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Thursday, 17 March 2016 **WRM# 16-11**

TOPIC: Hot Off the Press: Proposed Regulations on Basis Consistency and Information Reporting for Estate Fiduciaries – New Rules, New Headaches.

MARKET TREND: The IRS continues to clamp down on taxpayers by providing guidance and stiff rules on basis consistency and information reporting requirements.

SYNOPSIS: The Treasury Department and IRS have issued proposed regulations that help clarify the application of the basis consistency and corresponding information reporting requirements. These new proposed regulations also (1) include surprising new stiff rules regarding the basis of after-discovered or omitted assets not reported on an estate tax return and (2) impose additional reporting requirements when inherited assets are subsequently transferred by gift to a related party. Although the regulations have not been finalized, compliance will be required: any estate that filed a required estate tax return after July 31, 2015 and for which information returns are due will be required to comply with the information reporting requirements by March 31, 2016.

TAKE AWAYS: Although the concept of basis consistency seems straight forward, implementation will create heavy administrative burdens for the estate and its beneficiaries. Estate fiduciaries and their advisors will need to meet reporting deadlines as the proposed regulations include no extension of time to comply and penalties will be assessed. Beneficiaries, on the other hand, who receive a so-called "Information Statement" must keep it until the inherited assets are transferred, and if a beneficiary gifts an inherited asset, in whole or in part, the beneficiary will be required to comply with all new information reporting requirements. Estate fiduciaries should also be cognizant of the extremely severe zero basis rules applicable to after-discovered and omitted assets, which will require all such fiduciaries to be diligent about marshaling all estate assets to avoid triggering a zero basis for any assets.

PRIOR REPORT: 15-37.

MAJOR REFERENCES: REG-127923-1 (26 CFR Parts 1 and 301), 3/4/2016; TD 9757, 3/4/2016; Internal Revenue Code ("Code") §§ 1014(f) and 6035.

On March 4, 2016, the Treasury Department and IRS released proposed regulations concerning the new basis consistency and information reporting requirements for taxable estates. The basis consistency and reporting legislation, enacted on July 31, 2015, was previously discussed in *AALU's WRMarketplace Report No. 15-37*. This report examines some of the key clarifications made in the proposed regulations along with two unexpected and surprising new rules regarding after-discovered assets and subsequent transfers of inherited assets.

THE BASIS CONSISTENCY RULES

The basis consistency rules were enacted as part of the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 (the "**Act**") and impose new basis consistency requirements on recipients of certain inherited assets. Generally, the basis of an inherited asset is the value as determined for federal estate tax purposes (the fair market value of the asset as of the decedent's date of death or, if elected, the alternate valuation date). Prior to the Act, the value was treated as presumptive rather than conclusive, and beneficiaries were able to claim that the fair market value of an asset, and thus the basis, was actually greater than the value reported for estate tax purposes in an effort to reduce future capital gains.

The new basis consistency rules found in Code § 1014(f) and the proposed regulations impose a general restriction that the *initial* basis of certain inherited assets cannot exceed the assets' final value as determined for federal estate tax purposes.[1] The restriction applies to an asset until it is sold, exchanged, or otherwise disposed of in a transaction that results in the recognition of gain or loss for federal income tax purposes.[2]

Rules Apply to Assets that Increase the Estate Tax Liability. The basis consistency rules only apply to taxable estates.[3] Accordingly, if an estate meets the value threshold for filing a federal estate tax return ($5,450,000 for 2016, less lifetime taxable gifts) but, due to allowable deductions and credits there is no federal estate tax liability, all assets reported on the estate tax return are excluded from the basis consistency restriction. The below table summarizes the estates and assets that are and are not subject to the basis consistency rules.

Estates/Assets Subject to the Basis Consistency Rules	Estates/Assets Not Subject to the Basis Consistency Rules
• If a federal estate tax return is required (e.g., estate reaches the filing threshold of $5,450,000 (for 2016), less lifetime taxable gifts), all assets that contribute to the tax liability, including assets covered by the federal estate tax exemption[4] • Tangible personal property required to be separately appraised that contributes to the estate tax liability	• All assets of an estate that is not required to file an estate tax return • All assets of an estate that is required to file an estate tax return but does not have an estate tax liability due to allowable deductions and credits • Assets that do not increase the estate tax liability (assets that qualify for the federal estate tax marital and charitable deductions) • Tangible personal property that is not required to be separately appraised

Practical Comment. As noted above, the basis consistency rules apply only if there is an estate tax liability. The typical estate plan for spouses defers all estate tax liability until the death of the surviving spouse. In such cases, the proposed regulations provide that the basis consistency rules would not apply until the death of the surviving spouse.

Final Value. The proposed regulations define the "**final value**" of an asset as: (i) the value reported on the federal estate tax return if the limitations period for assessments (generally three years after filing the estate tax return) expires without the IRS contesting the value, (ii) the value determined by the IRS that is not timely contested by estate fiduciaries, or (iii) if the value determined by the IRS is timely contested, the value determined pursuant to an agreement or determined by a court.[5]

Until the final value is determined, the recipient of an asset may not claim an initial basis for the asset that exceeds the value reported on the estate tax return. If the reported value is changed on audit, the recipient may not rely on the reported value. Consequently, if the final value is lower than the reported value and the recipient has sold the asset, the recipient may be assessed with a deficiency and underpayment penalties.[6]

Basis of After Discovered and Omitted Assets. The proposed regulations also include harsh rules for after-discovered and omitted assets.

- If an additional asset is discovered after filing a required estate tax return but before the expiration of the limitations period for assessment of estate tax, the basis of the asset will be the value as finally determined for federal estate tax purposes if the estate fiduciary files a supplemental estate tax return. However, if the estate fiduciary does not report the after-discovered or omitted asset on a supplemental return before the expiration of the limitations period, the basis of the unreported asset is zero.[7]

- If an estate tax return was not required to be filed but an additional asset is discovered that brings the value of the estate above the filing threshold, triggering an estate tax liability, the basis of all assets in the decedent's estate will be zero until the estate fiduciary files an estate tax return or the IRS determines a value for the assets.[8]

> *Example*: D passed away in January 2016 without making lifetime taxable gifts. His gross estate includes a residence valued at $2,000,000, securities valued at $3,000,000 and tangible personal property having a combined value of less than $10,000. D's estate is not required to file an estate tax return. One year after D's death, the executor of his estate discovers a safe deposit box that contains stock certificates valued at $500,000 at the time of D's death. The basis of all assets in D's estate will be zero until the executor files an estate tax return.

THE INFORMATION REPORTING REQUIREMENTS

To implement the basis consistency rules, the Act also imposes new reporting obligations on fiduciaries of certain estates. First, estate fiduciaries are required to file a new Form 8971, Information Regarding Beneficiaries Acquiring Property from a Decedent (referred to as an "**Information Return**") with the IRS to report the final value of certain assets and the beneficiaries receiving the assets.[9] The Information Return includes a separate Schedule A (an "**Information Statement**") for each beneficiary, which lists the assets the beneficiary received (or is expected to receive) from the estate and the value of such assets.

Second, estate fiduciaries are required to provide each beneficiary with the Information Statement prepared for the beneficiary.[10] If the beneficiary is a trust, estate or business entity, the estate fiduciary is required to provide the Information Statement to the trust, estate or business entity rather than the beneficiaries of the trust or estate or to the owners of the business entity.[11] If the estate fiduciary has not determined which assets a beneficiary will receive, the estate fiduciary is required to list all assets that could be used to fund the beneficiary's distribution on that beneficiary's Information Statement.[12] This means that the same assets may be reflected on more than one Information Statement. Once a decision is made regarding allocation, the estate fiduciary may, but is not required to, file a supplemental Information Return and provide supplemental Information Statements.[13]

Practical Comment. If the estate fiduciary has not decided how estate assets are to be distributed among the beneficiaries, preparation of the Information Statements will likely mean giving each beneficiary a small version of the estate tax return - and much more information than the estate fiduciary may want to provide. Going forward, estate fiduciaries will be well advised to develop a distribution strategy as part of preparing the estate tax return.

When Information Return and Statements Are Required. The Information Return and Information Statements are mandated only if an estate is required to file an estate tax return. Accordingly, an estate fiduciary is not required to file an Information Return or provide Information Statements if the estate does not meet the value threshold for being required to file an estate tax return, even if the estate fiduciary elects to file a return for other purposes, such as to make an allocation of the decedent generation-skipping transfer tax exemption, make a portability election to transfer the decedent's unused estate tax exemption to a surviving spouse, or to make a protective election to avoid a penalty if an asset value is later determined to cause a return to be filed.[14]

Practical Comment. Note that if an estate tax return is required, the Information Return and Information Statements are also required even though the basis consistency rules may not apply (e.g., there is no estate tax liability due to value and/or allowable deductions and credits).

Assets Required To Be Reported. If an Information Return is required, all assets required to be reported on the estate tax return must be included on the Information Return, with the following exceptions:

- Cash (other than a coin collection or other coins or bills with numismatic value), including cash proceeds from a life insurance policy;

- Income in respect of a decedent (such as IRAs, qualified pension plans, accrued interest and uncollected compensation);

- Tangible personal property for which an appraisal is not required (generally, items having an artistic or intrinsic value of less than $3,000); and

- Assets sold, exchanged, or otherwise disposed of by the estate (and therefore not distributed to a beneficiary) in a transaction in which capital gain or loss is recognized.[15]

> *Example*. D's gross estate includes the contents of his residence. An estate tax return is required and lists D's tangible personal property, including a Persian rug, a painting, and a diamond necklace, each of which has an appraised value in excess of $3,000. No other item of tangible personal property has a value of more than $100. Pursuant to the proposed regulations, only the rug, painting and diamond necklace are required to be listed on the Information Return and the Information Statements.

Subsequent Transfers. If all or any portion of an asset that was previously reported to the IRS on an Information Return is transferred (by gift or otherwise) by the recipient to a related transferee (such as family members, controlled entities, and grantor trusts), directly or indirectly, in a manner where the transferee's basis in the asset is determined, in whole or part, with reference to the transferor's basis, <u>the transferor is required to file a new Information Return with the IRS and provide the transferee with an Information Statement documenting the new ownership of the asset within 30 days of the transfer</u>. If such a transfer occurs before the final value of the asset is determined, the transferor must also provide the information statement to the estate fiduciary. This proposed reporting requirement is imposed on each subsequent recipient of the asset where the transferee's basis in the asset is determined with reference to the transferor's basis.[16]

> *Example*: D's estate is required to file an estate tax return and has provided an Information Return to the IRS and Information Statements to the beneficiaries. A commercial property having a final estate tax value of $1,000,000 was distributed to T as part of his share of the estate. Four years later, T gifts the commercial property to his son, S. T is required to file an Information Return with the IRS and provide S with an Information

Statement within 30 days of the transfer. Three years later, S transfers the property to an irrevocable grantor trust for the benefit of his children. S is also required to file an Information Return with the IRS and provide the grantor trust with an Information Statement within 30 days of the transfer.

Practical Comment. The unfortunate inclusion of subsequent transfers in the new information reporting requirements creates an unexpected burden for future transferees – many of whom may be unaware of the asset's origin and their reporting obligations. Penalties will be assessed for failing to satisfy information reporting requirements triggered by subsequent transfers.

Due Date for Information Returns and Statements. The estate fiduciary must provide the Informational Return and Information Statements no later than 30 days after the due date of the federal estate tax return (including extensions) or, if earlier, 30 days after the date the return is actually filed.[17]

If there are adjustments to the value of the assets or changes to other information reported that causes the information to be incorrect or incomplete, a supplemental Information Return and supplemental Information Statements must be provided within 30 days of the adjustment or change.[18]

The Information Return and Information Statement requirements apply to assets reported on required estate tax returns filed after **July 31, 2015**, even if the decedent died before that date. Simultaneous with issuing the proposed regulations, the IRS issued temporary regulations[19] containing transition rules that delay the deadline for Information Returns and Information Statements that would otherwise be due, until **March 31, 2016**.

Practical Comment: Each estate fiduciary who has filed an estate tax return since July 31, 2015 will have only until March 31, 2016 to submit the mandated Information Return and Information Statements. It will be imperative to satisfy the reporting requirements by that date as the proposed regulations do not provide for an extension and penalties will be imposed for not providing the required information on a timely basis.

TAKE AWAYS

- Although the concept of basis consistency seems straight forward, implementation will create heavy administrative burdens for the estate and its beneficiaries.

- Estate fiduciaries and their advisors will need to meet reporting deadlines as the proposed regulations include no extension of time to comply and penalties will be assessed. Beneficiaries, on the other hand, who receive a so-called "Information Statement" must keep it until the inherited assets are transferred, and if a beneficiary gifts an inherited asset, in whole or in part, the beneficiary will be required to comply with all new information reporting requirements.
- Estate fiduciaries should also be cognizant of the extremely severe zero basis rules applicable to after-discovered and omitted assets, which will require all such fiduciaries to be diligent about marshaling all estate assets to avoid triggering a zero basis for any assets.

DISCLAIMER

This information is intended solely for information and education and is not intended for use as legal or tax advice. Reference herein to any specific tax or other planning strategy, process, product or service does not constitute promotion, endorsement or recommendation by AALU. Persons should consult with their own legal or tax advisors for specific legal or tax advice.

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NOTES

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[1] Code § 1014(f)(1). Note that adjustments to the initial basis of an inherited asset that are permitted by other sections of the Code as a result of post-death events (for example, depreciation, amortization or improvement of the asset) will not cause the recipient's basis in the asset on the date of a taxable event to be treated as exceeding the final value of the asset.
[2] Proposed Reg. § 1.1014-10(a)(i).
[3] Proposed Reg. § 1.1014-10(b)(1) & (3).
[4] Proposed Reg. § 1.1014-10(b)(2)-(3).

[5] Proposed Reg. § 1.1014-10(c)(1).
[6] Proposed Reg. § 1.1014-10(c)(2).
[7] Proposed Reg. § 1.1014-10(c)(3)(i).
[8] Proposed Reg. § 1.1014-10(c)(3)(ii).
[9] Proposed Reg. § 1.6035-1(a)(1).
[10] *Id*.
[11] Proposed Reg. § 1.6035-1(c)(2).
[12] Proposed Reg. § 1.6035-1(c)(3).
[13] Proposed Reg. § 1.6035-1(e)(3).
[14] Proposed Reg. § 1.6035-1(a)(2).
[15] Proposed Reg. § 1.6035-1(b)(1).
[16] Proposed Reg. § 1.6035-1(a)(1) and § 1.6035-1(f).
[17] Proposed Reg. § 1.6035-1(d).
[18] Proposed Reg. § 1.6035-1(e).
[19] TD 9757, released March 4, 2016.