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## **New Rules Require Inherited/Transferred Property Basis Returns**

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### **Overview**

The Surface Transportation and Veterans Health Care Improvement Act of 2015 (Act) added I.R.C. §6035 to the Code. I.R.C. §6035 specifies that a decedent's estate that is required to file a federal estate tax return (Form 706) after July 31, 2015, must provide basis information to the IRS and estate beneficiaries by the earlier of 30 days after the date Form 706 was required to be filed (including extensions, if granted) or 30 days after the actual date of filing of Form 706. The purpose of the provision is to ensure that beneficiaries of estate assets use the same basis numbers when later selling the assets as were used in the decedent's estate.

The initial filing deadline was moved forward to March 31, 2016 (from February 29, 2016).<sup>1</sup> However, IRS failed to timely issue proposed regulations (and a temporary regulation), waiting until early March (in the middle of tax filing season) to do so, mere days before the filing deadline.<sup>2</sup> As a result, practitioners had very little time to study the proposed regulations and deal with their inconsistencies and breadth. Consequently, in late March, the IRS again delayed the filing deadline, this time to June 30, 2016.<sup>3</sup>

The new rules do two things – (1) specify that the basis of property subject to the new rules cannot exceed the final value as determined for estate tax purposes in a decedent's estate; and (2) impose a reporting requirement with regard to the value of property included in a decedent's gross estate.

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<sup>1</sup> By statute, the filing deadline was August 31, 2015 for executors who either filed Form 706 on August 1, 2015 or should have filed Form 706 with a due date of August 1, 2015. However, there was no way to comply with the law without forms on which to report the required information. Thus, the IRS issued Notice 2015-57 stating that any reports due before February 29, 2016, should not be filed before that date.

<sup>2</sup> REG-127923-15, Mar. 4, 2016. The temporary regulation (Temp. Reg. §1.6035-2T), merely specifies the due date of the relief that was provided in I.R.S. Notice 2016-19, 2016-9, I.R.B. 362.

<sup>3</sup> I.R.S. Notice 2016-27, 2016-15 I.R.B. 1.

## The Filing Requirement

Under the Act, I.R.C. §6035(a)(1) requires the executor of an estate that is required to file Form 706 by I.R.C. §6018(b) to furnish to the IRS and the person acquiring any interest in property that is included in the decedent's gross estate for federal estate tax purposes, a statement detailing the value of each interest in the property inherited as reported on Form 706 along with any other information that the IRS might require by regulation.<sup>4</sup>

**Note:** An estate executor must: (1) furnish a statement (IRS Form 8971 and the accompanying Schedule A) to the IRS identifying the reported value of each asset that was included in the gross estate; and (2) give that information (Schedule A of Form 8971) to each person who acquired the interests and identify those individuals in the report to the IRS.

The Act allowed IRS to move the filing deadline forward and the IRS did move the date forward to February 29, 2016 for statements that would be due before that date under the 30-day rule contained in the Act.<sup>5</sup> IRS stated at the time that executors and other persons were not to file or furnish basis information statements until the IRS issued forms or additional guidance. Relatedly, the Act modifies I.R.C. §1014(f) to require beneficiaries to limit basis claimed on inherited property to either the value of the property as finally determined for federal estate tax purposes, or the value reported to the IRS and beneficiary under I.R.C. §6035.

In early 2016, the IRS again delayed the estate basis reporting due date to March 31, 2016 to allow time for proposed regulations to be issued that provide guidance on numerous questions concerning the new provision.<sup>6</sup> The IRS again pushed the deadline forward to June 30, 2016.<sup>7</sup> The information reporting is to be accomplished via Form 8971.

**Form 8971.** The information required to be furnished to the IRS and beneficiaries is reported on Form 8971. Form 8971 that is filed with the IRS is to include a copy of each statement that is required to be furnished to the beneficiaries – Schedule A. Schedule A is the beneficiary statement form that gets filed with the beneficiaries.<sup>8</sup> Form 8971 and the attached Schedule A are not to be filed with Form 706.

**Note:** The purpose of the Form is to make sure that when a beneficiary later sells the inherited assets, that the gain on sale (if any) is properly reported by using the same value for the heir's basis in the asset on sale as was reported on Form 8971.

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<sup>4</sup> I.R.C. §6035(a)(2). Any statement filed under I.R.C. §6035 is subject to the failure to file penalties contained in I.R.C. §§6721 and 6722.

<sup>5</sup> I.R.S. Notice 2015-57, 2015-36, I.R.B. 294.

<sup>6</sup> I.R.S. Notice 2016-19, 2016-9 I.R.B. 362 and Treas. Reg. §1.6035-2T(a).

<sup>7</sup> I.R.S. Notice 2016-27, 2016-15, I.R.B. 1.

<sup>8</sup> I.R.C. §6035(a)(3)(A). The Schedule A for a beneficiary lists the assets the beneficiary receives and the value of those assets for federal estate tax purposes.

Form 8971 is to be completed within 30 days of the due date of the Form 706 or within 30 days of when Form 706 is actually filed,<sup>9</sup> which could be difficult to comply with.<sup>10</sup> In an attempt to deal with this situation, the Form 8971 instructions direct the executor to report *all* of the *potential* assets that a beneficiary *might possibly* inherit on Schedule A.<sup>11</sup> In addition, when the administration process is far enough down the road so that the executor knows the actual asset allocation to the beneficiaries, the executor is to file an “updated” Form 8971.<sup>12</sup>

**Observation:** It would make sense to statutorily change the due date of Form 8971 to either the time when the actual assets to be distributed to a particular beneficiary can be determined or when the distribution to a beneficiary is actually made.

While the instructions to Form 8971 state that the Form need not be filed if the only reason for filing the Form is to elect the GSTT or make a GSTT allocation, the instructions are silent on the portability issue. The statute, I.R.C. §1014(f)(2), says that the new “basis consistency” rules only apply to property included in an estate that increases the estate’s federal estate tax liability (reduced by any credits allowed against the tax). That would mean that property passing outright to a surviving spouse that qualifies for the marital deduction and property passing to a charity aren’t subject to the basis consistency rules because they don’t trigger estate tax. By the same logic, estates that file Form 706 for the sole purpose of electing portability of the unused estate tax exclusion at the death of the first spouse should not trigger a Form 8971 filing requirement.

## Proposed Regulations

**Consistent Basis Reporting Rules.**<sup>13</sup> The statute<sup>14</sup> specifies that the application of the basis consistency rule is limited in its application to property that would increase the liability for estate tax (reduced by allowable credits against the tax) if it were included in the decedent’s estate.<sup>15</sup> This rule, however, applies only for purposes of the basis consistency rule. It does not apply to the information reporting requirements. Thus, for example, property that qualifies for the estate tax marital or charitable deduction does not impact an estate’s tax liability and is not subject to the basis consistency rule but is subject to the information reporting requirement. Likewise,

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<sup>9</sup> I.R.C. §6035(a)(3)(A). The Form 8971 instructions state that basis information statements are due within 30 days of the filing date when Form 706 is not filed in a timely manner. In addition, if an adjustment is made to Form 706, a supplemental basis information statement is to be filed within 30 days after the adjusted Form 706 is filed.

<sup>10</sup> In many situations, estates (and trusts that are related to estates) have not proceeded through the administration process sufficiently within 30 days of the 706 filing to be able to pin-down the heirs that are to receive particular assets. Determining value is one thing, but interpreting will and trust language to determine who gets what is a completely different task.

<sup>11</sup> This is consistent with Prop. Treas. Reg. §1.6035-1(c)(3). As the preamble to the proposed regulations note, this will result in duplicate reporting of assets on multiple Forms Schedule A. Also, assets do not have to be reported if they are not “property for which reporting is required.”

<sup>12</sup> That will present some interesting client consultations, especially in large estates. For those estates, any particular beneficiary could receive a rather lengthy Schedule A and might assume that they will be inheriting all of the assets listed on the Schedule. That assumption will be “corrected” when they receive the “updated” Form 8971.

<sup>13</sup> Prop. Treas. Reg. §1.1014-10.

<sup>14</sup> I.R.C. §1014(f)(2).

<sup>15</sup> The corresponding regulation is Prop. Treas. Reg. §1.1014-10(b)(1). This means that the basis consistency rule applies to property that is included in a decedent’s estate under either I.R.C. §2031 or I.R.C. §2106 which triggers a federal estate tax that exceeds allowable credits (except for the credit for prepayment of estate tax).

Prop. Treas. Reg. §1.1014-10(b)(2) states that property for which an appraisal is not required under Treas. Reg. §20.2031-6(b) is not subject to the basis consistency requirement,<sup>16</sup> and the basis consistency rule also doesn't apply to a "no tax" estate even where a Form 706 filing is required.<sup>17</sup>

**Note:** On the appraisal issue, Example 1 in Prop. Reg. §1.6035-1(b)(2) indicates the exception applies to any individual asset that is valued at less than \$3,000. However, Treas. Reg. §20.2031-6(b) applies if the total value of articles having marked artistic or intrinsic value exceeds \$3,000. The instructions to Form 706 state that an appraisal is required for "works of art,..." etc., if any item is valued at more than \$3,000.

The proposed regulations allow for post-death changes in basis,<sup>18</sup> and also apply the basis consistency rules to property that had been omitted from Form 706.<sup>19</sup> If the omission is discovered and the omitted property is reported on a supplemental Form 706 before the period of limitation on assessment of tax expires, nothing changes. The normal rules on final value are applicable.<sup>20</sup> If the omission is discovered *after* the statute of limitations has expired on assessing estate tax against the estate, the proposed regulations assert that the beneficiary of the property will receive a zero basis.<sup>21</sup>

**Note:** There is no statutory authority in I.R.C. §1014(f) for the position taken in the proposed regulations of adjusting basis to zero for omitted assets discovered after the statute of limitations on assessment has run. Also, for assets discovered after Form 706 is filed, but before the statute of limitations on assessment of estate tax has run, practitioners may not find it worthwhile to file a supplemental Form 706 (to avoid a zero basis). That's because no duty exists to report after-discovered property with respect to an estate for which Form 706 was filed in good faith.<sup>22</sup>

The proposed regulations are the sole guidance on the basis consistency rules and must be relied upon for both the preparation of Form 8971 and the preparation of income tax returns of heirs receiving property subject to the basis consistency rules until final regulations are published.

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<sup>16</sup> This regulation requires an appraisal for "household and personal effects articles having marked artistic or intrinsic value of a total value in excess of \$3,000. Thus, the appraisal requirement generally applies to jewelry, furs, silverware, paintings, etchings, engravings, antiques, books, statuary vases, oriental rugs, coin or stamp collections.

<sup>17</sup> Treas. Reg. §1.1014-10(b)(3). Thus, if the estate owes no federal estate tax, the basis consistency rules apply to none of the assets in the estate.

<sup>18</sup> Prop. Treas. Reg. §1.1014-10(a)(2). The estate tax value of the property sets the upper limit on the initial basis of the property after the decedent's death.

<sup>19</sup> Prop. Treas. Reg. §1.1014-10(c)(3).

<sup>20</sup> Prop. Treas. Reg. §1.1014-10(c)(3)(i)(A).

<sup>21</sup> Prop. Treas. Reg. §1.1014-10(c)(3)(i)(B).

<sup>22</sup> As noted by Steve R. Akers in "Basis Consistency Temporary and Proposed Regulations, March 8, 2016, located at [www.bessemer.com/advisor](http://www.bessemer.com/advisor), this rule could put an estate executor in conflict. The estate will not want to report the newly discovered asset, but the beneficiary will want the asset reported to get a date-of-death basis.

**Reporting requirement regulations.**<sup>23</sup> The proposed regulations do provide an exception from the reporting requirements for estates that file Form 706 for the sole purpose of making a portability election under I.R.C. §2010(c)(5), or simply to make a GSTT exemption allocation or election, or to make a protective filing.<sup>24</sup>

The proposed regulations on the reporting issue generally follow the initial guidance:

- The values to be reported are the “final values” as reported on Form 706 (or as the IRS later determines then, or as agreed to or determined by a court);<sup>25</sup>
- For “final values” that later change, the estate must supply a new “final value”;
- Basis reporting for a non-resident, non-citizen decedent applies only to property in the estate that is subject to federal estate tax;
- If property is subject to non-recourse debt, the basis of the property is its gross value (rather than the net value that is reported on Form 706);<sup>26</sup>
- For a decedent’s community property, only the decedent’s one-half of community property is subject to the basis consistency reporting requirement;<sup>27</sup>
- Generally, all property reported on Form 706 must be reported on Form 8971. However, exceptions exist for income in respect of a decedent (IRD) property,<sup>28</sup> cash (other than collectible coins and bills) or property for which an appraisal is not required (personal effects of the decedent, for example),<sup>29</sup> or property that the estate disposed of that triggered capital gain or loss.
- If the executor hasn’t determined the property that will be transferred to each beneficiary as of the reporting deadline, the executor is to give the beneficiary a list of every asset the beneficiary might receive;<sup>30</sup>
- The executor must include a statement concerning any beneficiaries that cannot be located, and explain efforts undertaken to locate them. A supplemental filing will be required if the property is ultimately distributed to someone else, just as it is required to be filed within 30 days of the locating of the previously unascertained beneficiary;<sup>31</sup> and
- A supplemental Form 8971 must be filed with the IRS and each beneficiary is to receive a supplemental Schedule A if previously reported information turns out to be incorrect or incomplete, unless the erroneous information is merely an inconsequential error or

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<sup>23</sup> Prop. Treas. Regs. §§1.6035-1 and 2.

<sup>24</sup> Prop. Treas. Reg. §1.6035-1(a)(2).

<sup>25</sup> Prop. Treas. Reg. §1.6035-(a)(1) with “final value defined in Prop. Treas. Reg. §1.1014-10(c). This “final value” establishes the initial basis with the normal post-death basis adjustments remaining available. Once a final value is determined, if it turns out to be less than the reported value, the recipient of the property so valued cannot rely on the value that was listed in the original statement and could have a deficiency and underpayment attributable to the difference. Prop. Treas. Reg. §1.1014-10(c)(2).

<sup>26</sup> Prop. Treas. Reg. §§1.1014-10(a)(2) and 1.1014-10(e), Example 4.

<sup>27</sup> But, both halves of the community property will receive a basis adjustment in accordance with I.R.C. §1014(b)(6).

<sup>28</sup> It may not always be the case that IRA funds are not subject to the basis reporting rules. For example, an account could consist of non-deductible contributions and part of the amounts in the account may not be IRD.

<sup>29</sup> However, works of art or an item or collection of items with an artistic or collectible value exceeding \$3,000 as of the date of death must be reported.

<sup>30</sup> Prop. Treas. Reg. §1.6035-1(c)(3). After the bequest is funded, a supplemental Schedule A need not be filed with the IRS or the beneficiary.

<sup>31</sup> Prop. Treas. Reg. §1.6035-1(c)(4).

omission.<sup>32</sup>

**Note:** Generally, a 30 day rule applies to supplemental returns – 30 days after the final value is determined; 30 days after the executor discovers incomplete or incorrect information; 30 days after a supplemental Form 706 is filed.<sup>33</sup>

**Contingent beneficiaries.** For a contingent beneficiary, the executor’s reporting requirement is triggered when the contingent beneficiary actually receives the property from the estate.<sup>34</sup> Thus, for a life tenant that is the beneficiary of a life estate, the executor must send Schedule A of Form 8971 to the life tenant and the remainder holders as the beneficiary of the remainder interest. Also, any change in a beneficiary due to a contingency must be reported.<sup>35</sup>

**Note:** This rule appears to subject an estate executor to a continuing duty to provide supplemental reports into the future.

**Entity beneficiaries.** For beneficiaries that are entities, the executor files the basis information (Schedule A of Form 8971) with “the appropriate” entity representative of a trust or an estate (i.e., the trustee or executor) or directly with a business entity that is a beneficiary.<sup>36</sup>

**Transfers by beneficiaries.** If a beneficiary that receives property (that is subject to a basis reporting requirement) from an estate later transfers the property to a related party<sup>37</sup> and the transferee’s basis is determined at least partially by the transferor’s basis, the beneficiary that transfers the property must file a supplemental Schedule A with the IRS and give the transferee a copy that reports the change in ownership and the final estate tax value of the property.<sup>38</sup> The supplemental Form 8971 for such transfers is due within 30 days after the date of the transfer.<sup>39</sup> Thus, when a beneficiary subsequently gifts the inherited property, for example, the basis reporting rule applies and Form 8971 must be filed within 30 days of the transfer.

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<sup>32</sup> As stated in the Form 8971 instructions, a Form 8971 error that relates to a taxpayer identification number, a beneficiary’s surname or value of the asset that a beneficiary is receiving is not inconsequential. Likewise, errors on Schedule A to Form 8971 that relate to the value of an asset that a beneficiary receives from an estate or relate to a “significant item in a beneficiary’s address” are not inconsequential.

<sup>33</sup> Prop. Treas. Reg. §1.6035-1(a)(4)(ii). But, the rule is 30 days from the date property is distributed to a beneficiary from a probate estate or revocable trust if final value is determined before the distribution, or the executor discovers an incorrect or incomplete information return before the distribution, or a supplemental Form 706 is filed before the distribution. Prop. Treas. Reg. §1.6035-1(f).

<sup>34</sup> Prop. Treas. Reg. §1.6035-1(c)(1).

<sup>35</sup> For example, if a remainderman dies before a life tenant, the executor must file a supplemental report with the IRS and the new remainderman. *Id.*

<sup>36</sup> Prop. Treas. Reg. §1.6035-1(c)(2). Supplemental reporting could be triggered if the entity transfers the asset and the carryover basis rule applies.

<sup>37</sup> A “related party” for this purpose is any member of the transferee’s family as defined in I.R.C. §2704(c)(2), any controlled entity and any trust of which the transferor is the deemed owner for income tax purposes. That would include a grantor trust as a “related party,” but *not* a non-grantor trust. For grantor trusts, it appears that when the trust makes a distribution to a beneficiary, the trustee need not file a basis information statement with the IRS and beneficiary.

<sup>38</sup> Prop. Treas. Reg. §1.6035-1(f). Thus, the rule could apply *ad nauseum* and would also apply in situations that involve, for example, a like-kind exchange of the property or an involuntary conversion of the property.

<sup>39</sup> There is no specification in the proposed regulations that gifts covered by the present interest annual exclusion are excluded from the reporting requirement, and there is also no de minimis amount specified that would be exempt from the reporting requirement.

**Note:** The position taken in the proposed regulations is contrary to I.R.C. §6035 which imposes the basis reporting requirement *solely* on the party responsible for filing Form 706.<sup>40</sup>

Other scenarios can involve subsequent transfers:

- If the original recipient transfers the property before the estate is required to file a Form 8971, the original recipient still must file Form 8971 but only need report the change in ownership;<sup>41</sup>
- Where the basis of the property has changed after being distributed to the beneficiary, the transferor is to report the original basis as received from the decedent's estate, and has the option of providing information on the basis change of the asset while in the transferor's hands.
- Where a subsequent transfer occurs before a "final value" is set, the transferor is to provide the executor with a copy of the supplemental statement that is filed with the IRS, and the executor is to provide any required basis notification statement to the transferee.
- If an individual beneficiary transfers the property to a grantor trust (a non-taxable event), the transferor will have to file a basis information statement with the IRS and the trustee of the trust (probably the transferor). But, a similar requirement does not apply if the transfer is made to a non-grantor trust.

**Accuracy-related penalty.** An accuracy-related penalty is imposed on taxpayers who report a basis higher than that reported by the estate on Form 8971 with respect to transactions reported on the taxpayer's income tax return.<sup>42</sup>

## Effective Date

The Proposed Regulations are effective only upon publication as final regulations, but can be relied upon before final regulations are issued. Temp. Treas. Reg. §1.6035-2T specifies that March 31, 2016 is the due date for any basis information statement required to be filed before March 31, 2016. However, as noted earlier, that deadline has been moved to June 30, 2016.<sup>43</sup>

## Summary

The new basis information reporting rules are designed to deal with the problem of property being reported for federal estate tax purposes at one value (which establishes the basis of the assets included in the decedent's estate), and then having gain reported for tax purposes based on an entirely different income tax basis. The problem is real. The solution as proposed in the regulations has shortfalls. Hopefully, final regulations will clean up the problems that the

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<sup>40</sup> See, I.R.C. §6035(a)(1).

<sup>41</sup> Prop. Treas. Reg. §1.6035-1(f).

<sup>42</sup> Prop. Treas. Reg. §1.6662-8.

<sup>43</sup> Notice 2016-7, 2016-15 I.R.B. 1

proposed regulations create. In any event, the administration of many decedents' estates has become more complicated.