useful and effective here. See, e.g., *King v. United States*, 545 F.2d 700, 703-06 (10th Cir. 1976).

120. See I.T.A., *supra* note 86, § 54(f).

121. See *id.* § 46(1).

States tax law, losses on sales of personal-use property cannot be deducted.<sup>122</sup>

Finally, we consider the trust and generation-skipping deemed disposition rules. One of the major complaints about the early American CR proposals was that they included no generation-skipping provision<sup>123</sup> so that through the use of trusts, deemed disposition could be deferred for several generations. Mindful of the importance of such a provision, Canada enacted section 104, under which, except for "spousal trusts," trusts are ordinarily subject to CR twenty-one years after the later of January 1, 1972 or the date that the trust was created, if trust assets are not distributed.<sup>124</sup> (Because the CR rules were made effective for years beginning on January 1, 1972, the day of reckoning is well-nigh upon us.) By contrast, actual dispositions of capital from a trust ordinarily do not result in a deemed disposition;<sup>125</sup> hence it is important in Canada to give the trustee discretion to terminate the trust whenever there is a significant possibility of appreciation in the value of the corpus.

As for basis, because the trust received property in a taxable transaction, it is assigned a basis equal to the fair market value of the corpus at the time of transfer by the decedent.<sup>126</sup> When the trust terminates, the beneficiary carries over the trust's basis in the property because there is no deemed disposition.<sup>127</sup> If there is a deemed disposition of property while in the trust, there is a step-up in basis.<sup>128</sup> Again, the foregoing rules do not apply to spousal trusts.

### C. Degree of Retroactivity

Sensitive to charges that the tax rules (including the deemed disposition rules) might be unfair if they taxed appreciation accruing prior to enactment of the capital gains tax, Parliament provided a mechanism that would exempt gains accruing prior to December 31, 1971. With respect to most assets owned on that date, the

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122. See *id.* § 40(2)(g)(iii). To be most precise here, the I.T.A. recognizes a quasi personal-use asset. It is called "listed personal property" and is defined as such property as artwork, stamps, or coins. See *id.* § 54(e). Losses from transactions involving these assets are deductible to the extent of gains from such property. See *id.* § 41(2).

123. See Waterbury, *supra* note 10, at 1.

124. See I.T.A., *supra* note 86, § 104(4) (applicable to "personal" and "prescribed" trusts).

125. See *id.* § 107(2)(a).

126. See *id.* § 70(5).

127. See *id.* § 107(2)(b).

128. See *id.* § 104(4).

"adjusted cost base" would be based on either (1) the valuation day value or (2) an amount that is neither the greatest nor the least of the following amounts: the actual cost, the valuation day value, or the proceeds of disposition (the "median rule" or the "tax free zone" method).<sup>129</sup>

#### D. The Spousal Rollover

A postponement of the deemed disposition tax burden is available on inter vivos transfers or transfers at death to a spouse.<sup>130</sup> Moreover, consistent with the theory of the marital trust in American estate and gift tax law, deferral is also available for transfers to trusts that are created for the benefit of the grantor's spouse ("spousal trusts").<sup>131</sup> To qualify for nonrecognition, the transferee trust must provide that while the spouse is alive, only the spouse will enjoy the income.<sup>132</sup> In these cases where deemed disposition does not apply, the spouse or spousal trust essentially takes a carryover basis.<sup>133</sup>

As suggested above, spousal trusts are treated differently from regular trusts.<sup>134</sup> Because property going into such a trust is not subject to deemed disposition,<sup>135</sup> a taxable disposition occurs at the death of the beneficiary spouse, regardless of whether there is an actual disposition from the trust.<sup>136</sup> When this occurs, the holder of the property takes a fair market value basis.<sup>137</sup> To determine whether tax liability results from the disposition, any gain is tested under the general and the specific exemptions to determine whether it can be sheltered.<sup>138</sup> This gain is attributable to the beneficiary spouse, so it can qualify for that spouse's capital gain exemption.<sup>139</sup>

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129. See B. ARNOLD, D. MCNAIR & C. YOUNG, *supra* note 119, at 598-99. To illustrate the first method, if the cost were \$70, the valuation day value were \$90, and the selling price were \$80, the result based exclusively on the valuation day value would be a loss of \$10. Under the second option, the adjusted cost base would be deemed to be \$80, the dollar value within the above range which produces neither a gain nor a loss. If in the above example we reversed the values for valuation day value and the selling price, the results under both methods would be the same.

130. See I.T.A., *supra* note 86, §§ 70(6)(d), 73(1)(e).

131. See *id.* §§ 70(6)(b), 73(1)(c).

132. See *id.*

133. See *id.* §§ 70(6)(d), 73(1)(e)-(f).

134. See *supra* note 124 and accompanying text.

135. See I.T.A., *supra* note 86, §§ 70(6), 73(1).

136. See *id.* § 104(4)(a).

137. See *id.*

138. See *supra* note 90 and accompanying text; *infra* notes 153-54 and accompanying text.

139. See I.T.A., *supra* note 86, § 110.6(12).

One might suppose, given these rules, that those who make gratuitous transfers would ordinarily pass appreciated property to spouses while passing remaining property to other beneficiaries. This is indeed so. There is a problem, however, with pursuing this path mechanically, because it may not be desirable to treat interspousal transfers under nonrecognition rules.<sup>140</sup> This might be the case, for example, if decedents have not exhausted their capital gains exemptions,<sup>141</sup> or if they have loss carryforwards that could offset any gain upon deemed disposition.<sup>142</sup> In these circumstances, the decedents would almost surely prefer to waive the exemption so that the spouse or trust could get a stepped-up basis. If property has depreciated in value, they might also wish to avoid nonrecognition treatment. Sections 70(6.2) and 73(1) allow the executor and donor (in the case of lifetime gifts) respectively to elect regular deemed disposition treatment.<sup>143</sup>

Even absent the above circumstances, the taxpayer may be able to ignore ordinary incentives inherent in the basis rules because, with regard to depreciable property transferred to a spouse, a special basis rule applies. The total basis of property of each depreciation class is allocated to each individual asset in that class in proportion to the fair market values of the assets in that class.<sup>144</sup> This results in carryover basis overall for the class of property, although not necessarily carryover basis for each item of property.

#### *E. The "Small Business Corporation" and Farm Exemptions*

Canada has historically offered favorable tax treatment to owners of active "small businesses" and farms, whether ownership was acquired through inter vivos transfer or at death.<sup>145</sup> In the first half of the 1980s the tax law provided neither a general nor a specific capital gains exemption. There were, however, two rollover provisions beneficial to business and farm owners. The former could roll over up to \$200,000 of gain over the course of their lives,<sup>146</sup> while the latter were eligible for an unlimited roll-

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140. See *supra* note 133 and accompanying text.

141. See *supra* note 90 and accompanying text.

142. See *supra* note 91.

143. See I.T.A., *supra* note 86, §§ 70(6.2), 73(1). There is a concept in Canadian tax law known as "superficial loss" which (in part) prevents taxpayers from recognizing losses on certain transfers to spouses. Because death is not, from all appearances, superficial, this restriction applies only to inter vivos transfers. See *id.* §§ 40(2)(g)(i), 54(i).

144. See *id.* § 70(6)(d)(i).

145. See *id.* §§ 110.6(2.1), 110.6(2); *id.* § 248(1) (definition of "small business corporation").

146. See *id.* §§ 70(9.4), 70(11)(a) (repealed by Act of Feb. 13, 1986, ch. 6, §§ 33(3), 33(5), 1986 Can. Stat. 221, 242).

over.<sup>147</sup> Only a child of the transferor could enjoy the benefits of the rollovers. The child had to be designated as transferee for the rollover benefits to be available to the transferor.<sup>148</sup>

To stimulate investment,<sup>149</sup> Parliament in 1986 introduced the general exemption, effective for 1985.<sup>150</sup> Exempting only \$20,000 of gains in that year, the exemption was scheduled to increase to \$300,000 by 1989. (It was subsequently scheduled to increase to \$500,000 by 1990.) As part of the 1986 plan, the small business rollover was repealed effective beginning in 1988.<sup>151</sup>

The plan never came into full effect. In 1988, believing that the scheduled general exemption was unnecessarily generous, Parliament decided to freeze the general exemption at the 1987 level of \$100,000.<sup>152</sup> At the same time, almost without notice or explanation, it enacted the \$500,000 exemption for small businesses<sup>153</sup> and farms.<sup>154</sup>

How will these new exemptions play out? Where there is appreciation in property, individuals owning exemption property will probably at least consider making lifetime gifts to their spouses to ensure that exemptions are not wasted in case the property owner does not die first. Moreover, such individuals will not waste their exemptions by transferring all of their property outright to spouses and claiming nonrecognition on such transfer (which would mean carryover basis to the surviving spouse). By selectively using the Canadian "marital deduction," a married owner of a small business or farm will be able to shelter \$1,000,000 of appreciation on

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147. See *id.* § 70(9).

148. See *supra* notes 146-47 and accompanying text.

149. See B. ARNOLD, D. MCNAIR & C. YOUNG, *supra* note 119, at 585.

150. Section 110.6(3) was added by Act of Feb. 13, 1986, ch. 6, § 58, 1986 Can. Stat. 221, 288-97.

151. See *id.* §§ 33(3), 33(5), 1986 Can. Stat. 221, 242. There is one principal difference between the small business and the farm rules. In the latter area, the rollover was not repealed. Thus, much like the American tax law, which allows individuals over age 55 to benefit from both an exclusion and a rollover on the sale of a residence, see I.R.C. §§ 121, 1034 (West Supp. 1989), Canadian tax law allows transferors of farm property to benefit from both the exemption and the rollover.

152. See I.T.A., *supra* note 86, § 110.6(3).

153. See *id.* § 110.6(2.1). The small business exemption is subject to the same limitations as the general exemption. See *supra* note 91 and accompanying text.

154. See I.T.A., *supra* note 86, § 110.6(2). A lower exemption amount had been prescribed by the statute prior to the 1988 amendment. The farm exemption is subject to the same limitations as the general exemption. See *supra* note 91 and accompanying text.

Under § 110.6(4), the taxpayer is limited to \$500,000 in total (that is, general and special) exemptions. See I.T.A., *supra* note 86, § 110.6(4).

such property.<sup>155</sup> In this respect, the deemed disposition game is likely to resemble the ones played in the United States to maximize the unified credit shelter.

#### *F. The Liquidity Problem*

The question arises as to how to raise money to pay the tax on a deemed disposition. Income Tax Act section 159(5) allows the taxpayer to elect to make payments on an installment basis, with interest, over no more than a ten-year period.<sup>156</sup> The taxpayer must make appropriate arrangements in these cases to collateralize this debt. The election is not available to the maker of an inter vivos gift. Because this transfer is by definition voluntary, the taxpayer can make sure that the transaction does not take place until the funds are available to pay the tax.

### IV. RECOMMENDATIONS

Most significantly, the Canadian system works. Astonishingly, given our tortured debates on the issue, the Canadian system seems to have generated no serious complaints. The issue thus becomes whether we can profit from the Canadian experience and, if so, how.

#### *A. Prior Proposals in Light of the Canadian Experience*

Perhaps a limited general exemption on capital gains constructively realized would be appropriate in the United States. Although the administrative burden of a CR system has surely been overstated,<sup>157</sup> such an exemption would stimulate investment and allow the transferor's basis to be ignored in some circumstances. If such an exemption were enacted, however, it should apply to lifetime transfers as well as to those at death. There is simply no justification for a different rule in the two cases.

A more important benefit from a general exemption is that such a provision would make the income tax system more progressive,

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155. Assume an individual purchases stock for \$10,000 in a corporation that qualifies for the small business corporation exemption, while the fair market value is \$1,000,000. Presumably, upon the individual's death, the executor will elect marital rollover treatment with respect to half the stock and deemed disposition with respect to the other half. Thus, at the beneficiary's death (assuming no change in asset values), the \$500,000 gain incurred will be sheltered under § 110.6(2.1). See *id.* § 110.6(2.1).

156. See *id.* § 159(5).

157. See *supra* pt. II.B.2.c.

making the total CR burden less regressive.<sup>158</sup> It should be noted from the previous discussion on the subject of regressivity that all the illustrations were based on a flat-rate income tax.

The exemption for gains from sales of residences is a much more serious matter. This is Canada's gaping loophole; by allowing residences to qualify for the exemption,<sup>159</sup> Canada ensures that the vast majority of taxpayers pay no tax on sales (or "deemed" sales) of homes. For 1979, this exemption, together with noninclusion of imputed income, represented an estimated loss to the Treasury almost equal to that of all other "preferential" exclusions, deductions, and exemptions combined.<sup>160</sup> The full impact of this provision on the allocation of resources in Canada is unknown, but one can speculate that its effect is profound. The exemption has been criticized for the inefficiencies it has created.<sup>161</sup>

This exemption would not work in the United States. What brings some balance to the investment world in Canada is the absence of a deduction for interest and taxes on the home;<sup>162</sup> in our system, such an exemption would be an overwhelming non-neutrality in favor of home ownership. One could argue that perhaps we should adopt the Canadian model wholesale, but until we are clear about the impact on the real estate market of such a momentous step, the status quo is preferable.

On the subject of interspousal transfers there can be no real dispute; gains here would have to be postponable, as in Canada.<sup>163</sup> Since the first CR proposal in 1963, our tax system has come a long way in treating marriage as a special relationship. In contrast to prior law, for example, transfers between spouses now produce neither income tax nor transfer tax liability.<sup>164</sup> A rule denying the

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158. See *supra* pt. II.B.2.d. To illustrate, consider our original taxpayer who bought stock for \$10,000 and saw it appreciate to \$1,000,000 in value. If a CR system is imposed and (to simplify) the income and estate tax rates are 28% and 50%, respectively, but there is a \$200,000 exemption for CR-based gain, the total tax (income tax \$221,000 and estate tax \$390,000) comes to \$611,000, or 61% of the pre-tax value of the estate. Now consider the taxpayer with the basis of \$100,000 in his stock where the fair market value is \$10,000,000. The total tax here amounts to (income tax \$2,716,000 and estate tax \$3,642,000) \$6,358,000, or 64% of the pre-tax value of the estate. In sum, an exemption amount for CR in effect makes the tax structure more progressive. This is similar to the exemption amount for the estate tax. See *supra* pt. II.B.2.d.

159. See I.T.A., *supra* note 86, §§ 40(2)(b), 54(g).

160. See B. ARNOLD, D. MCNAIR & C. YOUNG, *supra* note 119, at 586.

161. See Fulton, *Tax Preference for Housing: Is There a Case for Reform?*, in TAX POLICY OPTIONS IN THE 1980s 73-95 (1982).

162. See I.T.A., *supra* note 86, § 20(1)(c).

163. See *id.* §§ 70(6), 73(1).

164. See I.R.C. § 1041 (West Supp. 1989); *id.* §§ 2056, 2523 (West 1989).

economic unity of the married couple only upon constructive sales would simply make no sense.

There is also something for us to learn in the way Canada has solved the basis problem in interspousal transfers. Except for legislation of a special rule for gifts of multiple properties in one depreciation class,<sup>165</sup> Canada simply does not worry about inducing spouses to transfer low basis property to each other and high basis property to others. If taxpayers want the benefits of nonrecognition,<sup>166</sup> they have to pay the price. There appears to be little, if any, controversy on this issue as well.

As for the core CR provision, we could borrow the language of the Canadian Income Tax Act wholesale. Indeed, under current conditions, application of the rule could be even simpler in the United States because, absent a capital gains deduction, recapture loses its significance and the special rules for depreciable property could be eliminated.<sup>167</sup>

The de minimis rules<sup>168</sup> are worthy of serious consideration not only for CR purposes, but for regular sales as well. Although there appears to be no data on the point, it is reasonable to suppose that gains on dispositions of personal-use property are usually not reported. A de minimis rule would at least help make honest taxpayers out of many of us.<sup>169</sup>

Any CR system we adopt must have a CR rule for property held in trust. Would it be preferable to have CR triggered by the passage of time as in Canada or by the passage of life as is done in our generation-skipping tax? Although not perfect, the United States system seems better. By not imposing tax during the life of the income beneficiary, it allows a more even flow of benefits to the taxpayer. It also puts taxpayers in the same position that they would have been in if they had owned the property outright. Some alternative provision would be necessary if income went to a beneficiary more than one generation removed from the grantor.

Effective date considerations<sup>170</sup> have generally received too little attention. From a constitutional standpoint, future application of

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165. See *supra* note 144 and accompanying text.

166. See *supra* notes 130, 133 and accompanying text.

167. See *supra* notes 96-97 and accompanying text.

168. See *supra* notes 120-21 and accompanying text.

169. It seems that this aspect of tax theory is too often neglected. For example, it may well be that the tax system does not attempt to collect income tax from farmers on their personal consumption of home-grown produce not only because such a tax would be difficult to enforce against farmers, but also because widespread tax evasion in one area demoralizes taxpayers across the board.

170. See *supra* note 129 and accompanying text.

CR to pre-existing, unrealized gains is unassailable.<sup>171</sup> A contrary rule probably would have made it impossible for the Government to ever impose an estate tax on anything but "new wealth." Yet the estate tax, when challenged, has been held to come within the constitutional ambit.<sup>172</sup> More importantly, no tax provision has ever been held to be constitutionally infirm because of retroactive application.<sup>173</sup>

This is not necessarily to imply that it would not be equitable to grandfather gains accrued prior to an effective date for CR, as was done in Canada. The equity argument, however, has been overstated in this context.<sup>174</sup> We have heard the counterargument before: Taxpayers know that if they sell investment property during their lifetimes, a tax will be imposed on any gain, but they cannot be altogether sure that the economics of their investments are such that a sale would *never* be appropriate, regardless of the circumstances. Thus, the taxpayers cannot persuasively claim reliance.

Professor Graetz suggests possible alternatives to the grandfathering of pre-effective date gains.<sup>175</sup> One such alternative would make CR effective only for decedents who die more than three years after the date of enactment.<sup>176</sup> This would give taxpayers time to modify existing estate plans. A second alternative would phase in CR over a number of years,<sup>177</sup> a type of solution that seems increasingly popular today. Either of these alternatives seems preferable to the unnecessary write-off of billions of dollars of potential tax revenue, as is now the fashion.

This brings us to the special exemptions.<sup>178</sup> Should the full gain on all property be taxed, even if the property consists of a small business or a farm? From an equity perspective, the answer is yes, and we should be loathe to adopt a contrary rule. From a tax simplification perspective, however, it would seem not to matter too much, although an exemption would allow the basis of some estates to be ignored. Perhaps the key element is that notwithstanding that until 1988 the only tax benefit was a rollover, the system nevertheless worked perfectly well. The adoption of the special exemption in Canada was not motivated by serious administrative

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171. See B. BITTKER & M. MCMAHON, *supra* note 3, ¶ 1.1.

172. See generally *New York Trust Co. v. Eisner*, 256 U.S. 345 (1921).

173. See B. BITTKER & M. MCMAHON, *supra* note 3, ¶ 1.1; see generally Graetz, *Legal Transitions: The Case of Retroactivity in Income Tax Revision*, 126 U. PA. L. REV. 47 (1977).

174. See *supra* pt. II.B.2.c.

175. See Graetz, *supra* note 13, at 853-57.

176. See *id.* at 854.

177. See *id.*

178. See *supra* pt. III.E.

considerations. It seems unnecessarily generous, therefore, to give away so much of the store. To solve any liquidity problems caused by full taxation, perhaps deferral of tax payment could be provided along with deductibility of interest on installment payments.<sup>179</sup>

### B. CR or an Estate Tax?

We come now to our final question: What should be done if, notwithstanding the strong equity case for incorporating CR into the tax system, our options are limited to choosing between CR and an estate tax? Given our past inability to add a second tax applicable at death, this formulation of the question may be the practical consequence of articles such as this. In an important sense the question is not a real one because our review of CR history has shown that it has attracted only limited interest. Perhaps, however, this is because the estate tax is already in place and none of the proposals that have been advanced has raised the possibility of eliminating the estate tax.

From a revenue standpoint, the choice between CR and an estate tax is a toss-up. The transfer taxes bring in roughly \$6.5 billion, while estimates are that CR would bring in about \$5 billion.<sup>180</sup>

From a number of other vantage points, however, the Canadian solution makes more sense. Among the nonrevenue arguments advanced in support of the estate tax, three stand out for our purposes. First, the estate tax is a back-up to the income tax in which (on account of prior practice) there are numerous loopholes.<sup>181</sup> Second, the estate tax helps to break up large estates which, left unchecked, would result in the accumulation of economic and thus political power in the hands of a small number of American families.<sup>182</sup> Finally, the estate tax diminishes the likelihood of formation of an effete "leisure class."<sup>183</sup>

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179. See *supra* pt. III.F.

180. See S. SURREY, P. MCDANIEL & H. GUTMAN, *FEDERAL WEALTH TRANSFER TAXATION*, CASES AND MATERIALS 42 (1987); *supra* note 50 and accompanying text.

181. See Eisenstein, *The Rise and Decline of the Estate Tax*, 11 TAX L. REV. 223, 256 (1956).

182. The goal of estate taxation "has been—and continues to be—to decrease the inequality in the distribution of wealth, to thwart the concentration of economic (and with it, some argue, political) power." Boskin, *An Economists' Perspective on Estate Taxation*, in DEATH, TAXES AND FAMILY PROPERTY: ESSAYS AND AMERICAN ASSEMBLY REPORT 56, 57 (1977). Whether the estate tax has succeeded in this objective is another issue.

183. This drive towards equalization has drawn its strength from several sources: a moralistic abhorrence of idleness or profligacy, thought to be the result of unearned wealth; the belief that the economic well-being of the community requires that all of its members earn their own livings; and an ethical insistence

Whatever the persuasiveness of these arguments in the past, it is much diminished now. For one thing, thanks to the Tax Reform Act of 1986 and other recent legislation, the loopholes are fewer and farther between. The passive loss rules,<sup>184</sup> alternative minimum tax,<sup>185</sup> restrictions on the deductibility of "personal" interest,<sup>186</sup> lengthening of depreciation periods,<sup>187</sup> and prescription of the straight-line method for real estate<sup>188</sup>—to name just a few provisions—have combined to ensure that far fewer high gross income taxpayers escape taxation.

At the same time, wealth has spread out so significantly and inflation has had such a profound effect that individuals with asset holdings of over \$600,000 can no longer be considered a menace to the republic.<sup>189</sup> Moreover, unlike the apparent situation in Great Britain, far from turning into the idle rich, the sons and daughters of our empire-builders are going to the University of Chicago or Harvard Business Schools so that by working eighty-hour weeks, they can successfully make the family empire "world class."<sup>190</sup>

The matter is clearer yet from the administrative perspective on the estate tax versus CR issue. The estate and gift tax rules are spelled out in about forty code sections. Relating to these sections are innumerable and technical regulations, as well as judicial opinions that frequently are classifiable only as soaring flights of fancy.<sup>191</sup> Estate planning has become so other-worldly and esoteric that it makes up an entire area of professional specialization. If this entire structure could be collapsed and replaced with a few new code sections (we now know that it *can* be done), Congress

on equality of opportunity.

B. BITTKER, *FEDERAL ESTATE AND GIFT TAXATION* xxv (1984).

An inconsistency in these objectives seems not to have occurred to anyone. If our tax system actually promoted the idleness of the wealthy classes, would it not be less likely that economic and political power would be concentrated in their hands?

184. See I.R.C. § 469 (West Supp. 1989).

185. See *id.* §§ 55-57 (West Supp. 1989).

186. See *id.* § 163(h) (West Supp. 1989).

187. See *id.* § 168(c) (West Supp. 1989).

188. See *id.* § 168(b)(3) (West Supp. 1989).

189. In 1982, there were 407,000 millionaires, 32,000 of whom enjoyed a net worth in excess of \$5,000,000. See BUREAU OF THE CENSUS, U.S. DEP'T OF COMMERCE, *STATISTICAL ABSTRACTS OF THE UNITED STATES* 438-39 (108th ed. 1988) (Tables 725 and 723).

190. For an in-depth look at work and leisure (and in particular the new "greed for work") in the 1980s see L. SHAMES, *THE HUNGER FOR MORE: SEARCHING FOR VALUES IN THE AGE OF GREED* (1989).

191. Consider, for example, the following: "Although the assumptions on which it is founded are dubious [§ 2038 of the Internal Revenue Code makes no mention of it, although § 2041 does, see I.R.C. §§ 2038, 2041 (1982)], the external standard doctrine is routinely applied in the courts . . . ." B. BITTKER, *supra* note 183, at 198.

would finally be able to boast justifiably that it has simplified the tax system.

## V. CONCLUSION

Ten years ago, the chair of the Tax Section of the New York City Bar Association delivered the prestigious Hess Lecture to the membership on the subject of constructive realization. In his presentation, entitled "Taxing Unrealized Gains: The Nettle and the Flower," he forecast, "On balance, it seems likely that, although the votes for a tax on gain at death are not in Congress now, such a tax will be the ultimate solution."<sup>192</sup> In effect this Article asks, what, if anything, has changed over the intervening ten years and whether we should be working for or against realization of that prophecy today.

More precisely, this Article has examined constructive realization at death (and through gift) in theory and as practiced in Canada. The end product of this study: Viewed from the equity and revenue perspectives, the Internal Revenue Code is severely deficient—an inglorious state of affairs for when Americans are called to glory.

To redeem the tax system, and incidentally to strike a blow against (alleged) American intellectual imperialism, we should import constructive realization from Canada into the United States. If for political reasons a choice must be made between constructive realization and an estate tax, we should opt for the former.

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192. Lewis, *Taxing Unrealized Gains: The Nettle and the Flower*, 34 REC. A.B. CITY N.Y. 355, 365 (1979) (Tenth Mortimer H. Hess Memorial Lecture).