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The Tax-Free Basis Step-Up at Death, the Charitable Deduction for Unrealized Appreciation, and the Persistence of Error

As every student of the federal income tax well knows, two of the system's most glaring conceptual errors are the tax-free step-up in basis at death[1] and the deduction for unrealized appreciation in property donated to charity.[2] The two errors are closely related in both character and history.

As for character, both permit taxpayers to claim benefits which should be conditioned on the recognition of income, despite the absence of any recognition event. A basis step-up at death would be appropriate if gains were taxed at death, and a deduction for the fair market value of an appreciated asset donated to charity would be appropriate if the donation triggered taxation of the appreciation. The provisions are errors because the income tax does *not* treat either transfers at death or transfers to charity as gain recognition events.

As for history, both mistakes originated very early in the development of the modern federal income tax, and in similar ways. In each case, Congress enacted a statutory provision so vague and general that it did not address the issue, and shortly after enactment the Treasury Department promulgated a regulation introducing the conceptual error. There was no apparent intent on the part of either Congress or Treasury to subsidize bequests of appreciated property, or to subsidize charitable donations of appreciated property more heavily than cash donations; the

[1]IRC § 1014.

[2]Treas. Reg. § 1.170A-1(c)(1) ("the amount of the contribution is the fair market value of the property at the time of the gift"), as limited by Code § 170(e) (limiting the amount of the deduction to basis in certain situations).

overly-generous rules resulted from the failure of Congress to consider the issues, and from errors of tax logic made by Treasury when it addressed the issues left open by Congress.

A generation ago, Gerard M. Brannon wrote an elegant and insightful essay on "Tax Loopholes as Original Sin,"[3] in which he explained that Congress and Treasury had made a number of crucial mistakes in the early years of the income tax, because "[t]he concept of income was not clearly delineated," and "[t]he crucial background work had not been done, staff work was negligible and the political payoff was . . . not in conceptual elegance."[4] Brannon ruefully observed, "Many of our apparently insoluble current tax problems were born in the original sin of sloppy thinking about defining income at a time when it was the subject of only a minor tax. Unfortunately, as the tax became major, its original sins resisted baptism."[5]

But why were the original sins of the income tax so resistant to baptism? We all know better now, so why do these twin errors persist in the Internal Revenue Code (the Code) more than a century after the birth of the tax, and many decades after the errors were widely recognized as errors? Brannon explained: "Even where a mistake is reparable, it is hard to accomplish change *after the mistake has been in place for decades* because interests have been created and defensive institutions developed."[6]

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[3]Gerard M. Brannon, Tax Loopholes as Original Sin: Lessons from Tax History, 31 Vill. L. Rev. 1763 (1986).

[4]Id. at 1765. Both the tax-free basis step-up at death and the charitable deduction for unrealized appreciation were among the early errors identified by Brannon. Id. at 1772 (treatment of gains at death), 1773 (gifts of appreciated property to charity).

[5]Id. at 1766.

[6]Id. (emphasis added).

Brannon's account of the original sins of the income tax rings true: Congress and Treasury made conceptual errors in the early days of the tax, it took decades for the errors to be fully recognized and acknowledged, and by that time powerful interest groups benefitted by the errors were able to prevent their correction. As it turns out, however, the stories of the death basis and charitable donation mistakes are more complicated and more surprising than that simple account would suggest. In each case the error was recognized *and corrected*–partially in one case, and completely in the other–within just a few years of the original mistake. The original version of the tax-free basis step-up for gratuitous transfers applied both to intervivos gifts and to bequests; quickly recognizing the mistake, Congress corrected it in 1921 as to gifts, while leaving in place the error as to bequests–despite widespread understanding that the gift and bequest basis issues were conceptually identical. Treasury recognized its mistake with respect to charitable contributions even earlier, and fully corrected it by regulation in 1920. Three years later, however, the Treasury Department of a different presidential administration withdrew the 1920 regulation and reintroduced the error in a new regulation. The surprise, then, is that the errors are still with us today *despite* early detection and corrective action–because of an incomplete correction in the case of noncharitable gratuitous transfers, and because of a reversal of the corrective action in the case of charitable donations.

Beyond their parallel early histories, the two errors also have strikingly similar later histories. In each case, Congress eventually managed (to the considerable surprise of many observers of income tax politics) to pass legislation correcting the error in significant part–in 1976 replacing the tax-free basis step-up at death with a carryover basis regime, and in 1986 disallowing a deduction for unrealized appreciation in charitable gifts for purposes of the alternative minimum tax (AMT)–only to repeal those reforms, with retroactive effect, a few years later.

This essay recounts, as a study in the remarkable persistence of some early errors even when the errors were promptly recognized and addressed, the legislative and administrative histories of the tax-free basis step-up at death and the charitable deduction for unrealized appreciation. Part I describes the early development of the basis rules for property transferred by gift or bequest, and Part II covers the early history of the charitable deduction for appreciated property. Parts III and IV are concerned with less ancient events. Part III recounts the short unhappy life of the 1976 carryover basis reform, and Part IV does the same for the 1986 AMT reform.

I. The Basis of Property Received by Gift or Bequest

As enacted in 1913, the original version of the modern federal income tax provided that the base of the tax included "the income from but not the value of property acquired by gift, bequest, devise or descent."[7] In the case of a gift or bequest of appreciated stock (for example), two things were clear from the 1913 statute: the transferee was not required to include in his income the value of the stock in the year in which he received it, and the transferee was taxable in the years in which he received any post-transfer dividends on the stock. The statute did not, however, specify how a transferee was to calculate his gain or loss upon an eventual sale of the stock. Was his basis in the stock its value at the time of the gift or bequest, a carryover basis from the transferor, or something else?

On January 5, 1914–rather remarkably, just three months after the October 3, 1913

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[7]Revenue Act of 1913, Pub. L. 63-16, § II.B, 38 Stat. 114, 167.

enactment of the income tax statute–the Treasury Department issued a sixty-page set of regulations covering the entirety of the statute.[8] Article 4(d) of the regulations restated the statutory language and added italics: "Gross income includes . . . the *income* from, but not the value of, property acquired by gift, bequest, devise, or descent."[9] Similarly, Article 5(a) specified that gross income did not include "*Value* of property acquired by gift, bequest, devise, or descent during the year."[10] The regulations were no more helpful than the statute itself in resolving the basis question. The Article 5(a) year-of-receipt exclusion for gifts and bequests could be either a deferral provision (in which case the transferee's basis would be a carryover basis from the transferor) or a permanent exclusion provision (in which case the transferee's basis would be the value of the property at the date of the transfer). To resolve the ambiguity, later in 1914 Treasury issued a ruling explaining that if property acquired by gift was "subsequently sold at a price greater than the appraised value at the time the property was acquired by gift, the gain in value is held to be income and subject to tax under the provisions of the Federal income-tax law."[11] By 1918 there was a companion ruling providing that "[t]he appraised value at the time of the death of a testator is the basis for determining gain or profit upon sale subsequent to the death."[12]

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[8]Regulations No. 33, Law and Regulations Relative to the Tax on Income of Individuals, Corporations, Joint Stock Companies, Associations, and Insurance Companies (January 5, 1914).

[9]Id. at 30.

[10]Id.

[11]Treasury Decision 2090 (Dec. 14, 1914), 16 Treas. Dec. 259, 267.

[12]Supplement to Treasury Decisions (T.D. 2690), Regulations No. 33 (Revised) Governing the Collection of the Income Tax Imposed by the Act of September 8, 1916, as

Looking at the 1914 regulations and the gift and bequest rulings with the benefit of a century of experience with the federal income tax, it is impossible not to wonder how the drafters of the regulations and the rulings could have been–to be blunt–so foolish as to have blessed the wholesale avoidance of tax on capital gains by the simple expedient of transferring appreciated assets to family members in anticipation of sale, rather than simply selling the assets oneself. Given that the statutory language did not compel this result, why did Treasury give away nearly the entirety of the taxation of capital gains? Following Brannon, one possible explanation is simple mistake. Errors–including some major ones–were inevitable in a project to write, in just three months, regulations covering the entirety of a new tax unfamiliar to the regulators. Beyond mere error, there was the influence of the income tax of the United Kingdom–the existing foreign income tax most prominent in the minds of the writers of the 1914 regulations–which did not tax capital gains at all.[13] As Marjorie Kornhauser has demonstrated in her definitive work on the early history of capital gains taxation under the federal income tax, from 1913 until 1921 Treasury's interpretation of the income tax as encompassing capital gains was controversial, and it was unclear whether Treasury's interpretation would withstand judicial challenge.[14] If total exemption of capital gains was thinkable based on the UK model, then basis rules allowing for widespread self-help exemption might have seemed unexceptionable. In addition, the trust law

Amended by the Act of October 3, 1917, at 11 (1918).

[13]The income tax of the United Kingdom did not include a general tax on capital gains until 1965. Hugh J. Ault & Brian J. Arnold, Comparative Income Taxation: A Structural Analysis 123 (2d ed. 2004).

[14]Marjorie E. Kornhauser, The Origins of Capital Gains Taxation: What's Law Got to Do with It?, 39 Sw. L. J. 869 (1985).

distinction between principal and income–under which capital gains are assigned to principal rather than income–may have influenced the Treasury's misunderstanding of the role of the concept of basis in an income tax.[15] Finally, there was the statutory declaration that income did not include the value of property received by way of gift or bequest; for regulators not accustomed to the distinction between deferral and exclusion provisions, it would have been easy to overread the statute as implying a permanent exclusion, rather than as merely being silent on the question of permanent exclusion versus deferral.

Even with a rule treating basis as equal to date-of-transfer value, the regulations could have protected the integrity of the taxation of capital appreciation if they had included a rule treating the making of a gift or bequest as a realization event to the transferor, with the transferor realizing gain or loss as if she had sold the property for its transfer-date value. Although nothing in the statute expressly called for that approach, neither did anything in the statute clearly foreclose it. Interestingly, and perhaps a bit surprisingly, the regulations issued by the Comptroller of the State of New York under the New York State income tax *did* treat the making of a gift (whether to relatives or to charity) as an occasion for taxing the donor on the appreciation in the gifted property; however, in two 1921 companion cases the Appellate Division of the Supreme Court of New York held those regulations invalid as contrary to the New York income tax statute.[16] In any event, there is no indication that the Treasury even

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[15]Calvin Johnson, The Undertaxation of Holding Gains, 85 Tax Notes 807, 813 (1992) (explaining that, in the early years of the 1913 income tax, "'capital' was thought to refer to some tangible thing, whatever its value, rather than to a monetary account keeping track of what has been taxed").

[16]Brewster v. Wendell, 188 N.Y.S. 510 (1921); Wilson v. Wendell, 188 N.Y.S. 273 (1921). According to a news report, the Comptroller decided not to appeal its losses in the

considered taking such a bold position in the regulations implementing the 1913 federal income tax.[17]

It did not take taxpayers long to notice and take advantage of the tax avoidance opportunities created by Treasury's regulations and rulings. The use of gifts to avoid capital gains taxes was not infrequently discussed in newspaper columns, especially in a long-running tax question-and-answer column in the *Wall Street Journal,* " Answers to Inquirers" (featuring the slogan, "Intelligent Inquiry is the Public's Great Safeguard"). In a column from 1920, an inquirer referred to several earlier columns discussing a donor's basis in gifted property: "[I]t would seem that . . . by buying at 90, deciding to take profits at 115, it is only necessary to give the stock to your wife with instructions to sell, and the profit will all remain in the family. This seems to me to so easily permit evasion of the income tax law that there must be further explanation for it somewhere."[18] The anonymous columnist replied, "There is no further explanation. Under the Federal law, no taxable profit is realized when stock is given away, even though the wife immediately sells it at the market value and thus keeps the profits in the family."[19] The columnist did note, however, that legislation was pending (passed by the House,

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Appellate Division. "Denies Right to Tax Stocks Sold at Loss," New York Times, May 5, 1921, at 32.

[17]In addition to the likelihood that federal regulations treating gifts as realization events would have met the same fate as the New York State regulations as a matter of statutory interpretation, it is also probable that invalidation of such regulations would have followed from the Supreme Court's constitutionalization of the realization requirement in Eisner v. Macomber, 252 U.S. 189 (1920).

[18]"Answers to Inquirers," Wall Street Journal, September 11, 1920, at 2.

[19]Id.

and under consideration by the Senate) under which "if the wife sells at 115 she will have to pay tax as if she had bought at 90."[20]

As indicated by "Answers to Inquirers," Congress gradually awakened from its slumbers and realized that Treasury's interpretation of the income tax laws had effectuated something close to an administrative repeal of the taxation of capital gains. Urged by Treasury to put an end to the massive evasion of capital gains taxation, Congress considered legislative revisions. It is a bit of a puzzle why Treasury waited for Congress to fix the problem by legislation, rather than fixing the problem itself by regulation or even by ruling. Nothing in either the statute or the regulations clearly called for a date-of-transfer basis in the case of either gifts or bequests. Treasury had created the problem with its rulings, and it might have solved the problem by issuing new rulings or regulations.

As detailed below, when Treasury (around the same time) realized it had created a closely analogous problem by allowing charitable deductions for unrealized appreciation in donated property, it fixed the problem itself by issuing a new ruling limiting the deduction to the taxpayer's basis in the donated property.[21] Why Treasury chose to wait for legislation in one situation, but to act itself in the other, is unclear. The dubious gift basis ruling was a few years older than dubious charitable deduction ruling, and the gift basis ruling must have been of considerably greater economic consequence than the charitable donation ruling, but those considerations scarcely compelled reliance on legislation in one case and on a new ruling in the

[20]Id.

[21]As also detailed below, however, a few years after Treasury issued one ruling solving the problem, it issued yet another ruling resurrecting the problem.

other. Perhaps a better explanation relates to the fact that in the non-charitable context Treasury–as detailed below–urged Congress to continue the date-of-transfer basis rule for bequests, even as it called upon Congress to adopt a carryover basis rule for lifetime gifts. Treasury may have recognized that having inconsistent basis rules for gifts and bequests violated income tax logic, and may have thought that Congress had greater leeway to violate tax logic in legislation than tax administrators had to violate tax logic by ruling or regulation.

In any event, the Senate Finance Committee held hearings in 1921 to consider whether it should do Treasury's bidding on the gift basis issue. In May the Committee heard from Edwin R. A. Seligman, professor of economics at Columbia University, who was among the handful of most influential academic experts on the taxation of income.[22] Seligman began by noting the "notorious fact that our income tax differs from the British income tax in that we count as income accretions to capital."[23] Seligman opined that the American practice of taxing capital gains was "economically justified," but expressed concern that under the current law (as interpreted by the Treasury Department) "it will be relatively easy to evade the tax legally by simply turning over one's securities to one's wife or son or a friend as a gift. . . . Unless we stop that gap before business becomes good again we shall lose the hundreds of millions of taxes

[22]Ajay K. Mehrotra, Making the Modern American Fiscal State: Law, Politics, and the Rise of Progressive Taxation, 1877-1929, 86 (2014) (describing Seligman as "at the forefront of the intellectual and political movement for the graduated taxation of incomes, profits, and wealth transfers").

[23]Testimony of Edwin R. A. Seligman, Internal-Revenue Hearings on the Proposed Revenue Act of 1921, Committee on Finance, United States Senate, 67th Cong. 1st Sess. (May 9-27), at 473.

which we would otherwise get."[24]

To close this massive loophole, Seligman recommended to the Senate not carryover basis (which was the approach taken in the bill passed by the House and under consideration in the Senate), but the New York State approach of taxing the donor on the appreciation at the time of the gift. According to Seligman, carryover basis was "a very inequitable method. The old saying is that you should not look a gift horse in the mouth; but if [the House] bill should ever become a law we should always be looking a gift horse in the mouth because of the risk of losing pretty much all of our gift."[25] In Seligman's opinion, "If you are going to impose [an income tax on appreciation in] gifts, you should tax the donor, not the donee. If you do that, you will stop the gap."[26] Seligman did not mention that, just a few days before his testimony, the attempt of the New York State Comptroller to tax donors upon the making of gifts of appreciated property had suffered what proved to be a fatal judicial defeat.[27] However, the defect in the Comptroller's attempt to tax donors–that such taxation was, in the view of the Appellate Division, contrary to the New York State income tax statute–would not have had a parallel at the federal level if Congress had enacted a statute clearly mandating the taxation of donors.

The Senate Finance Committee hearings continued in September, with extensive testimony from economist Thomas S. Adams. Adams was perhaps the only public finance economist of the time whose influence on the legislative development of the income tax

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[24]Id. at 473-74.

[25]Id. at 474.

[26]Id.

[27]Brewster v. Wendell, supra note 16; Wilson v. Wendell, supra note 16.

exceeded that of Seligman.[28] From 1917 to 1923 he served as Treasury's principal advisor on tax policy and administration.[29] He has been aptly described as the father of the 1921 Revenue Act.[30] At the time he "had no rival" for the attention of the tax-writing committees.[31]

Adams told the Senate Finance Committee, "Perhaps the greatest abuse of the income tax in recent years has been through gifts" of appreciated property followed by a prompt sale by the donee.[32] Adams explained that this tax avoidance technique was permitted under existing law: "[W]here there seems to be a bona fide gift, we are unable to do anything. The practice is said to have been widespread and prevalent. We hear of it from every point."[33] Treasury, Adams explained, proposed putting an end to this evasion by the enactment of a carryover basis rule in the case of intervivos gifts.[34] He dismissed without explanation the alternative of taxing the donor on appreciation at the time of the gift: "I do not think that the donor can be taxed. But I

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[28]John Witte, The Politics and Development of the Federal Income Tax 91 (1985) (describing Adams as "the leading tax expert of his time"). For a review of Adams' career and the extent of his influence, see Michael J. Graetz & Michael M. O'Hear, The "Original Intent" of U. S. International Taxation, 46 Duke L. J. 1021, 1028-33 (1997).

[29]Id. at 1029.

[30]Carlton Fox, Memorandum Concerning Whose Ideas Formed the Basis of the 1921 Revenue Revision, reprinted in 95 Internal Revenue Acts of the United States 1909-1950: Legislative Histories, Laws, and Administrative Documents (Bernard D. Reams, ed., 1979).

[31]Graetz & O'Hear, supra note 28, at 1031.

[32]Internal Revenue Hearings on H.R. 8245 (Part I), Senate Finance Committee, 67th Cong., 1st Sess., 24 (1921).

[33]Id.

[34]Id.

believe that the donee may be taxed when he sells the property acquired by gift."[35] Adams probably based his conclusion that the donor could not be taxed on concerns about liquidity and (in some cases) valuation, but the Committee's interest in that option was so slight that no one pressed him for an explanation.

Although the majority of the Committee members eventually voted in favor of Adams' preferred solution of carryover basis,[36] several members strongly objected to the proposal. Senator Porter McCumber (R., N.D.) objected that carryover basis amounted to a penalty on donees of appreciated property:

> Suppose you give to your child . . . property that cost you 30 points 10 years ago and is now worth 80 points. . . . Suppose [a year or two later the child sells the stock] for 81 points. Why should that child be penalized by having to pay a tax on a profit based upon the value of that property 10 years ago? It has not made a profit. Why should it be compelled to pay a profit if it has not received it?[37]

Senator Reed Smoot (R., Utah) took Senator McCumber's objection and promoted it to constitutional status: "The constitutional question which appears to me is as to the power to tax a person on income gained or profit made where no gain has occurred to the individual."[38]

In contrast with the stormy reception of the Treasury's carryover basis proposal for gifts, the Committee accepted almost without discussion the Treasury's proposal to continue–and for the first time to specify in legislation–the rule that basis equaled date-of-death value in the case of property acquired from a decedent. Adams explained that permanent removal from the base of

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[35]Id. at 197.

[36]Id. at 197.

[37]Id. at 25.

[38]Id. at 197.

the income tax of appreciation in property held at death was acceptable, despite the unacceptability of the same treatment of appreciation in intervivos gifts, "because the estate or inheritance tax has been imposed. That is the thought behind that."[39] Apparently satisfied with Adams' explanation, the committee members asked no further questions on that point.

And so, at the urging of Adams on behalf of the Treasury, Congress provided in the Revenue Act of 1921 that the basis of property acquired by gift (after December 31, 1920) "shall be the same as that which it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift,"[40] and that the basis of property acquired from a decedent "shall be the fair market price or value of such property at the time of such acquisition."[41] The political acceptability of carryover basis for gifts was enhanced by its being included in legislation featuring–for the first time in the history of the modern federal income tax–a top capital gains rate lower (much lower) than the top rates on ordinary income. Whatever the force of Senator McCumber's unfairness-to-donees complaint might have been if selling donees had faced ordinary income tax rates topping out at 58 percent,[42] that force was much reduced when donees faced the prospect of a capital gains tax of no more than 12.5 percent.[43]

From a twenty-first century perspective, the most interesting aspect of this story is not the

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[39]Id. at 27.

[40]Revenue Act of 1921, Pub. L. 67-98, § 202(a)(2), 42 Stat. 227, 229.

[41]Id., § 202(a)(3), 42 Stat. at 229.

[42]Id., § 210, 42 Stat. at 233 (normal tax rate of 8 percent), and § 211(2), 42 Stat. at 235-37 (surtax rates, including top surtax rate of 50 percent).

[43]Id., § 206(b), 42 Stat. at 233.

adoption of carryover basis for gifts; with the benefit of hindsight, that seems to have been more-or-less inevitable. Rather, the main interest is in the introduction of the inconsistency–which persists to this day–between the deferral of tax on unrealized appreciation in property transferred by gift and the permanent forgiveness of tax on unrealized appreciation in property transferred at death. The tax-free step-up in basis at death (now embodied in section 1014 of the Code) appears on every short list of most egregious structural errors in the federal income tax; no less a tax policy luminary than Stanley Surrey–who might fairly be called the Thomas S. Adams of a later era–described it as "the most serious defect in the federal tax structure."[44] It comes as something of a surprise, then, that the blame for that "most serious defect" appears to belong in significant part to none other than the great Thomas S. Adams. Given that Adams was able to persuade Congress to follow his lead with respect to the basis of gifted property, he might well have been able to persuade Congress also to enact carryover basis for property transferred at death. We will never know, because he did not try.

The policy distinction Adams drew between gift basis rules and bequest basis rules depended on the fact that in 1921 the federal estate tax existed but the federal gift tax did not. The estate tax had been introduced in 1916,[45] but the first gift tax was not enacted until 1924[46]

[44]Stanley Surrey & Jerome Kurtz, Reform of Death and Gift Taxes: The 1969 Treasury Proposals, the Criticisms, and a Rebuttal, 70 Colum. L. Rev. 1365, 1381 (1970).

[45]Revenue Act of 1916, Pub. L. 64-271, §§ 200-212, 39 Stat. 756, 777-80..

[46]Revenue Act of 1924, Pub. L. 68-176, § 319, 43 Stat. 253, 313.

(only to be repealed in 1926,[47] and then reenacted in 1932[48]). If the gift tax had existed in 1921, Adams could not have justified inconsistent basis rules for gifts and bequests on the grounds that a transfer tax applied to bequests but not to gifts. In that case, would Adams and Treasury have been as comfortable with stepped-up basis for gifts as they were with stepped-up basis for bequests, on the grounds a transfer tax applied in both cases? Or would they have examined more closely the argument that the application of a transfer tax justified a stepped-up basis, concluded that the argument was wrong, and advocated carryover basis for bequests as well as for gifts? Or would they have offered different reasons for the inconsistency between their two proposed basis rules? For example, they might have defended applying carryover basis reform only to gifts on the grounds that a loophole that could be exploited simply by making a gift posed a much greater threat to the fisc than a loophole that could be exploited only by dying, or on the grounds that obtaining cost basis information from a decedent was more difficult than obtaining such information from a living donor.

In any event, Adams' claimed reconciliation of Treasury's basis proposals–that the existence of a transfer tax justifies a stepped-up income tax basis–does not fare well under scrutiny. The fundamental problem is that the income tax and the estate tax are conceptually distinct taxes with conceptually distinct bases. Thus it makes perfect sense for appreciation transferred at death to be subject to the income tax because it is gain, and for that same value to be subject to the estate tax because it is gratuitously transferred.[49] Moreover, there has never

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[47]Revenue Act of 1926, Pub. L.69-20, § 1200, 44 Stat. 9, 125-26.

[48]Revenue Act of 1932, Pub. L. 72-154, § 501, 47 Stat. 169, 245.

[49]Lawrence Zelenak, Taxing Gains at Death, 46 Vand. L. Rev. 361, 364 (1993).

been a rule that both taxes cannot apply to the same value. Both in 1921 and today, if a taxpayer sells appreciated property during life and holds the (after-tax) sales proceeds until death, the income tax applies to the gain in the year of sale *and* the estate tax applies to the sales proceeds still held at death. Adams offered no explanation as to why the application of both taxes was appropriate when the sale preceded death, but only one tax should apply when death preceded the sale.

But even accepting, for the sake of argument, the dubious notion that the imposition of an estate tax could substitute for the imposition of an income tax on appreciation, the 1921 Adams-Treasury support of stepped-up basis at death would still not have made sense in most cases. As noted earlier, in addition to specifying the basis rules for gifts and bequests the Revenue Act of 1921 introduced into the federal income tax special rates for capital gains. Under the Act, capital gains were generally taxed at 12.5 percent (with ordinary income rates below 12.5 percent applying to taxpayers with incomes below $16,000).[50] Substantial amounts of capital gain, then, were taxed at a flat rate of 12.5 percent under the 1921 Act. How much estate tax had to be imposed for the stepped-up basis to apply to eliminate the potential for a 12.5 percent capital gains tax? It might seem that elimination of a 12.5 percent income tax could be justified, if at all, only by an estate tax imposed at a rate of at least 12.5 percent. But that was not remotely how the 1921 legislation worked. The first $50,000 of value transferred at death was exempt from the

[50]Revenue Act of 1921, Pub. L. 67-98, § 206(b), 42 Stat. 227, 233 (providing for a maximum rate of 12.5 percent on capital gains). For the lower rates on a taxpayer with income below $16,000, see id. § 210, 42 Stat. 233 (normal tax) and § 211(2), 42 Stat. 235-37 (surtax).

estate tax,[51] and the rates above the exemption level started out very low–1 percent on the first $50,000 of taxable estate, 2 percent on $50,000 to $150,000, 3 percent on $150,000 to $250,000, 4 percent on $250,000 to $400,000, and so on.[52] Marginal rates equal to or greater than 12.5 percent applied only to the portion of a taxable estate in excess of $2 million.[53] Adams did not explain why the imposition of no estate tax (in the case of estates of $50,000 or less) or of an estate tax at a rate well below 12.5 percent (in the case of most taxable estates) was an acceptable substitute for a 12.5 percent capital gains tax.

If Congress had consistently applied the (il)logic of 1921, it would have replaced carryover basis for gifts with stepped-up basis when it introduced the gift tax in 1924, and when it reintroduced the gift tax in 1932. Instead, neither the 1924 nor the 1932 enactment of the gift tax was accompanied by any change in the rules governing the basis of property acquired by gift. Decades later, in 1958, Congress did amend the Code to permit an increase in the basis of gifted property equal to the gift tax attributable to the property,[54] but this fell far short of being the equivalent of the basis step-up for property acquired from a decedent. If a particular gift did not generate a gift tax liability, the 1958 amendment would produce no basis increase. Or if (for example) a gift of property with a basis to the donor of zero and a value of $100 generated a gift

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[51]Revenue Act of 1918, Pub. L. 65-254, § 403(a)(4), 40 Stat. 1057, 1098 . According to the inflation calculator of the Bureau of Labor Statistics, one dollar in 1921 is the equivalent of $13.47 in 2016. http://www.bls.gov/data/inflation_calculator.htm.

[52]Id., § 401, 40 Stat. at 1096-97.

[53]Id.

[54]Technical Amendments Act of 1958, Pub. L. 85-866, § 43(a), 72 Stat. 1606, 1640 (enacting IRC § 1015(d)).

tax of $10, the donee would take the property with a basis of $10–a far cry from the $100 basis that would have resulted from inheriting the property. The Tax Reform Act of 1976 limited the gift tax basis increase to the gift tax paid on the unrealized appreciation in the gift,[55] making the increase an even farther cry from the step-up in basis at death. In short, the inconsistency between the gift and bequest basis rules has persisted to this day, despite the fact that the justification for the inconsistency offered in the legislative history of the 1921 Act was premised on a state of affairs–the existence of an estate tax combined with the nonexistence of a gift tax–that disappeared more than eighty years ago.

Although from today's perspective the explicit statutory blessing of stepped-up basis at death is the controversial aspect of the 1921 basis legislation, the locus of controversy was very different in 1921. The enactment of stepped-up basis at death attracted little attention, since it merely confirmed what had been the administrative practice. Carryover basis for gifts was the innovation, and as such it attracted considerably more commentary.

Speaking at the Annual Conference of the National Tax Association (NTA) shortly before the Revenue Act of 1921 became law, J. F. Zoller of General Electric described the gift-to-relative strategy for avoiding tax on stock profits, and explained–seemingly with approval, and certainly without criticism–the carryover basis provision in the pending legislation as "an attempt to close that avenue of escape from the payment of a tax upon actual profits."[56] The only recorded criticism of carryover basis at the NTA meeting came from Franklin Carter, a member

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[55]Tax Reform Act of 1976, Pub. L. 94-455, § 2005(c), 90 Stat. 1520, 1877 (enacting IRC § 1015(d)(6)).

[56]National Tax Association, Proceedings of the Fourteenth Annual Conference on Taxation 304 (1921).

of the NTA's committee on taxation of banking institutions, who thought that requiring donees to ascertain the cost basis of their donors was unworkable: "This provision means that the cost to the donor of every gift must be determined by the donee when he disposes of it. It means that every wedding, Christmas, birthday or other family gift, if disposed of, must have the cost ascertained. . . . Such a provision is . . . incapable of satisfactory enforcement."[57] Carter's complaint bears a striking resemblance to the complaints made in the late 1970s about the unworkability of carryover basis at death.[58] Those later complaints contributed to the retroactive repeal of the carryover-basis-at-death provision included in the Tax Reform Act of 1976.[59] Of course, the later opponents of carryover basis at death had an argument unavailable to Carter–that a transferee cannot obtain basis information from a deceased transferor.

In an opinion column published in the *New York Times* after the proposed Revenue Act had passed the House but before enactment, attorney John. T. Kennedy (formerly of the Bureau of Internal Revenue) warned that carryover basis for gifts would give rise to a new tax avoidance strategy–giving an asset with a built-in loss to a relative in order to shift the tax loss to a taxpayer better positioned to tax advantage of the loss.[60] According to Kennedy, there was "reason to

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[57]Id. at 337.

[58]For proof-of-basis critiques of carryover basis at death, see, e.g., Carryover Basis Provisions, Hearings Before the Committee on Ways and Means, 96th Cong., 1st Sess., 51, 79-101 (1979) (witness statements concerning proof-of-basis problems). For a description and evaluation of the proof-of-basis critiques of carryover basis at death, see Lawrence Zelenak, Taxing Gains at Death, supra note 49, at 388-392.

[59]Tax Reform Act of 1976, Pub. L. 94-455, § 2005, 90 Stat. 1520, 1874, repealed (with retroactive effect) by the Crude Oil Windfall Profit Tax Act of 1980, Pub. L. 96-223, § 401(a), 94 Stat. 229, 299 (1980).

[60]John T. Kennedy, "Taxes Lost on Gifts," New York Times, September 11, 1921, at 7.

believe that the proposed bill has merely substituted one method of avoiding taxes for another."[61] Kennedy also thought that there was "a serious question" concerning the constitutionality of carryover basis: "May what would have been income of the giver be legislated to be income of the recipient?"[62] Echoing Professor Seligman's congressional testimony, Kennedy proposed–as an alternative to carryover basis that would not require the possibly unconstitutional taxation of donees on donors' gains–treating a gift of appreciated property as an occasion for taxing the

[61]More than a decade later, in 1934, Congress came around to Kennedy's view on this issue, and enacted a bifurcated basis rule for gifts of loss property, under which the donee's basis for determining gain is a carryover basis, but the donee's basis for determining loss is the fair market value of the property at the time of the gift. Revenue Act of 1934, Pub. L. 73-216, § 113(a)(2), 48 Stat. 680, 706. See also S. Rep. 73-558 (1934), reprinted in 1939-1 C.B. (pt. 2) 586, 611 (noting that prior law had been "utilized to transfer losses from one person who has little income to another person with a large income"). The bifurcated basis rule has remained in the federal income tax ever since; it now appears in Code § 1015(a). It is curious that Congress should prohibit the shifting of tax losses by gifts to higher-bracket taxpayers while permitting the shifting of tax gains by gifts to lower-bracket taxpayers. One might have supposed that the shifting of tax gains would be the more serious policy concern, both because throughout most of the history of the income tax built-in gains in investment assets have been more common than built-in losses, and because the natural direction of large gifts is from richer to poorer taxpayers. What, then, explains this legislative straining at the gnat while swallowing the camel? It seems to have been a matter of path dependence. It is easy to appreciate why the transfer of tax losses caught the attention of Congress in the depths of the Great Depression, but that merely explains the 1934 legislation in isolation; it does not explain the continuation of this straining-and-swallowing for more than eighty years. But consider the policy baselines. Before 1921, the loss-shifting strategy was unavailable under the rule that the basis of gifted property equaled the value of the property at the time of the gift; comparison with that pre-1921 baseline was, of course, the premise of Kennedy's objection. Evidently the pre-1921 baseline remained salient enough in 1934 to spur Congress to enact the bifurcated basis rule. In contrast, the pre-1921 baseline for gifts of appreciated property was no taxation of gain ever to anyone, so relative to *that* baseline carryover basis did not *create* an opportunity for reducing capital gains taxation by gifts of gain property to lower-bracket relatives; rather it *shut down* a tax avoidance technique that had worked under prior law.

[62]Kennedy, supra note 60, at 7. As noted earlier (supra text accompanying note 42), Senator Smoot had expressed the same concern during the Finance Committee hearings on the proposed legislation.

donor on the appreciation. One might have supposed that that proposal was subject to even more serious constitutional objection than carryover basis, in light of the Supreme Court's decision the previous year in *Eisner v. Macomber*[63] that the taxation of unrealized gains was not permitted by the Sixteenth Amendment. Kennedy opined that this problem could be overcome by the simple expedient of clever labeling; instead of taxing the donor's gain under the income tax, call it a tax on the privilege of making a gift, with the amount of the tax a function of the amount of appreciation in the gift.[64] Finally, Kennedy proposed a tax–parallel to his proposed tax on the gifting privilege–on unrealized appreciation in property owned at death.

Later in 1921, after carryover basis had been enacted, the *New York Times* featured commentary on the new law by certified public accountant Joseph J. Kline.[65] Kline opined that carryover basis was of doubtful constitutionality for two reasons. First, carryover basis was inconsistent with the income tax exclusion for gifts (the predecessor of current Code § 102). This objection was without merit, for two reasons. First, if the objection had had any force, it would have been as a matter of statutory interpretation (presenting the problem of how to reconcile two seemingly inconsistent statutory provisions), not as a matter of constitutional law. Second, as every tax professional understands today, there is no inconsistency between the gift exclusion of IRC § 102 and the carryover basis rule of IRC § 1015. The obvious–and universally understood–harmonization of the two provisions is that the mere receipt of a gift of appreciated property is not taxable as income to the donee, but that if the donee later sells the property the

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[63]252 U.S. 189 (1920).

[64]Kennedy, supra note 60, at 7.

[65]"Believes New Tax Aids Realty Sales," New York Times, November 29, 1921, at 12.

donee's gain (or loss) on the sale will be determined using a carryover basis. Kline's second constitutional objection was more interesting. Being either unaware of or unimpressed by Adams' invocation of the estate tax as a reason for having different basis rules for gifts and bequests, Kline declared that the basis rules' "discrimination against gifts between living persons is too glaring to go unchallenged."

Lest this review of the several–and impressively varied–objections to carryover basis leave the reader with the impression that there was a near-firestorm of protest over the new provision, a bit of perspective may be helpful. In a long story detailing the contents of the 1921 proposed tax bill as agreed to by the Republican House caucus, the *New York Times* devoted just one sentence (31 words) to carryover basis–and that one sentence was relegated to the fifteenth paragraph of the story.[66] Most other news coverage of the legislation similarly treated the new basis rule for gifts as a minor matter. As for the change in step-up in basis at death from an administrative interpretation to a rule clearly stated in the statute, that received even less attention. It went unmentioned in the *New York Times* story, and in almost all other coverage of the 1921 legislation.

The final chapter in the story of the 1921 carryover basis legislation is well-known to all who have studied the federal income tax in law school. In 1929 the constitutional challenge to carryover basis suggested by Senator Smoot and by attorney Kennedy–that the Sixteenth Amendment did not permit the taxation of a donee on gain that had accrued while the property

[66]"New Tax Bill In; Amended by Caucus; Text as Presented," New York Times, August 16, 1921, at 1.

was owned by the donor–reached the Supreme Court in the case of *Taft v. Bowers.*[67] Recognizing that its endorsement of the taxpayer's constitutional objection "undoubtedly would defeat, to some extent, the purpose of Congress to take part of all gain derived from capital investments," the Court unanimously concluded, "There is nothing in the Constitution which lends support to the theory that gain actually resulting from the increased value of capital can be treated as taxable income in the hands of the recipient only so far as the increase occurred while he owned the property."[68]

Except for some tinkering around the edges–the enactment in 1934 of a bifurcated basis rule for gifts of loss property,[69] and the enactment in 1958 (with a narrowing revision in 1976) of a rule adjusting the basis in gifted property for gift tax imposed on the transfer[70]–the gift basis rule is the same today as the rule enacted by Congress in 1921 and blessed by the Supreme Court in 1929. The step-up in basis at death enacted in 1921 also remains with us today (in the form of Code § 1014), but its post-1920s history is considerably more complicated than that of the carryover basis rule for gifts. That subsequent history is told in some detail later in this Chapter.

II. The Deduction for Unrealized Appreciation in Property Donated to Charity

First appearing in the War Revenue Act of 1917,[71] the deduction for charitable

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[67]278 U.S. 470 (1929).

[68]278 U.S. at 482-84.

[69]For a description and discussion of this rule, see supra note 61.

[70]For a description and discussion of these developments, see supra text accompanying notes 54 to 55.

[71]War Revenue Act of 1917, Pub. L. 65-60, § 1201(2), 40 Stat. 300, 330.

contributions is four years younger than the modern income tax. The deduction originated not with one of the tax-writing committees, but with a proposal on the floor of the Senate by Senator Henry F. Hollis (D., N.H.). Hollis was concerned that, in the absence of a charitable deduction, the sudden introduction of high marginal tax rates (as high as 67 percent under the 1917 Act[72]) would result in a catastrophic decline in philanthropy:

> We have permitted these [charitable] institutions to grow up and become firmly established on the plan of depending upon private contributions. Now, however, the war affects these institutions more seriously than it does any other character of institution. . . . Now, when war comes and we impose these very heavy taxes on incomes, that will be the first place where the wealthy men will be tempted to economize, namely in donations to charity.[73]

The provision was enacted in the exact language proposed by Hollis, except that Hollis's proposal to cap the deduction at 20 percent of the taxpayer's taxable net income was changed to a 15 percent cap. The law allowed a deduction for "contributions or gifts actually made within the year," but said nothing about the method for determining the amount of a deduction. The only reference to an amount was in the ceiling on the deduction, which was expressed as "15 per cent of the taxpayer's taxable net income." The enactment of the charitable deduction is a striking illustration of the seat-of-the-pants character of much early federal income tax legislation. It is remarkable both that one of the most important and enduring personal deductions in the income tax originated not with the Treasury Department or a tax-writing committee, but with the suggestion of a single senator. It is also remarkable that the provision gave no guidance on a

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[72]War Revenue Act of 1917, Pub. L. 65-60, §§ 1 and 2, 40 Stat. 300, 300-301 (imposing a normal tax of 2 percent and surtax at rates as high as 50 percent, in addition to the normal tax and surtax already imposed by previous legislation).

[73]55 Cong. Rec. S6728 (September 7, 1917).

question as obvious and inescapable as the amount of a deduction in the case of an in-kind contribution.

It did not take long, however, for Treasury to fill the gap in the legislation. In 1918 it issued regulations stating, "Where the gift is other than money, the basis for calculation of the amount of the gift shall be the fair market value of the property the subject of the gift at the time of the gift."[74] Perhaps this rule was–and is–consistent with lay intuition, but as a matter of tax logic it is simply wrong. If a taxpayer donates to charity appreciated property which she bought for $200 and which is now worth $1,000, the appropriate deduction amount is only $200. Because of the nontaxability of unrealized appreciation,[75] the tax system has never treated the taxpayer as having possessed the $800 of gain in the property. It makes no sense, then, for the tax system to treat the taxpayer as having given away that which the tax system has never treated the taxpayer as having possessed.[76] Because the taxpayer has been previously taxed only on her $200 basis in the property (i.e., the $200 she paid for the property with after-tax dollars), the tax system logically should treat her as giving away only $200 when she makes her charitable donation. The result would be different–a deduction of $1,000 would be justified–if the gift of the property to the charity were treated as a realization event triggering the taxation of $800 gain

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[74]Supplement to Treasury Decisions (T.D. 2690), Regulations No. 33 (Revised) Governing the Collection of the Income Tax 15 (art. 8, § 9) (1918).

[75]Under current law, see Code § 1001(a) (treating the "sale or other disposition of property as a realization event," and implying that in the absence of a "sale or other disposition" gains and losses are unrealized and thus not taken into account by the tax system).

[76]See, e.g., Marvin A. Chirelstein & Lawrence Zelenak, Federal Income Taxation 215 (13^{th} ed. 2015) ("If the tax system has never treated the taxpayer as having received [the appreciation in an asset donated to charity], it cannot logically treat the taxpayer as losing (or donating) the appreciation").

to the taxpayer, but the federal income tax has never treated a charitable donation of appreciated property as a realization event. In any event, in a tax system without a capital gains rate preference–such as the federal income tax before 1921–simply limiting the deduction to the taxpayer's $200 basis would have been the functional equivalent of imposing tax on $800 gain and then allowing a charitable deduction for the $1,000 value.[77]

There is no evidence in the historical record of the thought processes of the authors of the 1918 regulations, but for all that appears the rule allowing a deduction for unrealized appreciation may have been nothing more than a careless or naive conceptual error. Others were not so careless or naive. In 1919, in a regular column in the *Wall Street Journal* devoted to answering readers' questions about taxes, a reader asked about the seemingly to-good-to-be-true results produced by a deduction for unrealized appreciation.[78] The anonymous columnist replied that the too-good-to-be-true result "seems to be technically in accordance with the rulings although we doubt very much that it is in accordance with the law" as enacted by Congress. The columnist explained:

> The fly in the ointment is that while B did not actually realize a gain of $16,000 on the stock he gave away, he did, in effect, get the benefit of realization by being allowed to deduct the appreciation in value from his income without having been required to account for that appreciation as income.
> It would appear that in a case of this kind the cost of the stock and not its market value should properly be the deductible item.

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[77] Actually, in one respect simply limiting the deduction to $200 would have been more taxpayer-favorable than taxing the $800 gain and then allowing a $1000 deduction: an actual deduction for $800 of donated appreciation would have been subject to the 15-percent-of-net income ceiling on charitable deductions, but the quasi-deduction under the alternative approach would not have been subject to the ceiling.

[78] "Answers to Inquirers," Wall Street Journal, July 17, 1919, at 2.

What was apparently beyond the ken of the Treasury was obvious to an anonymous journalist.

Tax professionals were also taken aback by the too-good-to-be-true regulatory interpretation. In 1919 the Boston law firm of Ropes, Gray, Boyden and Perkins sent a telegraphic inquiry to the Bureau of Internal Revenue. Noting that the regulations permitted a deduction equal to the value of property given to charity, the firm–with evident incredulity–inquired, "Does this mean donor can deduct market value of gift of securities without being treated as having realized as taxable income the difference between such market value and cost of securities to him? Please wire reply our expense."[79] The Bureau promptly wired back that a taxpayer "entitled to claim deduction for value of gift . . . is not required to report as a profit the excess in value of the property donated over its cost."[80]

By 1920–perhaps educated by the tax column of the *Journal* and the inquiry from the Boston tax bar–the tax administrators had changed their minds. The Bureau issued Solicitor's Law Opinion 979, concluding that the regulations were wrong not to limit the charitable deduction to basis in the case of appreciated property.[81] After noting that a gift of appreciated property is not a realization event, the Opinion explained that the amount of the casualty loss deduction for damage to or destruction of appreciated property was limited to the basis of the property, and reasoned that "[t]he same principle is applicable to deductions on account of

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[79]Ropes, Gray Telegram, reprinted in The Corporation Trust Company's 1913-1919 Income Tax Service, ¶3550 (1919).

[80]Letter (confirming telegram) signed by J. H. Callan, Assistant to the Commissioner, by N. T. Johnson, Chief of Section, reprinted in The Corporation Trust Company's 1913-1919 Income Tax Service, ¶3550 (1919).

[81]O. 979, C.B. 2, 148 (1920).

charitable contributions where the subject of the gift is property rather than money."[82] The Opinion "therefore held that where a gift is other than money, the basis of the calculation of the gift for the purpose of the [charitable] deduction . . . should be the cost of the property . . . ."[83] An amended regulation in conformity with Opinion 979 soon followed.[84] The regulatory revision seems not to have generated any controversy at the time. Indeed, except for a brief article in the *Wall Street Journal* the revision seems to have escaped all attention from the nation's newspapers.[85]

Although both the failure of the 1917 legislation to address the amount of the deduction and the illogical approach taken by the 1918 regulations might be explained as careless or naive mistakes, by 1920 the mistakes had been recognized and corrected. Moreover, there is no indication that the errors had persisted long enough for them to have developed a constituency–among either charities themselves or their wealthy donors–insistent on the preservation of error. If such a constituency had existed, Congress surely would have heard from it in 1921, when Congress was contemplating the closely-related question of the basis of a donee of a noncharitable gift of appreciated property. But the reversal of the 1920 regulation limiting the charitable deduction to basis made no appearance on the 1921 tax legislative agenda.

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[82]Id. at 148-49.

[83]Id. at 149.

[84]T. D. 2998, C.B. 2, 151-52 (1920) (amending Article 251 of Regulations 45 to provide, "Where the gift is other than money the basis for calculation of the amount of the gift shall be the cost of the property . . .").

[85]"Deduction for Charity Confined to Property Basis," Wall Street Journal, February 23, 1920, at 11.

Without any legislative involvement, however, Treasury re-reversed its position in 1923, issuing a revised regulation reinstating the rule of the original regulation of 1918. Under the 1923 revision, "Where the gift is other than money, the basis for calculation of the amount thereof shall be the fair market value of the property at the time of the gift."[86] The regulatory change was supported by a three-page Solicitor's Law Opinion.[87] The Opinion posed the question as "whether Congress intended to tax indirectly the unrealized appreciation in value of property, the subject of a charitable gift, by not permitting a deduction therefor to the extent of the appreciation in value."[88] This way of posing the question is both tendentious and simply wrong. As explained above, far from being an indirect way of taxing appreciation, disallowing a deduction for a gift of unrealized appreciation is a logical consequence of *not* taxing the appreciation. By the (il)logic of the Opinion, when a taxpayer donating property with a basis and value of zero is denied a deduction for $1 million of imaginary appreciation, that disallowance has the effect of indirectly taxing $1 million of nonexistent appreciation.

In any event, the Opinion's statement of the question eliminated any suspense as to what conclusion the Opinion would reach. Although the Opinion conceded that the statute itself said nothing about how to calculate the deduction for a contribution of property, it put great weight on the statement of Senator Hollis that the deduction should be for the "amount" contributed to

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[86]T.D. 3490, C.B. II-1 at 118 (1923).

[87]L. O. 1118, C.B. II-2 at 148 (1923).

[88]Id. at 149.

charity.[89] According to the Opinion,

> No technical language is used in the charitable contributions section of the statute, and it must be interpreted in accordance with the ordinary use and common understanding of the words used. Certainly, according to ordinary usage and common understanding, the "amount" of a gift and the value of a gift have the same meaning and effect. . . .
>
> Unless there is some provision in the statute or a clear inference was intended by Congress from the context which would indicate that the language used was intended to have a different meaning, it seems clear that the "amount" of a gift is the value of that which is parted with. An examination of the statute clearly shows that there is no language used from which an inference can be drawn that Congress intended a meaning different from that ordinarily attributed to the language used.[90]

By the end of the quoted passage, the author seems to have forgotten that the word "amount"–the "language used," on the plain meaning of which the Opinion leans so heavily–does not actually appear in the statute (except in the unhelpful-to-the-Opinion context of the limitation of the deduction to 15 percent of income). Even if "amount" had appeared in the statute in a context helpful to the argument of the Opinion, that would hardly have been conclusive. Consider a tax provision of similar antiquity and with a closely-related place in the structure of the income tax–the statement (now embodied in Code § 1012(a))–that "[t]he basis of property shall be the cost of such property." Although "cost" as used in § 1012(a) often means exactly

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[89]L. O. 1118, supra note 87, at 149, quoting 55 Cong. Rec. S6728 (1917) (statement of Senator Hollis). The Opinion flirts with, but does not quite make, a second argument based on the reenactment doctrine. The Opinion notes that the original 1918 rule–permitting a deduction for the value of contributed property–"was in effect when the Revenue Act of 1918 was passed." L.O. 1118 at 149. The reader expects a reenactment-doctrine argument to follow, but it does not. Perhaps the author realized that the charitable deduction provision was also–and more recently–reenacted following the promulgation of the 1920 revised regulation limiting the deduction to basis, and was concerned that the most recent reenactment would be the crucial one under the doctrine.

[90]L. O. 1118, supra note 87, at 149.

what a lay person would suppose it to mean, it is routinely assigned a specialized meaning when tax logic requires a specialized meaning.[91] The Opinion fails to note–much less attempt to resolve–the tension between ordinary usage and tax logic in the case of charitable gifts of appreciated property.

Like the 1920 regulation which it reversed, the 1923 regulation utterly failed to capture the imagination of the public. Aside from a one-sentence neutral description in the third paragraph of a brief story in the *Los Angeles Times*, the regulation seems to have gone unnoticed by the nation's major newspapers.[92]

The flimsiness of the Opinion's rationale suggests the Opinion may have been motivated by a consideration not mentioned in the Opinion. As explained earlier, in a tax system without a special rate structure for capital gains the same results can be achieved either by limiting the deduction to basis or by taxing the appreciation at the time of the donation and then allowing a deduction for the full value of the property. There were no special capital gains rates when the 1920 regulation was promulgated. The Revenue Act of 1921, however, introduced a top capital gains rate much lower than the top marginal rate on ordinary income. In 1923 the top ordinary income rate was 43.5 percent and the top capital gains rate was just 12.5 percent.[93] Consider a 1923 taxpayer in the top bracket (for purposes of both ordinary income and capital gain),

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[91]See, e.g., Boris I. Bittker, Martin J. McMahon, Jr., & Lawrence Zelenak, Federal Income Taxation of Individuals ¶29.02[5] (3d. ed. 2002) ("the term 'tax cost' is often used as a descriptive label for the basis of property that was not purchased in the conventional sense but whose fair market value was includable in the taxpayer's gross income on receipt").

[92]"Income Tax Exemption Rule Made," Los Angeles Times, July 25, 1923, at II-10.

[93]Citizens for Tax Justice, Top Federal Income Tax Rates Since 1913, www.ctj.org/pdf/regcg.pdf.

donating to charity an asset with a basis of zero and a value of $1,000. Setting aside for the moment the dictates of the statute and focusing on basic income tax logic, our taxpayer should receive the same tax treatment whether he (1) makes an in-kind gift of the property, or (2) sells the property to some third party, pays the tax on the capital gain out of other resources (rather than out of the sales proceeds), and donates the $1,000 sales proceeds to charity. In the case of the cash sale followed by cash donation, the taxpayer would owe a $125 capital gains tax and would save $435 by deducting $1,000 against ordinary income, for a net tax savings of $310. In sharp contrast, under the 1920 regulation the taxpayer would be taxed on no capital gain and would be entitled to no deduction, for a tax savings of zero (compared with simply holding onto the property). Finally, under the 1923 regulation the taxpayer would owe no capital gains tax and would be entitled to a $1,000 deduction against ordinary income, for a tax savings of $435. If Treasury reasonably believed that it did not have the authority under the statute to treat a charitable donation of appreciated property as a realization event, it might have concluded that in many situations (including situations like the example offered here) allowing a deduction for unrealized appreciation would come closer than the deduction-denial alternative to mimicking the tax results of a cash-sale-and-cash-donation.

But if Treasury believed it lacked the authority to reach the right result by regulation, why did it not urge Congress to do so by legislation, instead of promulgating an unreasonably taxpayer-favorable regulation? Perhaps it believed that, in light of the recent constitutionalization of the realization doctrine by the Supreme Court in *Eisner v. Macomber,*[94] even Congress did not have the authority to treat a charitable gift of appreciated property as a

[94] 252 U.S. 189 (1920).

realization event. Perhaps, but there would have been a good chance that the constitutional problem could have been finessed. Suppose in the ongoing example, that instead of formally imposing a capital gains tax on the appreciation in the donated property, Congress provided that (1) the gain was *not* taxable, but (2) the tax savings from the deduction for the unrealized appreciation was limited to the amount of the appreciation multiplied by the difference between the taxpayer's marginal rates on ordinary income and on capital gain. The resulting tax savings of $310[95] would have been the same as the net tax savings upon a cash-sale-and-gift-of-proceeds, yet in a formal sense unrealized appreciation would not have been taxed. We will never know whether this would have passed muster with the Supreme Court, but it certainly would have had a chance. A constitutional challenge to the provision would have been considered by the same late-1920s Supreme Court that unanimously rejected the constitutional challenge to carryover basis for gifts.[96]

The Treasury Secretary whose name appears at the bottom of the Treasury Decision promulgating the dubious 1923 regulation was Andrew W. Mellon. Ultimate responsibility for the regulation, which in later years proved to be of crucial significance to art museums and their in-kind donors, rested with the man who was to become–less than a decade later–the most important art donor in American history. In light of this coincidence–if coincidence it was–a brief digression is in order, concerning Mellon's founding donations to the National Gallery of Art and the ensuing litigation over their tax consequences.

Mellon had not become an art donor as of 1923, and there is no evidence that he was then

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[95]$1,000 x (43.5% - 12.5%) = $310.

[96]Taft v. Bowers, 278 U.S. 470 (1929).

contemplating future donations. In 1926 he told the Duchess of Rutland that he acquired art only for his residences: "I have not had occasion to consider the acquisition of such for public purposes."[97] David E. Finley, who served at Treasury as special assistant to Mellon, and who later became the first director of the National Gallery of Art, reminisced that Mellon first told him in 1927 of his plans to donate art to the nation as the foundation for a new National Gallery of Art.[98]

Moreover, the Treasury Department files from the Mellon years in the National Archives contain no documents suggesting any Mellon involvement in the process that led to the 1923 change in the charitable deduction regulations. In one significant respect, Mellon actually took a position contrary to his future interest as a large-scale philanthropist; he consistently rebuffed, on grounds of revenue needs, requests that he support an increase in (or elimination of) the 15-percent-of-income limitation on charitable deductions.[99]

More than a decade later, Mellon's art donations in contemplation of the founding of the National Gallery of Art played a prominent role in the high-profile Board of Tax Appeals case of

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[97]David Cannadine, Mellon 352 (2006). See also id. at 376 ("Until 1926, Mellon had rightly considered himself to be no more than a private buyer of art, and not a purchaser of the first rank").

[98]David Edward Finley, A Standard of Excellence: Andrew W. Mellon Founds the National Gallery of Art at Washington 12 (1973).

[99]Letter of Andrew W. Mellon of January 10, 1924, to Congressman Henry W. Watson, and letter of Mellon of November 25, 1927, to Mr. I. W. Frank, both in Record Group 56, General Records of the Department of the Treasury, 1775-2005, Central Files, 1917-1932, Box 192.

Mellon v. Commissioner.[100] The trial of the case lasted from February 1935 to May 1936,[101] and the Board did not issue its opinion until December 1937. In what many–including his even-handed biographer David Cannadine–have viewed as a meritless politically-motivated action,[102] the Bureau of Internal Revenue claimed that Mellon had underpaid his 1931 taxes by more than $2 million, and asserted that Mellon was liable for the 50 percent civil fraud penalty in addition to the tax itself.[103] The alleged deficiency had nothing to do with Mellon's philanthropy; rather, it related to losses claimed by Mellon on dispositions of stock. But Mellon responded to the Bureau by asserting that he had actually *overpaid* his 1931 income tax by neglecting to claim a deduction of more than $3 million for the value of five paintings he had donated to the Mellon Trust in that year in contemplation of their eventual conveyance to a yet-to-be-created National Gallery of Art.[104] (When the National Gallery was eventually established in 1937, it did receive the five paintings, along with a large cash donation and other paintings from Mellon.[105])

The five paintings–Raphael's Alba Madonna, Titian's Toilet of Venus, Perugino's Crucifixion, Van Eyck's Annunciation, and Botticelli's Adoration of the Magi–were stored by

[100]36 B.T.A. 977 (1937).

[101]Cannadine, supra note 97, at 525.

[102]Id. at 605 ("[W]hatever [Roosevelt's] reasons for wanting to make an example of Mellon, Roosevelt's advisers erred when they chose to attack Mellon for dishonesty: in paying his federal taxes, it bears repeating, Mellon had always been scrupulous to stay within the boundaries of the law").

[103]36 B.T.A. at 978.

[104]Cannadine, supra note 97, at 524; 36 B.T.A. at 1064 (noting that Mellon had not claimed a deduction for the paintings on his 1931 income tax return).

[105]Cannadine, supra note 97 at 557-67.

the Trust in a double-locked fireproof room in the Corcoran Gallery of Art.[106] Mellon had recently purchased the paintings (the Van Eyck in 1930, the other four in 1931) from the Soviet government–which, desperate for cash, was selling off some of the greatest treasures of the Hermitage–at a cost of more than $3.2 million.[107] In its argument before the Board of Tax Appeals, the government claimed that the alleged gift from Mellon to the Trust was a sham.[108] The Board disagreed: "We are convinced that the trust created by petitioner was a valid legal trust, organized and operated exclusively for educational and charitable purposes[,] and that in the taxable year petitioner made a valid gift to the trust of the property in question."[109]

The valuation of the five paintings was also at issue in the litigation, but in a way that did not implicate the 1923 revision of the charitable deduction regulations. Mellon claimed that the value of the paintings at the time of their donation was $3,247,695–precisely the amount he had paid the Soviet government for them.[110] The Board agreed with Mellon's valuation.[111] Given the fire sale character of the dismantling of the Hermitage collection, Mellon might plausibly have claimed a deduction for a value greater than his cost. On the other hand, the short time between the purchase and the donation weakened the case for an increase in value, as did the general

[106] 36 B.T.A. at 1046.

[107] Cannadine, supra note 97, at 421-24.

[108] The government claimed "that petitioner has never parted with dominion over the paintings." 36 B.T.A. at 1064.

[109] 36 B.T.A. at 1065-66.

[110] 36 B.T.A. at 1046 (Mellon's cost), 1064 (Mellon's claimed value equal to cost).

[111] 36 B.T.A. at 1046.

downward trend in asset prices during the Great Depression. In addition, in litigation in which he was concerned more with defending his good name than with the precise amount of his tax liability, Mellon may have thought it better not to make a highly contestable claim that the paintings were worth more than he had paid for them. In any event, despite the intriguing fact that the Andrew Mellon who approved the revision of the charitable deduction regulations in 1923 was the same Andrew Mellon who in 1931 donated five great paintings to charity and who in 1935 defended his deduction of those paintings before the Board of Tax Appeals, Mellon the philanthropist made no attempt to benefit from the tax rule approved in the previous decade by Mellon the Treasury Secretary.

The valuation of the paintings *was* at issue in the litigation, but only on the question of whether the paintings were worth *less* at the time of their donation than Mellon had paid for them. That issue produced a dramatic confrontation between government attorney (and later Supreme Court Justice) Robert H. Jackson and Mellon's great (and haughty) art dealer Joseph Duveen. When Jackson tried to get witness Duveen to concede that paintings were "a fluctuating commodity" that could decline in value, Duveen replied, "No. They are not a commodity. You cannot buy a picture like you buy a load of copper or a tin mine."[112] Duveen elaborated: "Really, my dear fellow, art works do not rise and fall in value like pig iron. . . . They have a value, and that's all there is to it."[113] Jackson later commented that Duveen was "about the most fantastic

[112]Meryle Secrest, Duveen 346 (2004) (quoting the trial transcript).

[113]Cannadine, supra note 97, at 533 (quoting the trial transcript).

witness I ever saw on the witness stand."[114]

The Board did not issue its opinion in the Mellon case until December 1937–more than three months after Mellon's death. Although the Board found that Mellon had underpaid his 1931 income tax by a bit less than half a million dollars,[115] it completely exonerated Mellon of the charge of fraud.[116] The Board also decided the art donation issue in Mellon's favor, as to both the genuineness of the gift and the value of the paintings.[117]

III. The Short Unhappy Life of Carryover Basis

Just as the tax-free step-up in basis at death and the charitable deduction for unrealized appreciation had similar early histories, they have also had parallel later histories. Proponents of tax reform managed–against heavy odds–to persuade Congress to repeal (basis step-up at death, in 1976) or greatly curtail (deduction for unrealized gain, in 1986) the illogical tax break, only to see their legislative victories reversed a few years later in response to intense lobbying. This Part III recounts the short unhappy life of carryover basis at death. The similarly short and unhappy life–a decade later–of the treatment of unrealized appreciation in donated property as a preference item for purposes of the alternative minimum tax (AMT) is described in Part IV.

A. The Reform

For decades following the 1921 enactment of the tax-free basis step-up at death, that

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[114]Robert H. Jackson, The Reminiscences of Robert H. Jackson 338 (1955) (clearly using "fantastic" in a non-complimentary sense).

[115]Cannadine, supra note 97, at 584.

[116]36 B.T.A. at 1048.

[117]36 B.T.A. at 1064-66.

violation of income tax logic proved impervious to the best efforts of would-be tax reformers.[118] In 1942 the Treasury Department–in the person of Randolph Paul, Tax Adviser to Treasury Secretary Henry Morgenthau, testifying before the Ways and Means Committee–included the death basis rule in a list of income tax "special privileges" that should be repealed: "To remove this special privilege, it is suggested that the basis of property to the recipient for the computation of capital gains and losses be the same as it was in the hands of the decedent."[119] The quoted sentence constitutes the entirety of Treasury's technical description of how its proposed carryover basis regime would operate. Both the lack of technical development of the proposal and the weakness of the language ("it is suggested") suggest that Treasury was not particularly serious about the proposal. In any event, the Ways and Means Committee ignored Treasury's suggestion; not a single member addressed the proposal during the questioning of Paul.

In 1963 Treasury launched a much more serious assault on the tax-free basis step-up at death (which by that time was codified at § 1014, where it remains today), during the tenure of

[118]There was an interesting early bump-in-the-road in the post-1921 history of the rule fixing the basis of property acquired from a decedent at the property's date-of-death value. In 1926 the Court of Claims ruled–contrary to the existing regulatory interpretation of the statute–that the decedent's cost basis, rather than the date-of-death value, governed in the case of a sale by the decedent's estate (as contrasted with a post-distribution sale by a beneficiary, as to which death-value basis clearly applied). McKinney v. United States, 62 Ct. Cls. 180, *cert. denied*, 273 U.S. 716 (1923). The result was pro-taxpayer on the facts of *McKinney*, because the property had declined in value in the hands of the decedent, before increasing in value in the hands of the executor. In 1928 Congress resolved the issue, prospectively, by providing that "the basis in the hands of the estate shall be the fair market value of the property at the time of the death of the decedent." Revenue Act of 1928, Pub. L. 70-562, § 113(a)(5), 45 Stat. 791, 819. In 1935 the Supreme Court put the issue to rest for earlier years as well, by holding that the pre-1928 version of the statute also gave an estate a basis equal to the value of the property as of the decedent's death. Hartley v. Commissioner, 295 U.S. 216 (1935).

[119]Revenue Revision of 1942, Hearings before the Committee on Ways and Means of the House of Representatives, 77th Cong., 2nd Sess., vol. 1, at 90 (1942).

the great tax reformer Stanley S. Surrey as Assistant Secretary of the Treasury for Tax Policy. Instead of half-heartedly proposing carryover basis at death, as the Roosevelt administration had done two decades earlier, the Kennedy administration offered a detailed proposal for "impos[ing] a tax at capital gains rates on all net gains accrued on capital assets at the time of transfer at death or by gift."[120] The administration's thorough description of the proposal covered thirteen pages, and included a number of exceptions and detailed examples of the application of the exceptions.[121]

This time Ways and Means was at least paying attention, as were several witnesses who spoke in opposition to the proposal. Testifying on his own behalf, the prominent tax lawyer Roswell Magill–who had served in high-level tax policy positions in the Roosevelt Treasury of the 1930s[122]–told the Committee that the proposal was of doubtful constitutionality,[123] and even if constitutional was objectionable on policy grounds: "At the time I was in the Treasury, this same reform was talked over. But we always decided against it, because it was contrary to the general theory of the income tax . . . that income arises when some gain is realized."[124] Reading from the same page, G. Keith Funston, President of the New York Stock Exchange, told the Committee

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[120]John F. Kennedy, President's 1963 Tax Message 20 (1963).

[121]Id. at 122-34.

[122]Joseph J. Thorndike, Profiles in Tax History: Roswell Magill, 118 Tax Notes 657 (2008).

[123]President's 1963 Tax Message, Hearings before the Committee on Ways and Means, House of Representatives, 88th Cong., 1st Sess., at 1379 (1963).

[124]Id. at 1380.

that "the taxation of capital gains at death, would be most, most unfortunate and unwise."[125] Apparently persuaded by Magill, Funston, and several other witnesses opposed to the proposal, the Ways and Means members voted against income taxation of gains at death,[126] and that was the end of the issue for 1963 and several years thereafter.

Treasury tried again, however, in 1969, the last year of Surrey's service at Treasury. In that year Treasury included in its voluminous "Tax Reform Studies and Proposals" a recommendation for treating both lifetime gifts and transfers at death as occasions for taxing appreciation in transferred assets.[127] Even more detailed than the 1963 Treasury proposal, the twenty-one-page 1969 proposal featured a $60,000 minimum basis allowance, exemption of all appreciation occurring before the date of the enactment of the proposal, and complete exemption in the case of transfers to surviving spouses and to charity. Like its 1963 predecessor, this proposal went nowhere in Congress.

Seven years later, however, Congress gave the opponents of § 1014 at least a partial victory, by including in the Tax Reform Act of 1976 a new Code § 1023, which generally provided for carryover basis for assets received from a decedent.[128] Although commentators have

[125]Id. at 1436.

[126]"New Levy on Heirs is Dropped from Tax Bill by House Group," New York Times, August 27, 1963, at 17 (describing the Committee's vote against the proposal as "a surprise move").

[127]Treasury Department, Tax Reform Studies and Proposals 331-51 (1969).

[128]Tax Reform Act of 1976, Pub. L. 94-455, § 2005(a), 90 Stat. 1520, 1872-77 (codified at former IRC § 1023).

described the 1976 carryover basis rules as “a mere Congressional afterthought,”[129] as having been enacted “after only brief and hasty consideration,”[130] and as “not greatly noticed at the time,”[131] in fact the provision received a great deal of attention–from both legislators and interest groups–prior to its enactment.

In March 1976 Ways and Means held lengthy hearings “on the general subject of federal estate and gift taxes.”[132] The income tax treatment of appreciation in assets transferred at death was addressed by numerous witnesses. In a written statement, Stanley Surrey (then a professor at Harvard Law School) described the tax-free basis step-up at death as “[t]he most serious defect in our federal tax structure today,”[133] and called for “the imposition of income tax at death on the appreciation with a deduction of the tax from the gross estate.”[134] In sharp contrast, the American Bankers Association (ABA) favored retention of § 1014.[135] If Congress insisted on change, however, the ABA urged Congress to reject both carryover basis and income taxation of gains at death, and instead to enact the ABA’s proposal for an “additional estate tax” (AET) on

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[129]Charles J. Landry & Steven J. Willis, Carryover Basis Provisions of the Tax Reform Act of 1976: Section 1023, 31 Tax Lawyer 191, 191 (1977).

[130]Howard J. Hoffman, The Role of the Bar in the Tax Legislative Process, 37 Tax L. Rev. 411, 441 (1982).

[131]James J. Kilpatrick, “The Tax Noose,” Baltimore Sun, October 17, 1979, at 19.

[132]Public Hearings and Panel Discussions before the Committee on Ways and Means, House of Representatives, 94th Cong., 2nd Sess., on the General Subject of Federal Estate and Gift Taxes, parts 1 and 2 (1976).

[133]Id. at 499.

[134]Id. at 491.

[135]Id. at 295.

net appreciation.[136] Commenting on both carryover basis and taxation at death, William C. Penick of the American Institute of Certified Public Accountants (AICPA) told the Committee, "We have worked with the present system for many years and there is merit in continuing a system that is understood and that reaches a reasonable result."[137]

Both the ABA and the AICPA included in their written submissions to Ways and Means detailed technical and policy analyses of carryover basis, income taxation of gains at death, and of the AET.[138] Numerous other witnesses on every conceivable side of the issue were also heard from. The hearings lasted eleven days and in print occupy more than 1,700 pages (including written submissions), with discussion of possible reforms of Code § 1014 taking up many of those pages.

Of all the proposals (including retention of current law), carryover basis was probably the least popular with those testifying before Ways and Means. Committed reformers (such as Surrey) much preferred realization at death to carryover basis.[139] On the other side, those who favored the continuation of current law rejected carryover basis even on the assumption that some sort of reform was politically inevitable. As noted above, the American Bankers Association preferred its AET proposal over carryover basis on grounds of both simplicity and

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[136]Id. at 292-295.

[137]Id. at 310.

[138]Id. at 63-274 (ABA; discussion includes, in addition to the treatment of gains death, a number of transfer tax issues), 318-327 (AICPA).

[139]See, e.g., id. at 502 (Surrey's assertions that "death is the appropriate occasion for these final accountings" and that "further postponement of the tax can only harden the lock-in effect").

fairness.[140] Similarly, Charles M. Walker, Assistant Secretary of the Treasury for Tax Policy, told the Committee that the Treasury Department of the Ford administration favored the retention of current law, but also noted that “the AET proposal is far simpler than either of the other two approaches.”[141] Ways and Means Chairman Al Ullman (D., Ore.) accurately summarized the testimony he had heard: “The carryover of basis is obviously difficult. No one seems to favor it very much.”[142]

As political compromise would have it, however, the estate and gift tax reform bill that Ways and Means produced in August 1976 included the replacement of Code § 1014 with a carryover basis regime.[143] Although the bill did provide for a $60,000 “minimum basis” in property included in a decedent’s estate,[144] it did not provide for any “fresh start” basis adjustment. In other words, the basis of assets owned by a decedent dying after the effective date of the new provision would *not* have been stepped up to the value of those assets as of the effective date.

The proposed carryover basis rule was part of a compromise within Ways and Means. In return for agreeing to a major increase (from $60,000 to $154,000) in the estate tax exemption

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[140]Id. at 293.

[141]Id. at 1182.

[142]Id. at 1444.

[143]H. Rep. 94-1380, 36-46 (Aug. 2, 1976).

[144]Id. at 41.

level, Committee liberals got an end to the tax-free basis step-up at death.[145] The bargain did not survive, however, on the floor of the House. Ullman had hoped that the House would consider the bill under a rule permitting only a very limited range of proposed amendments. When Republicans and conservative Democrats succeeded in opening the bill to a wide range of floor amendments, Ullman responded by taking the bill off the floor, thus canceling the scheduled vote.[146]

However, another route to enactment of carryover basis remained open. Even as Ullman pulled the estate tax bill, the House and Senate were conferring on the reconciliation of general tax revision bills passed by the two chambers; although the Senate bill did not change the death basis rules, it did include a large increase in the estate tax exemption.[147] This gave Ullman and the other House conferees leverage on the death basis issue. They could condition their acceptance of an increase in the estate tax exemption on the Senate's acceptance of carryover basis. In the end, the conferees agreed to both a major increase in the estate tax exemption (although not quite as large as the increase in the Senate bill) and to carryover basis at death.[148] There was also a compromise within the compromise. Ullman did not get the clean version of

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[145]Eileen Shanahan, "Advocates of Tax Reform Win Victories in House Committee and in Senate," New York Times, July 22, 1976, at 10 (noting that the Committee favored carryover basis "by an unexpectedly lopsided vote of 24 to 10").

[146]John Pierson, "Estate-Tax Plan Dealt Setback in House Action," Wall Street Journal, August 31, 1976, at 2.

[147]S. Rep. 94-1236, at 607 (1976) (describing provision of Senate bill that would have gradually increased the estate tax exemption to $197,667).

[148]Id. at 607 (estate tax exemption, when fully phased in, of $175,625), 611-13 (carryover basis).

carryover basis included in the Ways and Means estate tax reform bill; instead the conferees agreed to carryover basis with a "fresh start" adjustment, under which appreciated property owned by a person dying after December 31, 1976, would generally be given a basis equal to its value on that date.[149]

On September 15, the day before the House was scheduled to vote on the Conference Report, Wilbur Mills, the long-time Ways and Means Chairman who had been forced to resign his chairmanship in the aftermath of the Fanne Foxe scandal,[150] gave an emotional speech on the floor of the House in support of carryover basis: "I would like to see this one additional tax reform adopted while I am still a Member of Congress. If we are to have a fair tax system this reform must come sooner or later."[151]

When the House considered the Conference Report the next day, it voted twice–once on the gift and estate tax provisions (including the income tax carryover basis provision) and once on the report as a whole.[152] A full hour of debate time was reserved for the package of transfer tax reforms and carryover basis.[153] Ullman described carryover basis as "the centerpiece of this legislation" and made one of the worst predictions in the political history of the federal income tax: "This is the part of the package that will make this gift and estate tax reform bill stand up for

[149]Id. at 611-13.

[150]Dennis Hevesi, "Wilbur Mills, Long a Power in Congress, is Dead at 82," New York Times, May 3, 1992, at 53.

[151]122 Congressional Record H30547 (September 15, 1976).

[152]122 Congressional Record H30807 (September 16, 1976) (remarks of Al Ullman explaining the voting procedure).

[153]Id.

a long time to come."[154]

In the floor debate, in addition to arguing for carryover basis on its own merits, proponents emphasized that it was a crucial part of the legislative bargain; one side got a greatly increased estate tax exemption, while the other side got carryover basis. Ullman, for example, told the House, "While carryover basis deserves to be supported on its own merits, it also should be supported as part of a total package that has been carefully worked out. If carryover is defeated, it places the whole estate and gift tax package in jeopardy."[155] Members also emphasized that the fresh start adjustment was a politically crucial compromise within the larger compromise.[156]

Opponents of carryover basis, led by Barber Conable (R., NY), were able to expound their objections at length on the floor of the House. Summarizing the case against carryover basis, Conable remarked that the provision "will produce complex, costly, time-consuming litigation . . . and will complicate the duties of every administrator or executor of a decedent's estate. From a philosophical point of view the carryover basis provision will inhibit the free

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[154]Id. at 30846.

[155]Id. at 30809. See also id. at 30817 (warning of Floyd Fithian (D., Ohio) that "attempts to alter the sensitive balance achieved by House and Senate conferees in the agreements they have struck may well kill this legislation entirely."), 30822 (statement of Robert Drinan (D., Mass.) that "[w]hile I do support the estate and gift section as presently constituted, I would be forced to oppose them should the carryover basis provision be deleted from the entire estate and gift tax package."), and 30848 (statement of Dan Rostenkowski (D., Ill.) that "[t]he compromise reached by the conferees on the estate and gift taxes is delicately balanced on competing interests. To upset it now would require us to return to conference and drop the issue.").

[156]Id. at 30854 (remarks of James C. Corman (D., Cal.) and 30857 (remarks of Donald M. Fraser (D., Minn.).

transfer of property and increase the capital outlay in the future."[157] In light of the overwhelming post-enactment criticism of the complexity of the fresh start rules (described below), it is notable that the pre-enactment opponents of carryover basis did not object to the complexity of fresh start. Conable complained that fresh start eliminated most of the near-term revenue from carryover basis,[158] but no one criticized the provision for its complexity. In fact, one opponent of carryover basis conceded that carryover with a fresh start adjustment "did represent an improvement" over the pure version of carryover basis.[159]

Following the debate, the House approved the package of carryover basis and estate tax relief by a vote of 229 to 181.[160]

The Senate considered the Conference Report on the same day, also under a two-vote procedure.[161] The contrast between the House and Senate floor debates on carryover basis is remarkable. Although William Roth (R., Del.) strenuously objected to carryover basis on grounds of both irregularities in the legislative process and predicted administrative difficulties,[162] in the Senate his was a lonely voice. The package of carryover basis and estate tax

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[157]Id. at 30847.

[158]Id. at 30848.

[159]Id. at 30858 (remarks of John Paul Hammerschmidt (R., Ark.).

[160]Id. at 30858.

[161]122 Cong. Rec. S30716 (September 16, 1976) (remarks of Russell Long (D., La.) explaining the voting procedure).

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> In my opinion this is a perfect example of how not to legislate. Because there were no hearings on this amendment, most of my distinguished colleagues have absolutely no idea what the proposal does and what its impact will be. No one has explained how the capital gains at death

reforms passed by a vote of 82 to 2.[163]

The above recounting of the history of the 1976 enactment of carryover basis does not support commentators' claims that carryover basis was some sort of last-minute legislative afterthought. To the contrary, the issue had been the subject of extensive Ways and Means hearings, including unusually detailed technical and policy analyses from both the American Bankers Association and the AICPA, and following the hearings Ways and Means had voted in favor of a detailed set of carryover basis provisions (albeit without a fresh start adjustment). On the floor of the House Chairman Ullman described carryover basis as the "centerpiece" of the transfer tax reform legislation, and the extensiveness of the House floor debate on the issue was extraordinary for a single (non-tax-rate) provision in an enormous piece of tax legislation. The taxpayer-favorable fresh start adjustment was the only aspect of the carryover basis legislation that could be plausibly described as a legislative afterthought, and even that received considerable attention both in the Conference Committee and on the floor of the House.[164]

B. The Restoration

Following the enactment of carryover basis, and in response to complaints about the administrative unworkability of § 1023, both the Ways and Means Committee and the Senate

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> provision can be administered by the Treasury Department and the Internal Revenue Service.

Id. at 30725.

[163]Id. at 30730.

[164]122 Cong. Rec.H30846 (September 16, 1976) (Ullman statement that the House conferees "began negotiating with the Senate conferees in an effort to arrive at a reasonable compromise. We spent considerable time in doing that.").

Finance Committee (more precisely, its Subcommittee on Taxation and Debt Management) held hearings focusing on the defects of the new law.[165] Impressed by the complaints, Congress responded in November 1978 by delaying the effective date of carryover basis until 1980.[166] Support for permanent repeal of carryover basis grew throughout 1979, largely as a result of very effective pressure exerted on legislators by farm and small business groups.[167] In late 1979 both the House and the Senate voted for permanent repeal–with retroactive effect–by lopsided margins.[168] Repeal did not become law, however, until 1980, when it was included in the Crude Oil Windfall Profit Tax Act.[169] Attaching carryover basis to the windfall profit vehicle ensured that President Carter would not veto the legislation, since Carter wanted a windfall profits tax more fervently than he opposed carryover basis repeal (although the House and Senate votes in late 1979 indicated that carryover basis repeal would have been veto-proof even as stand-alone legislation).[170]

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[165]Estate and Gift Tax Carryover Basis and Generation-Skipping Trust Provisions and Deductibility of Foreign Convention Expenses, Hearings before the Committee on Ways and Means, House of Representatives, 95th Cong., 1st Sess. (1977); Estate and Gift Tax Problems Arising from the Tax Reform Act of 1976, Hearing before the Subcommittee on Taxation and Debt Management Generally of the Committee on Finance, United States Senate, 95th Cong., 1st Sess. (1977).

[166]Revenue Act of 1978, Pub. L. 95-600, § 515, 92 Stat. 2763, 2884 (1978).

[167]Hoffman, supra note 130, at 444, n. 131.

[168]125 Cong. Rec. H12158-59 (December 18, 1979) (vote of 326 to 77); 125 Cong. Rec. S16968 (November 11, 1979 (vote of 81 to 4).

[169]Crude Oil Windfall Profit Tax Act of 1980, Pub. L. 96-223, § 401, 94 Stat. 229, 299 (1980).

[170]"Congress Moves Closer to Repealing Law to Boost Tax on Heirs Who Sell Property," Wall Street Journal, December 19, 1979, at 4.

This article is not the place for a detailed analysis of the administrability problems of carryover basis as enacted in 1976, or of the extent to which proposed "clean-up" legislation–introduced by Representative Joe Fisher (D., Va.) and endorsed by Treasury[171]–would have made carryover basis workable.[172] It is worth noting here, however, that two crucial compromises agreed to by the reformers of 1976, both designed to make repeal of § 1014 more politically acceptable by reducing the substantive tax burden of repeal, ironically provided much of the ammunition to those who later argued against carryover basis because of its alleged impossibility of administration.

In the months preceding the enactment of carryover basis, the first choice of most reformers had been taxation of gains at death, and even the opponents of reform–if forced to accept some sort of reform–preferred taxation at death (if not income tax realization of gains at death, then the ABA's AET) to carryover basis. In large part, the widespread preference for taxation at death was based on the belief that it would be simpler in practice than carryover basis.[173] Unlike carryover basis, taxation at death would not mandate maintenance of basis records across generations, and would not require an executor to worry about fairly distributing not only value, but also basis, among the beneficiaries of the estate. The coordination between the estate tax and the income tax would also be simpler with taxation of gains at death; in that case the only required coordination provision would be an estate tax deduction for the death

[171]H.R. 4694, 125 Cong. Rec. H5491 (June 29, 1979).

[172]For a thoughtful and thorough analysis of the administrability of both the original version of carryover basis and of the clean-up proposal, see Hoffman, supra note 130, at 438-92.

[173]See Zelenak, supra note 58, at 368-70 (describing several administrative advantages of taxing gains at death over carryover basis).

gains tax. By contrast, with carryover basis the coordination of the taxes was accomplished by the more complicated procedure of increasing the bases of an estate's assets by the estate tax attributable to the unrealized appreciation in the estate, and allocating the basis increase among the estate's assets. Finally, carryover basis required an asset-by-asset allocation of any minimum basis allowance, because the timing of later gain realizations would be different for different assets; a minimum basis allowance in the context of realization at death did not present the same difficulty, because the tax timing would be the same for all assets.

The 1976 reform proponents had abandoned their favored approach of taxing gains at death as a substantive compromise with those who favored the retention of current law, but after enactment the opponents of carryover basis mounted powerful objections on administrability grounds to the very compromise that had been substantively to their benefit. During the 1977 Ways and Means hearing, Ullman expressed his frustration over this turn of events:

> I admit readily that carryover basis has tremendous problems. It was certainly not the original intention of the chairman nor of this committee to move in that direction. It became the only possible avenue to choose during the House-Senate conference, and therefore, that is what we wound up with, simply because everybody had opposed a reasonable approach, this became the only available alternative.[174]

The second compromise–really a compromise within a compromise–was the fresh start adjustment. As with carryover basis itself, fresh start was a major substantive concession by the reformers (providing permanent exemption from the income tax for pre-1977 appreciation in assets in the estates of persons dying after 1976), the administrative complexities of which

[174] Estate and Gift Tax Carryover Basis Hearings, supra note 165, at 100. Ullman did not mention, however, that his Committee's original version of § 1014 repeal, developed well before the House-Senate conference, also featured carryover basis (albeit without a fresh start adjustment) rather than taxation at death. H. Rep. 94-1380, supra note 143, at 36-46.

became a focal point of the post-enactment arguments for the restoration of § 1014. Perhaps because it was developed so late in the legislative process, the fresh start adjustment as enacted, although it provided major substantive tax relief, was a miserable failure in terms of administrability. For purposes of the fresh start adjustment (for appreciated assets other than marketable bonds and securities), new § 1023 called for a pro rata allocation of appreciation in an asset over the time the decedent had owned the asset.[175] For example, if a taxpayer had purchased an asset for $10 on January 1, 1970, and the asset was worth $110 when he died exactly ten years later, the $100 appreciation would be allocated $10 to each year during which the taxpayer had owned the asset. The resulting fresh start basis as of the beginning of 1977 (the fresh start date) would be $70 (the original $10 plus a $60 adjustment). This approach required knowledge of both what the taxpayer had paid for the asset and when he had acquired it, and thus did nothing to lessen proof-of-basis problems for assets acquired by decedents before 1977.[176] The fresh start relief actually created a greater administrative burden on executors than pure carryover basis would have done, because fresh start required knowledge of the acquisition date for the determination of basis, whereas that knowledge would not have been needed to determine basis under a pure carryover basis regime. Professor Michael Graetz of the University of Virginia School of Law emphasized the contribution of the fresh start rules to the complexity of carryover basis in his 1977 Ways and Means testimony:

> To the extent that you have complexity in the current system, it is because

[175]Former Code § 1023(h)(2).

[176]During the post-enactment hearings, numerous critics of carryover basis made this point. See, e.g., Estate and Gift Tax Carryover Basis Hearings, supra note 165, at 10 (statement of John S. Pennell, Chairman, Section of Taxation, American Bar Association).

> the Congress bent over backward to be generous as a matter of equity to people who are going to be subject to the carryover basis rule. Complexities arise because of the fresh start rule. . . . You tried to be fair and now you are faced with the argument that having been fair you were too complicated.[177]

Carryover basis defenders working on clean-up proposals soon realized that there was a way of providing fresh start relief without requiring knowledge of either original cost or acquisition date: start with the date-of-death value and determine the January 1, 1977, value by discounting back from the date of death at some statutorily-specified rate of interest. This approach was adopted by the leading clean-up proposal.[178] By then, however, the blood was in the water, and carryover basis opponents who might once have settled for an improved version of carryover basis would accept nothing less than complete (and retroactive) repeal. Referring to the improved fresh start adjustment and other features of the clean-up proposal, prominent tax attorney (and former IRS Commissioner) Donald C. Alexander told Ways and Means in 1979 that "we would not be here today" contemplating the imminent repeal of carryover basis "if Congressman Fisher's [clean-up] bill had been enacted instead of section 1023 back in 1976."[179] In addition to introducing a much easier-to-administer form of fresh start adjustment, Fisher's bill would have (among other things) increased the minimum basis allowance from $60,000 to $175,000 and increased the exclusion for personal and household effects from $10,000 to $25,000; in a 1979 presentation to Ways and Means the Treasury Department listed twelve

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[177]Id. at 157-58.

[178]H. R. 4694, supra note 171, § 1023(d)(2).

[179]Carryover Basis Provisions, Hearings before the Committee on Ways and Means, House of Representatives, 96th Cong., 1st Sess., 143 (1979).

problems with carryover basis as enacted in 1976 and explained how the Fisher bill resolved each problem.[180]

Testifying in 1979 on behalf of the AICPA (which officially took no position on the basic idea of carryover basis, but which did oppose carryover basis in the form enacted in 1976), Allen J. Dixon reported the AICPA's conclusion "that the Treasury proposals [i.e., the Fisher bill], with certain further corrections which we recommend, and possibly with other modifications, would make carryover workable, though continuing to be quite complex."[181] Although the AICPA's position on the Fisher bill was less than a ringing endorsement, it was a significant concession, coming from an expert professional association which had taken the position that the original version of carryover basis was unworkable. Several other witnesses in 1979 hearings echoed the AICPA's conclusion that a cleaned-up version of carryover basis would be administrable.[182]

Given that both houses of Congress had voted for carryover basis just a few years earlier, and that a ready-to-be-enacted bill would have made carryover basis administrable, why did Congress repeal what it had so recently enacted? The story of the short unhappy life of carryover basis is broadly similar to that of the 1986 reform of the charitable deduction for gifts of appreciated property (recounted in Part IV below); in each case the opponents of a reform enacted as part of a package deal were later able to isolate the reform and achieve its repeal

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[180]Id. at 23-26 (written statement of Donald C. Lubick, Assistant Secretary of the Treasury for Tax Policy).

[181]Carryover Basis, Hearing before the Subcommittee on Taxation and Debt Management Generally of the Committee on Finance, United States Senate, 96th Cong., 1st Sess., 70 (1969).

[182]See, e.g., Carryover Basis Provisions, supra note 179, at 102 (statement of John S. Nolan, Washington, D.C., tax attorney and former Assistant Secretary of the Treasury for Tax Policy), 239 (statement of prominent New York tax attorney Jonathan G. Blattmachr).

without having to sacrifice the taxpayer-favorable part of the original package deal. In the 1977 hearings that led to the 1978 postponement of carryover basis, Rep. Abner Mikva (D., Ill.) identified and deplored the strategy of the opponents of carryover basis: "[I]t sets a terrible precedent for anything else we do in the tax reform bill; that is, get all the goodies you can, have one big stick with which you are going to pay for them, knowing full well after you get it then you are going to postpone the stick."[183] Despite understanding the strategy perfectly well, Mikva and the other advocates of carryover basis were unable to prevent first the postponement, and later the repeal, of the 1976 reform.

The difficult question is why the opponents of carryover basis were able to postpone and eventually to repeal carryover basis, while retaining the benefit of the 1976 increase in the estate tax exemption. Three factors seem to have worked to the advantage of the carryover basis opponents. First, there was a principled case to be made that the 1976 Act's increase in the estate tax exemption was just a belated and partial response to inflation, and as such should have been enacted without any accompanying revenue-increasing reform. Remarkably, the $60,000 estate tax exemption had remained unchanged for more than three decades, from 1942 to 1976.[184] If the exemption had been set at $60,000 in 1942 and indexed for post-1942 inflation, by 1977 the exemption would have grown to more than $223,000[185]–considerably more than the $120,667 1977 exemption set by the 1976 Act, or even the fully-phased in $175,625 1981 exemption set by

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[183]Estate and Gift Tax Carryover Basis Hearings, supra note 165, at 182.

[184]Revenue Act of 1942, Pub. L. 77-753, § 414(a), 56 Stat. 798, 951.

[185]Bureau of Labor Statistics, CPI Inflation Calculator, www.bls.gov/data/inflation_calculator.htm.

the Act.[186] Although there are plausible objections to using inflation adjustments to the 1942 exemption as a normative baseline more than three decades later, the intuitive appeal of that approach is sufficient at least to call into question the need for a revenue-raising reform as a companion to the 1976 Act's increase in the exemption.

Second, the advocates of carryover basis repeal took full rhetorical advantage of the many technical defects of carryover basis as enacted. Recognizing that the 1976 version of carryover basis was a much more vulnerable target than the 1979 Fisher clean-up proposal, repeal proponents concentrated their fire on the undeniable flaws of the 1976 legislation, while largely dismissing clean-up proposals as irrelevant hypotheticals. Donald C. Alexander's previously quoted observation–"I do not think we would be here today" talking about carryover basis repeal in 1979 if the Fisher bill had been enacted in 1976[187]–was a testament to the effectiveness of the strategy adopted by the repeal proponents. When they did deign to address the merits of clean-up proposals, repeal proponents employed a rather brazen strategy of damned-if-you-do-damned-if-you-don't comparisons between the 1976 legislation and the clean-up proposals. For example, when the architects of clean-up responded to the criticism that the 1976 legislation was unduly burdensome to small estates by proposing to almost triple the minimum basis allowance, repeal proponents complained that would be unfair to *larger* estates. In the words of a representative of the American Bar Association, "If any equity ever existed in carryover basis, it has been shattered

[186]Tax Reform Act of 1976, Pub. L. 94-455, §§ 2001(a)(1) and (2), 90 Stat. 1520, 1847-48 (not directly stating exemption levels, but providing for a tax rate schedule and a unified credit the application of which resulted in the exemption levels specified in the text).

[187]Carryover Basis Provisions, supra note 179, at 143.

by the Fisher bill, which would apply carryover basis to fewer than 3 percent of the estates."[188]

Third, by focusing their complaints much more on the (real and imagined) administrability failings of carryover basis as enacted, than on the increased tax burden of carryover basis,[189] repeal proponents were able to claim with some plausibility that it was not about the money. And if carryover basis needed to be repealed for reasons having nothing to do with revenue, then it might follow that there was no reason to couple the repeal of carryover basis with a revenue-raising decrease in the estate tax exemption.

Beyond these three effective strategies of the advocates of repeal, informed commentators at the time attributed the success of the repeal campaign to a change in the nation's political climate between 1976 and 1979. Writing in April 1979, Robert J. Samuelson claimed, "There are few better illustrations of the dramatic change in attitudes toward government and wealth than an obscure tax controversy–called 'carryover basis'–now about to burst on Congress."[190] According to Samuelson, Congress found arguments "clothed in the garb of populism" compelling "in the climate of the mid-1970s," but in 1979 "today's new mood stigmatizes any government meddling" and "politicians are less eager now to make points by attacking the rich." Writing a few months later, Ward Sinclair offered a similar diagnosis. Attributing the impending

[188]Id. at 161.

[189]See, e.g., Estate and Gift Tax Carryover Basis Hearings, supra note 165, at 5 (statement of John S. Pennell on behalf of the American Bar Association: "From a practical basis carryover basis is unworkable, there are just too many problems in making carryover basis work. The cost is just too great. We urge that there be an immediate repeal of carryover basis retroactive to the date of its enactment.").

[190]Robert J. Samuelson, "Carryover Basis Not So Simple After All," Los Angeles Times, April 10, 1979, at C7.

demise of carryover basis to “intangibles of [national] ‘mood,’” Sinclair suggested that “[t]he momentum [for repeal] . . . comes in part from a more conservative bent in Congress and concern over a faltering economy.”[191]

The post-1980 political story of the restored tax-free step-up in basis at death can be quickly told. With the memory of the 1976 legislative fiasco fresh in legislative minds, carryover basis and taxing gains at death became the dogs that did not bark of the Tax Reform Act of 1986.[192] Even as the Reagan administration and Congress seriously considered virtually every other base-broadening proposal with significant support from tax policy analysts, they paid no attention to possible reforms of § 1014.[193]

In 2001 Congress enacted legislation repealing the estate tax, effective for the single jubilee year of 2010.[194] Apparently thinking that it would be a bit too generous to combine estate tax repeal with a tax-free basis step-up, Congress coupled the one-year estate tax repeal with a version of carryover basis, applicable only to property acquired from a decedent dying in 2010.[195] Even that one-year application of carryover basis was later made optional, when 2010 legislation

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[191]Ward Sinclair, “Bindings of Tax ‘Reform’ Unravel,” Washington Post, October 3, 1979, at A6.

[192]Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2058.

[193]Zelenak, supra note 49, at 364-65. See also Ronald Reagan, The President’s Tax Proposals to Congress for Fairness, Growth and Simplicity 147 (1985) (including “capital gains on appreciated assets transferred at death or by gift” in a list of “items not included in the tax reform proposal”).

[194]Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. 107-16, § 501(a), 115 Stat. 38, 69.

[195]Id. § 541, 115 Stat. at 76 (codified at IRC § 1022).

gave executors of estates of decedents dying in 2010 a choice between the regime of no-estate-tax-plus-carryover-basis and a regime of estate-tax-plus-stepped-up basis.[196] Aside from that single-year frolic in the context of the repeal of the estate tax, since the 1980 repeal of carryover basis Congress has evinced no significant interest in reforming the income tax treatment of unrealized appreciation in assets transferred at death.

IV. The Charitable Deduction That Would Not Die

A. The Reform

The Tax Reform Act of 1969 limited the charitable deduction to the taxpayer's basis in appreciated property if the appreciation would not have been taxed as long-term capital gain if the taxpayer had sold the donated property.[197] The effect was (and is) to allow a deduction for untaxed gain when the gain would have been taxed at favorable capital gains rates, but not when the gain would have been taxed at the higher rates applicable to ordinary income and short-term capital gains. The 1969 reform left unscathed, however, the most significant charitable deductions for unrealized appreciation–for long-term capital gains in stocks and real estate donated to any charity (other than a private foundation), and for long-term gains in art donated to art museums.

A more serious threat to the deduction for unrealized gains appeared in 1984, with the

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[196]Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. 111-312, § 301, 124 Stat. 3296, 3300.

[197]Tax Reform Act of 1969, Pub. L. 91-172, § 201(a)(1), 83 Stat. 487, 555-56 (codified at Code § 170(e)(1)). In addition, in the case of the contribution of tangible personal property to an organization whose use of the property was unrelated to the organization's tax-exempt purpose or to a private foundation, the same provision of the 1969 Act limited the deduction to basis plus half of the long-term capital gain. The current version of the unrelated-use-or-private-foundation limitation, codified at Code § 170(e)(1)(B)(i), simply limits the deduction to basis.

issuance of the Treasury Department's tax reform report to President Reagan (Treasury I).[198]

Treasury I clearly and succinctly stated the case against the deduction:

> The current treatment of certain charitable gifts of appreciated property is unduly generous and in conflict with basic principles governing the measurement of income for tax purposes. In other circumstances where appreciated property is used to pay a deductible expense, or where such property is the subject of a deductible loss, the deduction allowed may not exceed the taxpayer's adjusted basis plus any gain recognized. Thus, a taxpayer generally may not receive a tax deduction with respect to untaxed appreciation in property.[199]

Because Treasury I also proposed taxing capital gains (as determined after adjusting basis for inflation) at the same rates as ordinary income, it sufficed simply to recommend the denial of a deduction for contributions of unrealized appreciation;[200] there was no need for the more complicated approach of taxing the gain at capital gains rates and then allowing a deduction against ordinary income of the full value of the property.

Treasury I provided the foundations for President Reagan's 1985 tax reform proposals to Congress (Treasury II).[201] On the charitable donation issue, Treasury II represented a compromise between Treasury I and proponents of the continuation of current law–who had quickly and emphatically informed the White House of their unhappiness with Treasury I.[202]

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[198]Department of the Treasury, Tax Reform for Fairness, Simplicity, and Economic Growth (Vol. 2) 72-74 (1984).

[199]Id. at 72-73.

[200]"A deduction for charitable donations of property would be allowed for the lesser of the fair market value or the inflation-adjusted basis of the property." Id. at 73.

[201]Ronald Reagan, The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity (1985).

[202]"[L]oud protests from charities, including personal appeals to Reagan, led the administration [in 1985] to weaken the change in the proposal sent to Congress." Anne

Under Treasury II there would be no change in the deduction rules for purposes of the regular income tax, but for purposes of the alternative minimum tax (AMT) the deduction would be limited to basis.[203]

When the House Ways and Means Committee held hearings on Treasury II, the nonprofit community–especially major art museums and elite private colleges and universities–strenuously objected to even the proposed AMT compromise. Speaking on behalf of the American Association of Museums, Metropolitan Museum of Art president William Macomber told the Committee that "the principles of tax reform do not apply to the issue."[204] Enactment of the administration's proposal, Macomber told the Committee, would put at risk the nation's great museum heritage:

> We cannot believe that anyone who has walked through a history or art museum in the United States, or a zoo, botanical garden or aquarium, and seen the treasures and beauty which they preserve would be prepared to risk their ability to sustain themselves and to grow by adding the disincentive to give which is inherent in the President's alternative minimum tax proposal on top of the disincentives inherent in lower rates and other tax reform changes elsewhere contained in the proposal.[205]

Harvard University economist Lawrence B. Lindsey, on behalf of the Association of American Universities, told the committee of his estimate that "65 percent of all gifts of appreciated

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Swardson, "Charitable Groups Begging Senators," Washington Post, February 19, 1986, at A19.

[203]Reagan, supra note 219, at 330-31 (proposing that tax preference items subject to the AMT include "[w]ith respect to each item of contributed property for which a charitable deduction is allowed, the excess of the deduction allowed over the donor's basis in the property").

[204]Comprehensive Tax Reform, Hearings before the Committee on Ways and Means, House of Representatives, 99th Cong., 1st Sess., 3646 (1985).

[205]Id.

property made by high income taxpayers would be subject to this minimum tax treatment," and of his conclusion that "the price incentive to contribute" appreciated property to charity would be "greatly enhanced by removing appreciated gifts from the lists of tax preferences."[206]

Despite the best efforts of the museums and universities, the tax reform bill passed by the House in December 1985 treated appreciation in charitable gifts as an AMT preference item.[207] The museums and universities redoubled their efforts before the Senate Finance Committee. They formed a thirty-member ad hoc coalition–the Alliance for Philanthropy–featuring (in the words of the *Washington Post*) "the entire Ivy League, as well as many other universities and a panoply of foundations, hospitals, and symphony orchestras."[208] In its written statement to the committee, the Alliance claimed that by stripping the House bill of the AMT revision the Senate could "increase charitable giving by $560 million at a cost of $330 million in tax revenues, thereby increasing by a net of $230 million the total public and private resources allocated to public purposes."[209] The Alliance also saw to it that each of the twenty members of the Finance Committee received a letter from his alma mater begging him to oppose the AMT revision, and that each committee member was visited at least once by a representative of the Alliance.[210]

Despite the all-out efforts of the Alliance, and despite the absence of lobbying on the

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[206]Id. at 6651.

[207]H.R. 3838 as passed by the House of Representatives, December 17, 1985, § 701.

[208]Swardson, supra note 202.

[209]Tax Reform Act of 1986, Hearing before the Committee on Finance, United States Senate, 99th Cong., 2nd Sess., 141 (1986).

[210]Swardson, supra note 202.

other side of the issue,[211] somehow the AMT revision survived to become part of the Tax Reform Act of 1986.[212] The only explanation for the enactment of the AMT provision–in the face of the concerted efforts of a coalition of elite institutions wrapped in the mantle of the public interest–was the congressional understanding of the legislation as a package deal, in which the holy grail of revenue-neutral tax rate reduction could be reached only by merciless base-broadening reforms.

Legislators realized that the reform efforts could quickly unravel if Congress demonstrated that it could be persuaded by intense and skillful lobbying to retain a few high-profile tax expenditures targeted for elimination. This concern had been evident in the Ways and Means Committee's questioning of William Macomber of the Metropolitan Museum. After Macomber warned the committee that the AMT revision would "have an extremely damaging effect on the future flow of great art into public institutions," while "produc[ing] minimum income for the Treasury,"[213] Don Pease (D., Ohio) asked Macomber (and the other panel witnesses) a question clearly inspired by the unraveling concern: "[I]f the choice before the committee was to vote yes or no on the President's proposal, as it was submitted, with no changes one way or another, how would you advise us to vote?"[214] Although he resisted the hypothetical choice, Macomber reluctantly gave the only answer he could:

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[211]"No such lobbying is taking place on the other side of the issue. The only support for the provision comes from tax-policy experts . . . ." Id.

[212]Tax Reform Act of 1986, Pub. L. 99-513, § 701, 100 Stat. 2085, 2335 (codified at former IRC sec. 57(a)(6)).

[213]Comprehensive Tax Reform, supra note 223, at 3638-39.

[214]Id. at 3666.

"[I]f I had to, I would vote no and go back to work and get many of the good provisions in a new bill. But some of these provisions really do challenge our way of life and should not be there."[215] As demonstrated by the passage of the 1986 Act, neither the committee nor Congress as a whole was satisfied with Macomber's answer.

In late 1986–after passage of the 1986 Act but before its 1987 effective date–universities, museums, and other charities benefitted from a brief but dramatic spike in contributions. Eager to claim deductions before tax rates dropped and before unrealized appreciation became an AMT preference item, wealthy donors showered charities with gifts of appreciated stock and art. Anecdotal reports of this phenomenon at the time were later confirmed by a large-scale study.[216]

B. The Restoration

The first sign of the predicted post-tax-reform apocalypse for museums appeared in September 1987, when John Whitney Payson announced that he would sell Vincent van Gogh's "Irises" rather than donating it to Westbrook College in Maine (where it had been on loan for a decade).[217] In reporting Payson's announcement, the *New York Times* noted that the AMT revision was not the only development discouraging gifts of appreciated art; would-be donors were also discouraged from giving by the soaring prices they could realize at auction, and by the drop in marginal tax rates (which both increased the after-tax proceeds of a sale and decreased the after-tax benefit of a gift). Despite the plausibility of a canary-in-the-coal-mine view of the

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[215]Id.

[216]Bill Sing, "Tax Code Changes Spur New Strategies to Cope," Los Angeles Times, December 21, 1986, at A1; Charles T. Clotfelter, The Impact of Tax Reform on Charitable Giving: A 1989 Perspective (NBER Working Paper 3273), tbl. 5 (1990).

[217]Rita Reif, "Tax Law and Art Gifts," New York Times, September 7, 1987, at 9.

1987 "Irises" development, the complaints of museums and universities about the 1986 Act garnered only a modest amount of public attention until 1990.[218] There is, however, an interesting piece of evidence that the tax treatment of donations to art museums had penetrated at least the upper-middle-class public consciousness in the late 1980s: a 1989 *New Yorker* cartoon depicted an art museum facade (resembling that of the Metropolitan Museum of Art) festooned with a banner for a special exhibit of "Masterpieces from the Golden Age of Tax-Deductible Contributions."[219]

The issue regained a place in the tax policy agenda in early 1990, thanks in part to the threat that a second van Gogh painting would be lost to American museumgoers. In January Christie's announced that the "Portrait of Dr. Gachet," which had been on loan to the Metropolitan Museum, would be offered at auction in May.[220] Concern that America's precious heritage of European paintings would continue its westward march across the globe heightened when the auction resulted in the sale of "Dr. Gachet" to a Japanese businessman for the then-record price of $82.5 million.[221] Around the same time, Duke University economist Charles Clotfelter released an NBER Working Paper reporting that "[f]or a group of 119 [art] museums, donations of artwork surged dramatically in 1986 and then fell to a level in 1988 below that

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[218]Only a few news stories on the topic appeared after 1987 and before 1990. See, e.g., Grace Glueck, "Museums Feel the Pinch of Tax Law Changes," New York Times, October 3, 1988, at C22; Daniel Grant, "Record Prices, Tax Reform Bring More Artworks to Auction," Baltimore Sun, December 4, 1988, at G4.

[219]Lee Lorenz, *New Yorker*, December 11, 1989.

[220]Heidi L. Berry, "On the Auction Block," Washington Post, March 8, 1990, at F15.

[221]Rita Reif, "Businessman Identified as Buyer of van Gogh," New York Times, May 18, 1990, at C28.

achieved in 1985, a result that is consistent with the [1986] act's having a permanent effect on such contributions."[222]

Testifying before the Ways and Means Committee in February 1990 on a bill to remove unrealized appreciation in donated property from the list of AMT preference items,[223] Assistant Secretary of the Treasury for Tax Policy Kenneth W. Gideon stated that the Bush administration opposed the bill, largely out of concern about the potential unraveling of the 1986 Act: "[T]he concern we have, frankly, is one of support for the minimum tax provisions that were put in place in 1986. If we take these out, essentially all the other people who are adversely affected by a minimum tax, I think, will be back at your door saying, 'us too.'"[224]

By October 1990 Congress had become fully engaged with the issue–with Senator Daniel Patrick Moynihan (D., N.Y.) leading the pro-museum forces and with Ways and Means Chair Dan Rostenkowski (D., Ill.) resisting the unraveling of the 1986 reforms.[225] The controversy inspired a wonderfully snarky Michael Kinsley op-ed column.[226] After describing Moynihan and his allies as concerned that "America's heritage of European paintings is being shipped abroad," and after explaining why the deduction for unrealized appreciation was an "absurd loophole,"

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[222]Clotfelter, supra note 216, at 20.

[223]H.R. 173, introduced by Representative Bill Frenzel (R., Minn.).

[224]Hearings before the Subcommittee on Select Revenue Measures of the Committee on Ways and Means, House of Representatives, 101st Cong., 2nd Sess., 50-51 (Vol. 2) (1990).

[225]Don Phillips, "Art Donors Caught in the Balance," Washington Post, October 17, 1990, at C1; Nathaniel C. Nash, "An Old Tax on Upper Income Takes Center Stage," New York Times, October 18, 1990, at D25.

[226]Michael Kinsley, "Art Heist," Washington Post, October 25, 1990, at A23.

Kinsley commented, “If the generosity of art donors is drying up because of a mild limit on their right to take what is in essence a double deduction, this puts that generosity into perspective as well.” The column ends, however, with a rueful acknowledgment that the “special pleaders” might well prevail: “If the special pleaders were loggers arguing for jobs or defense contractors arguing for national security, they could expect a stern talking-to from the *bien pensants.* But art humbles us all.”

The 1990 legislative battle ended in compromise; appreciation in donated property was removed from the list of AMT preference items, but only in the case of contributions of “tangible personal property,” and only for taxable years beginning in 1991.[227] The 1990 legislation did nothing for museums beyond 1991, and did nothing at all for universities concerned about dwindling donations of stock shares. Predictably, the response of art donors to the temporary AMT reprieve was a repeat of their end-of-1986 performance; 1991 proved to be a banner year for donations to art museums.[228] In late 1991, additional legislation extended the AMT holiday for another six months, through June 30, 1992.[229]

The stars finally aligned in 1993 for the complete and permanent repeal of the 1986 Act’s AMT treatment of unrealized appreciation in donated property. Senator Moynihan had become the Chairman of the Finance Committee. Newly-elected President Bill Clinton and his Treasury

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[227]Omnibus Budget Reconciliation Act of 1990, Pub. L. 101-508, § 11344, 104 Stat. 1388, 1388–472.

[228]Tom Herman, “It’s Down to the Wire for Donors of Art Works and Collectibles,” Wall Street Journal, November 22, 1991, at C1; Suzanne Muchnic, “A Glorious Year for Museums,” Los Angeles Times, December 25, 1991, at F1.

[229]Tax Extension Act of 1991, Pub. L. 102-227, § 112, 105 Stat. 1686, 1689.

Secretary Lloyd Bentsen also supported repeal,[230] and even Ways and Means Chairman Rostenkowski had been persuaded by discussions with representatives of the Art Institute of Chicago.[231] The resulting legislation completely and permanently repealed the 1986 Act's treatment of appreciation in donated property as an AMT preference item, for stocks and real estate in addition to tangible personal property.[232] The provision was effective prospectively only for stocks and real estate, but for art it was effective for contributions made after June 30, 1992.[233] In combination with the earlier temporary repeal, this meant that the 1986 AMT revision did not apply to any post-1990 gifts of art.

Although the arguments for repeal of the 1986 AMT treatment had focused almost exclusively on the treatment of donations of art, and although the 1991-92 temporary relief legislation had been limited to tangible personal property, the permanent repeal applied just as much to gifts of stock to universities as to gifts of paintings to museums. Asked if restoring the tax break for donations of appreciated stock constituted a loophole, Moynihan "bellowed" (according to the *Washington Post*), "Tell that to the Sisters of Charity of St. Rose. For small liberal arts colleges, the gift of appreciated securities is much more important than an appreciated

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[230]Jacqueline Trescott, "Moynihan and the Art of Tax Breaks," Washington Post, March 31, 1993, at B1.

[231]Irvin Molotsky, "Tax Break to Aid Museums," New York Times, August 19, 1993, at C11.

[232]Omnibus Budget Reconciliation Act of 1993, Pub. L. 103-66, § 13171(a), 107 Stat. 312, 454.

[233]Id., § 13171(d), 107 Stat. 312, 455.

van Gogh."[234]

The charitable deduction for gifts of unrealized appreciation has not been seriously threatened since 1993. What began with a 1917 legislative oversight (i.e., a failure to specify the amount of the deduction in the case of an in-kind donation), and a 1918 conceptual error on the part of the Treasury, has proven remarkably resilient. Killed once by regulatory revision in 1920 (without any recorded objection from the affected charities or their donors), the deduction for unrealized appreciation was resurrected three years later by the Treasury Department of Andrew Mellon. Killed again (albeit only for purposes of the AMT) as part of the great base-broadening-and-rate-lowering bargain of 1986, it was revived yet again–first partially and temporarily in 1991, and fully and permanently in 1993. Once the passage of a few years had weakened the legislative commitment to the integrity of the grand bargain of 1986, so that Congress was willing to consider the AMT issue in isolation, the triumph of the museums and the universities soon followed. Ars longa, tax reform brevis.

Perhaps the story would have ended differently if Moynihan (virtually the Senator from the Metropolitan Museum of Art) had not been Chair of the Finance Committee, and if Rostenkowski had not represented the city graced by the Art Institute of Chicago, but with hindsight the eventual triumph of the museums seems to have been almost inevitable. ("Art humbles us all," as Kinsley observed.) The repeal of the 1986 treatment of gifts of appreciated securities is a different matter. The vast majority of the outcry over the 1986 reform was directed at its effect on donations of art, not of stock. Not surprisingly, it was easier to stir up public and legislative concern about art (especially van Gogh paintings) departing the United States for

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[234] Trescott, supra note 230.

Japan than about a possible decline in the rate of growth of Harvard's endowment (Moynihan's impassioned invocation of the Sisters of Charity of St. Rose notwithstanding). Dr. Gachet left the country so that the deduction for unrealized appreciation might live.

Moynihan and his allies were able to use the momentum generated by the art issue to succeed on the securities issue as well. To indulge for a moment in a counterfactual, imagine that the 1986 AMT revision had applied to securities (and perhaps real estate), while exempting art. One can only speculate, but it seems probable in that case that a movement powerful enough to repeal the 1986 reform would never have emerged. Universities may owe the survival of their favorite tax break to the fact that the 1986 reform applied to art as well as to securities, and to the special, semi-sacred, status of art in the minds of many (both within and outside of Congress).

V. Is There a Moral to the Stories?

In his "original sin" essay, Brannon suggested a moral: "[A] lesson that can be pursued is the importance of beginnings in any tax system. The arena of tax legislation is a poor place for learning by doing or by on-the-job training. The system does not forgive the making of a mistake."[235] The histories of the two errors examined in this article support Brannon's warning that the system may not forgive early mistakes–not even if the mistake is promptly identified and corrected (as in the case of the 1920 regulatory correction of the charitable deduction mistake).[236]

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[235]Brannon, supra note 3, at 1781.

[236]These two histories are not, of course, the only stories from which the "get it right the first time" moral could be drawn. For a prominent recent example, consider King v. Burwell, 567 U.S. __ (2015), involving the interpretation of a very poorly drafted portion of the Affordable Care Act (ACA), for which a legislative fix was politically impossible. The poor drafting came within two Supreme Court votes (a switch of two votes would have changed a six-three split to a five-four split in the opposite direction) of eviscerating the ACA.

Even when, in later decades, Congress undertook heroic and briefly successful efforts to correct the early mistakes, the errors demonstrated a remarkable ability to rise from the dead.

Of course, "you should have gotten it right the first time" is a lesson learned too late to be of benefit to the drafters of the federal income tax. But there will be other complex federal statutes, both tax and non-tax, and the drafters and early administrative interpreters of those statutes would do well to heed Brannon's admonition. "Get it right the first time" is easier said than done, but the difficulty of following the advice does not diminish its importance.