Deutsche Bank
Wealth Management

Blanche Lark Christerson
Managing Director, Senior Wealth Planning Strategist

Tax Topics

2016-03

03/31/16

Basis reporting and consistency rules

As discussed in prior issues of *Tax Topics*, estate executors are now subject to basis reporting rules that took effect last summer (see the 9/28/15, 01/28/16 and 02/24/16 editions). These rules apply to estate tax returns filed on or after August 1, 2015, and provide that within 30 days of filing an estate tax return, an executor must file a statement, with both the IRS and estate beneficiaries, detailing estate property and its value; failure to file the statement will trigger a penalty. In addition, recipients of certain inherited property are now subject to "basis consistency" rules, and are subject to a penalty if they later overstate the basis of that property in subsequent transactions with it.

The new rules were effective immediately, with the first filings due at the end of August, 2015 (generally relating to decedents dying in the fall of 2014). Because the IRS needed time to develop forms and guidance, it issued Notice 2015-57 on August 21, 2015, and directed executors NOT to file anything that otherwise would have been due until February 29, 2016. In late 2015 and early 2016, the IRS issued Form 8971, "Information Regarding Beneficiaries Acquiring Property from a Decedent," and the related instructions, which are now final. (Schedule A of this form goes to beneficiaries as well as the IRS, and details the property the beneficiary is receiving, its value and whether the asset increased the decedent's estate tax liability.) Questions remained, however, and on February 11, 2016, the IRS issued a second filing postponement (Notice 2016-19), saying that the Form 8971 need not be filed before March 31, 2016 so that executors could have an opportunity "to review the proposed regulations to be issued."

Those regulations were issued on March 3, 2016 (REG-127923-15). Although they answer many questions, they inadvertently raise others; they also set forth basis rules regarding "after-discovered" or omitted property, and impose mandatory basis reporting for certain subsequent gifts of property subject to the initial basis reporting.

In response to industry requests for more time to digest these regulations, the IRS announced its third (and probably final) filing postponement on March 23, 2016: Notice 2016-27 provides that basis reports that would otherwise have been due for estate tax returns filed after July 31, 2015 need not be filed until June 30, 2016.

This is a welcome development, as the more people grapple with "real life" applications of the rules, the more questions there seem to be.

Before getting into the discussion, note that unless otherwise stated, the estate tax returns mentioned in the proposed regulations have been filed because the decedent's estate is *over* the estate tax return "filing threshold" (see below). Also, keep in mind that the term **"executor,"** when one hasn't been appointed for the decedent's estate, also refers to "any person in actual or constructive possession" of the decedent's property.

Example. Widowed Mom transfers to her Revocable Trust property that her Will would otherwise control, such as real estate and bank and brokerage accounts (i.e., "probate property"). Mom is the sole trustee of her Trust, and Daughter will become successor trustee on Mom's incompetence or death; Daughter is also the named executor under Mom's Will. Mom dies; Daughter doesn't need to probate Mom's Will, since there is no probate property. Daughter, as trustee, administers Mom's estate through the Revocable Trust, and is considered an "executor" for purposes of filing Mom's estate tax return and basis reporting statements.

With that preamble, here are some highlights from the proposed regulations:

"Portability" estate tax returns exempt from basis reporting. If the deceased spouse's estate is under the "filing threshold" (see below) and the executor is only filing an estate tax return so that the deceased spouse's unused exclusion amount carries over to the surviving spouse (a "portability" return), the executor is not subject to basis reporting; the same is true for the executor of an estate under the filing threshold who files a "protective" estate tax return (in case the decedent's estate ends up exceeding the filing threshold) or files a return to make a generation-skipping transfer tax allocation or election.

- **Translation:** the executor of an estate that is under the current $5.45 million **filing threshold** is not obligated to file an estate tax return unless the executor is electing portability; even so, the executor has no basis reporting requirements.

  An estate is over the filing threshold – and therefore requires an estate tax return (and basis reporting) – if the decedent's "gross estate" plus "adjusted taxable gifts" exceed the "basic exclusion amount" in effect when the decedent died.

  - The **"gross estate"** refers to everything in which the decedent had an interest, such as bank and brokerage accounts, real estate and retirement accounts.

  - **"Adjusted taxable gifts"** are typically lifetime gifts other than: a) annual exclusion gifts ($14,000 per donee, or $28,000 if the donor's spouse agrees to split the gift), and b) direct payments of tuition, medical expenses and health insurance premiums. Stated differently, adjusted taxable gifts are lifetime gifts that erode the donor's exclusion amount.

  - The **"basic exclusion amount"** is $5 million, indexed for inflation; in 2016, it is $5.45 million. It protects lifetime gifts and transfers at death from gift and estate tax.

Certain property exempt from basis reporting. Although the general rule is that property reported on an estate tax return must be reported on Form 8971 (and related Schedules A), the following property is exempt from basis reporting: a) cash (other than a coin collection or "other coins or bills with numismatic value"), b) "income in respect of a decedent," c) tangible personal property for which an appraisal is not required, and d) property that is sold or disposed of (and therefore not distributed to a beneficiary) in a transaction that triggers capital gain or loss.

- **Translation:** "income in respect of a decedent" refers to property, such as annuities or retirement accounts, which is not entitled to a basis adjustment because of the decedent's death and typically would be gross income to the decedent if he or she were still alive. Tangible personal property for which an appraisal is not required generally means that the aggregate value of such property is $3,000 or less. Property that is sold or disposed of in a transaction that triggers capital gain or loss means, for example, that the property has been liquidated for cash.

- **Comment.** Although the basis reporting exclusion for certain property is welcome, questions remain. Suppose, for example, that deceased Dad actually had some "basis" in his IRA – in other words, he also funded it with after-tax dollars, instead of just pre-tax dollars on which he had not yet paid income tax. Does the executor have any reporting requirements for this asset? Or what if the executor has largely liquidated Dad's estate, and is left with cash and inexpensive tangible personal property – must the executor still file a Form 8971, even though no "stuff" (other than cash and the inexpensive tangibles) will be distributed to beneficiaries?

"Entity" beneficiaries. If the beneficiary of estate property is a trust or an estate – rather than an individual – the executor reports the property's basis to the trustee or executor, as the case may be, and not to the beneficiaries of that entity. If the beneficiary is a business entity, the executor gives the basis statement to the entity.

Who gets what not yet determined. If the executor hasn't yet determined which beneficiary gets what property when the Form 8971 is due, the executor must give each beneficiary a Schedule A with the appropriate information about *all* of the property that could be used to satisfy the beneficiary's inheritance (yes, different beneficiaries could have the same property reported to them).

When supplemental basis reporting required. If a change in the information the executor initially reported makes that information incorrect or incomplete, the executor must file a supplemental Form 8971 within 30 days. Such changes include an adjustment in the property's value because of an audit or litigation, the discovery of property that should have been (but was not) reported on the decedent's estate tax return, a change in the identity of the beneficiary to whom property is to be distributed (perhaps because the beneficiary died or "disclaimed" the property), or an effective "exchange" of estate property, whereby the "new" property uses the "old" property's basis (as in, for example, a like-kind exchange). The executor may, but need not, file a supplemental form to correct an "inconsequential" error or omission, or to specify the property that was actually distributed to a beneficiary and was previously reported as available to satisfy the beneficiary's inheritance.

After-discovered or omitted property – "zero basis" possible. If property is discovered after the estate tax return has been filed (or is otherwise omitted from the return), the basis of that property depends on whether the executor files a supplemental estate tax return reporting the property while the statute of limitations is still open (generally, three years from when the estate tax return was filed). If the executor does so, that after-discovered property is subject to the same basis reporting rules as the previously reported property. If the executor does not report the after-discovered property within the statute of limitations, the property's basis is zero. Note that if an estate tax return was not filed because the estate was under the filing threshold (see above), and the after-discovered property would have increased the size of the gross estate and triggered estate tax, the basis of *all* estate property is zero until the executor files an estate tax return and a "final value" for the property is determined (see below).

- **Comment.** This "zero basis" rule underscores how important it is for the executor to make sure that all of the decedent's property has been identified and properly reported.

Due date of supplemental basis reporting. The supplemental Form 8971 is generally due within 30 days of: a) the determination of the property's "final value" (see below), b) the executor's discovery that the initial basis filing was incorrect or incomplete, or c) the supplemental estate tax return is filed reporting after-discovered or omitted property. Nevertheless, if property hasn't yet been distributed to a beneficiary prior to any of these events, the due date for the supplemental reporting is 30 days after distribution.

The property's "final value." The property's "final value" has been determined if the IRS does not contest the value reported on the estate tax return before the statute of limitations has expired (again, generally three years from filing the estate tax return); if the IRS contests the property's value within that period, the redetermined value becomes the basis if: 1) the estate does not timely disagree with the IRS, 2) the estate settles with the IRS, or 3) a court determines the property's value.

Subsequent transfers of property – when reporting required. If the beneficiary of basis-reported property later transfers that property – by gift or otherwise – to a "related transferee" who takes the beneficiary's basis in the property, the beneficiary must file a supplemental Form 8971 within 30 days of the transfer. A "related transferee" means a member of the beneficiary's family (such as the beneficiary's spouse, descendants or siblings), an entity that is "controlled" by certain family members (such as siblings, descendants and their spouses), or a trust the beneficiary "owns" for income tax purposes (this refers to a "grantor" trust, and means that the beneficiary is responsible for paying the trust's income taxes).

Example. Widowed Mom leaves Vacation Home to Son, who receives the basis statement (Schedule A of Form 8971) from Mom's executor detailing the property. 20 years later, Son (now Dad) gives the property to his daughter, who takes Dad's basis in the property. Within 30 days of the gift, Dad must file a supplemental Form 8971 and Schedule A. Daughter's Schedule A will show the "final value" (see above) of the property as reported on Dad's original Schedule A. Dad is allowed to give Daughter information regarding the capital improvements he's made to the property (these increase his basis in the property), but must report this information separately from the "final value" shown on Daughter's Schedule A.

- **Comment.** The preamble to the proposed regulations states that the Treasury Department and the IRS are concerned that "opportunities may exist" for the property recipient to "circumvent the purpose of the statute," for example, by gifting the property to a trust for family members. Accordingly, using the regulatory authority granted in the basis reporting statute (IRC Sec. 6035(b)(2), for tax mavens), the proposed regulations "require additional information reporting by certain subsequent transferors in limited circumstances." In other words, although the new statute applies to *executors of decedents' estates*, the proposed regs extend the basis reporting to *donors of certain lifetime gifts*. Whether the regulatory authority is indeed broad enough to permit this expansion of basis reporting remains to be seen.

  In addition, this open-ended subsequent transfer rule poses issues. Suppose that Daughter receives a $5,000 piece of jewelry from Mom, and that jewelry is duly reported on Mom's estate tax return and the basis reporting forms. Many years later, Daughter gives the jewelry, which is still worth $5,000, to her own daughter (to whom she makes no other gifts that year). Because the jewelry falls within the $14,000 gift tax annual exclusion, no gift tax return is required. Assuming Daughter is even aware of the subsequent transfer filing requirements, is she likely to observe them?

The basis consistency rule – certain basis adjustments OK. In general, a beneficiary's "initial" basis in property distributed to her cannot exceed the property's "final value" (see above) set forth in the basis statement (Schedule A of Form 8971). Nevertheless, basis adjustments permitted under other sections of the tax law are allowed. For example, if the beneficiary puts a new roof on her inherited vacation home, that capital improvement increases her basis in the property (see the Example above); if the beneficiary depreciates her inherited rental property, that decreases her basis in the property.

Exceptions to the basis consistency rule. Even though the executor is obliged to report the basis of most property to beneficiaries (see above for exemptions), the basis consistency rule only applies to property that *increases* the decedent's estate tax liability after applying allowable credits (other than the credit for prepaid estate tax). In other words, property that qualifies for the marital or charitable deduction is not subject to the basis consistency rule, nor is tangible personal property for which an appraisal is not required. If estate tax is payable, the consistency rule applies to the entire gross estate, except for marital or charitable deduction property (or inexpensive tangible property); if no estate tax is payable, then the entire gross estate is exempt from the consistency rule.

Example 1. Dad dies in 2016, and leaves his entire $20 million estate to Mom, who is a U.S. citizen. Because the marital deduction applies to the gift, Dad has a non-taxable estate. Although Dad's executor must file an estate tax return for Dad's estate along with the basis reporting statements, the property Mom receives is not subject to the basis consistency rule.

Example 2. Mom has a $20 million estate and has made no lifetime taxable gifts. She dies in 2016. Her Will creates a "credit shelter trust" for Dad and their children that equals her $5.45 million exclusion amount (and is therefore not taxable), and leaves the balance of her property to Dad in a trust that qualifies for the marital deduction (and is therefore not taxable). Mom's executor files an estate tax return for her estate and the basis reporting statements (Schedule A goes to the trustees of the two trusts). The property passing to the two trusts is not subject to the basis consistency rule.

Example 3. Same facts as Example 2, except that Mom gives $10 million in cash and valuable tangible property to the children from her first marriage; the balance of her property passes to her second husband in a trust that qualifies for the marital deduction. The gift to her children generates estate tax. The executor's basis report does not list the cash gifts to Mom's children, but does list the tangible property passing to them; that property is subject to the basis consistency rule. The property passing to her second husband's trust is also subject to basis reporting, but not the basis consistency rule.

- **Comment.** The basis reporting requirement is broad, but the basis consistency rule has some significant exceptions.

Final thoughts. Congress created these new basis reporting and consistency rules presumably because of concern that beneficiaries were routinely overstating their basis in inherited property (that basis is typically the property's date-of-death value). Whether this concern was well-founded is unknown. What seems clear, however, is that these rules are a big deal, not only for the executors and beneficiaries who are now subject to them, but also for the IRS, which must create tracking systems to implement them. Questions still remain regarding these rules, and practical considerations abound. Perhaps between now and June 30th, when the postponed basis reporting forms are now due, the IRS will issue additional guidance.

New York's estate tax exclusion increases again

In late March of 2014, New York updated its estate tax, in part, by incrementally increasing its $1 million estate tax exclusion so that by 2019, that exclusion reaches the inflation-indexed federal basic exclusion amount (currently $5.45 million). On April 1st, the latest increment kicks in – $4,187,500 – and will run through March 31, 2017. From April 1, 2017 through December 31, 2018, the exclusion will be $5.25 million. Note that if a decedent's New York taxable estate exceeds the New York exclusion by more than 5%, the exclusion disappears, and New York estate tax applies to the first dollar of the taxable estate. In addition, the New York exclusion is NOT portable between spouses; in other words, if the first spouse to die does not take advantage of the New York exclusion, unnecessary New York estate tax may be payable at the surviving spouse's death.

April 7520 rate

The IRS has issued the April 2016 applicable federal rates: the April 7520 rate remains at 1.8%, where it was in March. The April mid-term rates are down slightly: 1.45% (annual), and 1.44% (semiannual, quarterly and monthly); March's mid-term rates were 1.48% (annual), and 1.47% (semiannual, quarterly and monthly).

Blanche Lark Christerson is a managing director at Deutsche Bank Wealth Management in New York City, and can be reached at blanche.christerson@db.com.