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Consistent Basis Reporting Between Estates and Beneficiaries

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EXECUTIVE SUMMARY

■ Legislation enacted in 2015 now generally requires the basis of property acquired from a decedent to be consistent with the property's basis as reported on the decedent's estate tax return.

■ The basis of property subject to the consistency requirements cannot exceed its "final value" for estate tax purposes or, if the final value has not yet been determined, the value reported on a statement that the executor must file with the IRS and furnish to persons receiving estate property.

■ Proposed regulations under Sec. 1014 provide that property omitted from an estate tax return that would have generated an estate tax liability or additional liability if it had been included has a basis of zero in the hands of its recipient if the statute of limitation for assessment of the estate tax on the estate has expired.

■ Proposed regulations under Sec. 6035 provide details on compliance with the requirement to report to the IRS and beneficiaries the value of property included on a required federal estate tax return.

■ In addition to executors, beneficiaries may also be required to file a statement when estate property they receive then is transferred to a related person in a transaction in which basis is determined in whole or in part by reference to that of the transferor.

Federal laws requiring basis consistency of estate property between estate tax returns and the income tax returns of inheritors had been proposed periodically by congressional tax policy

writers. Then, suddenly, Congress included them in the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015.[1] The act added Sec. 1014(f), which requires consistent basis reporting between estates and persons acquiring property from a decedent, and Sec. 6035, which requires the executor of an estate that is required to file a return under Sec. 6018 to file with the IRS and provide each person acquiring an interest in property included in the decedent's gross estate with a statement identifying the value of the property as reported on the estate tax return. Beneficiaries who are required to file an estate tax return under Sec. 6018(b) are also subject to this requirement. Also added by the act were new Secs. 6662(k) and 6724(d)(1)(D), which provide for a 20% accuracy-related penalty for inconsistent basis reporting and for failure to file the required information reporting statements, respectively.

This last-minute addition, buried in an otherwise non–tax-related bill, caught both practitioners and the IRS off guard, since the bill was enacted on July 31, 2015, and applied to estate tax returns filed on or after Aug. 1, 2015. Consequently, the IRS had yet to develop a form and related instructions for executors and practitioners to comply with these new rules. Furthermore, many questions remained that Congress left to the IRS to address through regulations.

To allow the Service time to provide guidance and implement these new rules and for practitioners and executors to adapt to them, Notice 2015-57 first delayed the original reporting under Sec. 6035 to Feb. 29, 2016, for statements required to be filed and furnished before that date. Notices 2016-19 and 2016-27 effectively delayed the reporting requirement until March 31, 2016, and then June 30, 2016, respectively. A draft of new Form 8971, *Information Regarding Beneficiaries Acquiring Property From a Decedent*, was issued Dec. 18, 2015, along with instructions (issued Jan. 6, 2016), followed by temporary and proposed regulations.[2] However, many questions and inconsistencies still remain that executors and practitioners will have to deal with until the IRS has had time to address them.

Basis Consistency Rule

Sec. 1014(f) and the proposed regulations provide that a taxpayer's initial basis in property acquired from a decedent cannot exceed the property's "final value" for estate tax purposes or, if the final value has not been determined, the value reported on the statement required by Sec. 6035.[3] This rule applies only to property that increases the estate's liability (after credits) by reason of inclusion in the gross estate.[4] In a case where the federal estate tax is imposed, the proposed regulations also provide an exception for property that qualifies for the marital or charitable deduction, as well as tangible personal property for which an appraisal is not required under Regs. Sec. 20.2031-6(b).[5]

Final value is determined:

1. If the value has been reported on the Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*, filed with the IRS, and the value is not adjusted or contested by the IRS before the period of limitation for assessment has expired;
2. In a case where (1), above, does not apply, if the value is specified by the IRS and not contested by the executor of the estate before the period of limitation for assessment has expired;
3. If (1) and (2), above, do not apply, pursuant to a settlement agreement with the IRS once that agreement is final and binding on all parties; or
4. If (1), (2), and (3) do not apply, the value is determined by a court, once the court's determination is final.

An unanswered issue remains where a beneficiary has better information that produces a different value than that used by the executor on the estate tax return filed with the IRS.

The proposed regulations clarify that Sec. 1014(f) does not prohibit otherwise permitted adjustments to the basis due to post-death events such as capital improvements, depreciation,

amortization, adjustments to the basis of a partnership or S corporation interest, or a sale or exchange.[6] However, a deficiency and underpayment penalty could apply if the final value of specific property has been determined before the period for assessment has expired for the federal income tax return of the recipient but after the recipient has sold the property and reported a different basis (a harsh but real possibility).

Zero-Basis Rule

Creating much controversy, Prop. Regs. Sec. 1.1014-10(c)(3)(i)(B) provides that if, after the filing of a federal estate tax return, the executor discovers previously omitted property that would have generated an estate tax liability had it been included on Form 706, and the statute of limitation for assessment has expired, the final value (basis) of the after-discovered or omitted property is zero. Conversely, if the statute of limitation has not yet expired and the executor reports the property, then the property's final value is determined under the general rules described in Sec. 1014(f).

Many commentators, including this author, believe that the IRS has overstepped its statutory authority with this provision since (1) there is otherwise no related provision in the act and (2) it contradicts Sec. 1014, which provides for how basis of property acquired from a decedent is to be determined.[7] It otherwise would seem to be a harsh punishment on the beneficiary for what might be an inadvertent omission by the executor. Even allowing the executor to report the omitted property in a supplemental filing after the statute of limitation has passed and, thus, allowing the beneficiary to use the final value prescribed by Sec. 1014 would be a welcome relief. If the existing rule is upheld, executors will want to be sure to protect themselves and seek hold-harmless provisions prior to accepting a position.

New Reporting Requirements: Form 8971

New Sec. 6035 created by the act requires the executor of an estate to file a statement of value (Form 8971) with the IRS no later than 30 days after the earlier of the date the federal estate tax return is required to be filed or the date it is actually filed. This rule applies to all estate tax returns filed on or after Aug. 1, 2015, including returns that were on extension as of the date of enactment. At the same time, the executor is required to provide a copy of Schedule A, "Information Regarding Beneficiaries Acquiring Property From a Decedent," of Form 8971 to each beneficiary, showing a description and value of any and all possible assets the beneficiary could inherit from the decedent. The executor is required to provide only a copy of Schedule A to the beneficiaries and not Form 8971. As noted above, a transition provision allowed for Forms 8971 otherwise due between Aug. 1, 2015, and May 31, 2016, to be filed by June 30, 2016 (currently, there is no provision to request an extension of time for filing Form 8971 and Schedule A).

If the beneficiary is not an individual but is instead a trust, estate, or business entity, the executor should provide the Schedule A to the trustee, executor, or the business entity itself and not the beneficiaries or owners. If there is an adjustment to the information required to be included on the form, a supplemental statement (supplemental Form 8971) must be filed no later than 30 days after the adjustment is made.

The proposed regulations clarify and confirm that the reporting requirement under Sec. 6035 does not apply if a federal estate tax return is otherwise not required to be filed, including where returns are filed solely to make the portability election or a generation-skipping transfer tax election or exemption allocation.[8]

Practitioners and executors will face several obstacles when preparing Form 8971. First, and maybe most important, most executors will not know within 30 days after the Form 706 is filed which assets will be going to which beneficiaries, and multiple beneficiaries may be receiving a prorated portion of a single asset. In such instances, any and all possible assets that

could be used to satisfy a beneficiary's interest must be listed on each Schedule A. This would result in each beneficiary's receiving a Schedule A listing the same and possibly all of the assets of the estate, disclosure of which may not have been consistent with the intent of the decedent.

Supplemental Information Returns

The proposed regulations generally require a supplemental information return (supplemental Form 8971 and related Schedule A) to be filed within 30 days upon a change of information required to be reported that would otherwise render the original filing incorrect or incomplete. This could be the result of erroneous or incomplete information originally available to the executor, including the discovery of additional property, changed final property values (e.g., as the result of an audit or litigation), or the discovery of a new beneficiary or change of identity of a beneficiary who will receive the assets. The regulations make clear that a supplemental filing is not required to correct an inconsequential error or omission or to specify the actual distribution of assets previously reported as being available to satisfy the interest of multiple beneficiaries.[9]

The above rules raise the question of whether the filing requirement should be 30 days from the date the estate tax return is filed (or additional information is received) or 30 days from the date that assets are actually distributed. An alternative being recommended by the AICPA Trust, Estate, and Gift Tax Technical Resource Panel is to make the filing of Form 8971 annual, based on assets distributed to beneficiaries during the preceding calendar year, due by Feb. 15 after the close of the year.

Complicating these rules is an inconsistency between Secs. 1014(f) and 6035. The former exempts property subject to the marital deduction from the basis consistency rules (and related penalty provisions), but the same exemption does not apply to the reporting rules for

Form 8971, such as where the portability election is not used or is inapplicable and the surviving spouse is receiving assets. In these cases, Form 8971 will need to be filed and a Schedule A provided to the surviving spouse.

> ***Example 1:*** A husband dies in 2016 after using all of his applicable exclusion amount ($5,450,000), leaving his entire estate to his surviving spouse, subject to the marital deduction. The assets left to the surviving spouse will not be subject to the basis consistency rules, since Sec. 1014(f) excludes assets subject to the marital deduction. However, a similar exemption does not apply under Sec. 6035, and since the portability election cannot be made by the executor (there is nothing left to "port"), and an estate tax return is due in order to claim the marital deduction, the executor must file Form 8971 with the IRS and provide a copy of Schedule A to the surviving spouse.

Practice tip: More than ever, practitioners preparing client tax returns will have to inquire whether any assets sold by the taxpayer were inherited and, if applicable, obtain a copy of Schedule A to verify basis.

The proposed regulations provide four categories of assets that are not required to be reported on Form 8971:[10]

- Cash. However, it is unclear to what extent this would include cash equivalents. Does this include receivables, bank accounts, and money-market accounts?
- Income in respect of a decedent. Technically, unless clarified, this exemption would not apply to balances in a Roth IRA or Roth account with an employer or the after-tax contributions in a traditional IRA or employer retirement account.
- Tangible personal property for which an appraisal is not required under Regs. Sec. 20.2031-6(b).

- Property that is sold or otherwise disposed of by the estate during the course of administration in a transaction in which capital gain or loss is recognized. Not addressed here is a situation where ordinary gain or loss is recognized (e.g., under Sec. 1231).

Subsequent Transfers

Sec. 6035(a) clearly states that the responsibility for furnishing the statement of information to the IRS and beneficiaries falls on the executor. A controversial provision in the proposed regulations, however, requires additional information reporting *by the beneficiary* (recipient) upon a subsequent transfer to a related transferee (generally, a family member or related entity) in a transaction in which the transferee's basis is determined in whole or in part with reference to the transferor's basis, such as in the case of a gift.[11]

> ***Example 2:*** *J* inherits 100 shares of *ABC* stock with a final estate value of $1,000, which is properly reported on the decedent's estate tax return and on Form 8971 and Schedule A prepared by the executor. *J* holds the stock for 50 years and then gifts the shares to his son and reports the gift on a timely filed gift tax return. *J* will also need to file a supplemental Form 8971 with the IRS and provide his son with a copy of Schedule A.

Again, whether the IRS is overstepping its statutory authority is an issue, not to mention the question of why the IRS needs the information if a gift tax return is being filed reporting it. Until this issue is resolved, estate beneficiaries will need to retain the initial Schedule A indefinitely or until all inherited assets have been disposed of.

Conclusion

As Treasury and the IRS wade through the comments and recommendations from various professional organizations in an effort to provide more clarity and guidance, practitioners and

executors will need to be wary of the gaps and inconsistencies of the new statute and regulations and keep on top of developments to properly advise clients of their filing obligations and avoid surprises.

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1. Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, P.L. 114-41.

2. T.D. 9757 and REG-127923-15, published in the *Federal Register* on March 4, 2016 (81 *Fed. Reg.* 11486).

3. Sec. 1014(f)(1); Prop. Regs. Sec. 1.1014-10.

4. Sec. 1014(f)(2).

5. Prop. Regs. Sec. 1.1014-10(b)(2).

6. Prop. Regs. Sec. 1.1014-10(a)(2).

7. See, e.g., Madara, "Basis Consistency Rules May Exceed Statutory Authority," 2016 TNT 43-1 (March 4, 2016), also comment letters to Treasury and the IRS on the proposed regulations submitted by the AICPA, Texas Society of CPAs, American College of Trust and Estate Counsel, and American Bankers Association.

8. Prop. Regs. Sec. 1.6035-1(a)(2).

9. Prop. Regs. Sec. 1.6035-1(e)(3).

10. Prop. Regs. Sec. 1.6035-1(b)(1).

11. Prop. Regs. Sec. 1.6035-1(f).