Back to Basis: Step In & Step Up, or Step Out?

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Brief Outline

» **Basis Planning in light of the new Basis Consistency Rules (IRC §1014(f))**

» **Trust Funding**

» **2704 – Think Before Jumping**

» **Updating Estate Plans for the New Basis Paradigm**

Brief Outline

- » Basis Planning in light of the new Basis Consistency Rules (IRC §1014(f))
- » Trust Funding
- » 2704 – Think Before Jumping
- » Updating Estate Plans for the New Basis Paradigm

Basis Planning in light of the new Basis Consistency Rules

Basis Consistency | IRC §1014(f)

Planning for Basis within the new Statutory and Regulatory Framework

- **Surface Transportation and Veterans Health Care Choice Improvement Act of 2015**
- ***General Rule:*** the basis of property *received* from a decedent cannot exceed the value of the property "as finally determined" for Estate Tax purposes.
- ***Additional Rules*** (Proposed Regulations)
  - 1014(f) Property: all property included in the gross estate that actually generates tax liability after application of allowable credits; includes property that derives its basis from such property (e.g. 1031 property). *Exceptions*: (i) marital/charitable deduction property and (ii) *de minimis* tangible personal property.
    - Note: cash is not excluded
  - Final Value: the value of the property reported on an estate tax return, *unless* there is an IRS adjustment, binding agreement, or court determination otherwise.
  - Initial Basis: the "final value" of 1014(f) property received by the Taxpayer; post-death adjustments may be made (e.g. depreciation) without violating the consistency requirement.

Basis Consistency | IRC §1014(f)

Basis Planning Strategies

» **Estate Tax Returns for "Marginal" Estates**

- The Zero Basis Rule
- Where the possibility exists for an "after-discovered asset" (which would make the estate taxable) *or* significant (downward) adjustment to value of an asset, consider filing a return.

» **Protective Refund Claims**

- Where the income tax statute of limitations closes before the estate tax statute of limitation, consider filing a protective claim for refund in the event the final value of property is increased.
  - Applies where property is sold or depreciation/amortization deductions have been reported.

» **Record Keeping**

- Taxpayers receiving 1014(f) property should maintain the Schedules A they receive from the PR;
- Avoid signing releases that cover the PR for liability relating to basis misreporting (Form 8971);
- Consider subsequent transfer reporting obligations Prop. Treas. Reg. §1.6035-1(f))

» **Valuation**

- Basis consistency rules do not apply to marital deduction property, so surviving spouses could potentially claim a *higher* basis in the property at some later date
- Consider whether a surviving spouse that served as PR might be estopped from making such a claim

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Trust Funding

»Time to fund the Marital Trust & Credit Shelter Trust

- "Pick and choose" method
- Considerations
  - Asset basis
    - Do you need a step-up at survivor's death?
    - 40% will always be greater than 23.8%
  - Potential value at survivor's death
  - Will the asset be sold prior to survivor's death?
    - If yes, Marital Trust better to shoulder the gain? (Perhaps push out to the survivor?)

Trust Funding

»Hypo 1

- Fair market value is $1,000,000 at death of first spouse
- Survivor lives 10 years
- Asset appreciates at 10% per year
- Option 1: Fund in the Marital Trust
  - Estate tax at death: $1,037,497
  - Capital gains tax on liquidation: $0 (full step-up at survivor's death)
- Option 2: Fund in Credit Shelter Trust
  - Estate tax at death: $0
  - Capital gains tax on liquidation: $379,311 (23.8% tax; basis $1 M)
- Better option? → OPTION 2!

Trust Funding

»Hypo 2 = Hypo 1 with a twist

- Fair market value is $1,000,000 at death of first spouse
- Survivor lives 10 years
- Asset appreciates at 10% per year
- *Asset is sold after 2 years. (That's the twist.)*
- Option 1: Fund in the Marital Trust
  - Capital Gains tax at sale: $49,980
  - Estate tax at death on proceeds (assume 5% annual growth): $685,511
- Option 2: Fund in Credit Shelter Trust
  - Capital Gains tax at sale: $49,980
  - Estate tax at death on proceeds (assume 5% annual growth): $0
- Better option? → OPTION 2!

Trust Funding

» Discussion point: Is there ever a time when the concern of capital gains will outweigh the estate tax????

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Basis & 2704

- »Interest in closely held business
- »Assume no basis (funded w/stock earned & no 754 election)
- »Will we lose the discount?
- »Possible solution: sell the interest now to grantor trust
  - Advantage: sale price in 2016 reflects discount
  - Disadvantage: no step-up in basis at death
- »What about selling the interest to a non-grantor trust
  - Advantage: sale price in 2016 reflects discount & step up(?) in basis now
  - Disadvantage: cap gains tax now (but at discounted value)

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The New Basis Paradigm

Updating Estate Plans for Clients with Previously Taxable Estates

- **Opportunity:** rising estate tax exemptions, portability (with reduced reporting obligations), and new basis rules mean that clients should revisit the structure existing plans.

- **The Credit Shelter/Marital Formula:**
  - This structure *minimizes* the amount passing to the marital trust
  - In a non-taxable estate, many clients will benefit from the opposite approach
  - ***Consider:*** a marital trust residuary gift with spousal disclaimer power to a family credit shelter trust
  - <u>Keys</u>:
    - Basis step-up at death of *each* spouse;
    - Portability prevents tax at the second to die;
    - Disclaimer power provides flexibility if the gross estate is larger than expected; and
    - Basis consistency will not apply to property passing to the marital trust.

The New Basis Paradigm

Updating Estate Plans for Clients with Previously Taxable Estates

» **Opportunity:** updated trust provisions can protect fiduciaries in light of the new basis rules.

» **Potential Liabilities:**

- Fiduciaries have significant basis reporting obligations under 6035 (to IRS and beneficiaries) and may have liability (to beneficiaries) stemming from mistakes in reporting under 1014(f).
- ***Consider:*** building in protective provisions that indemnify fiduciaries making innocent mistakes relating to the new basis rules.
- Keys:
  - Reporting obligations are difficult to comply with and trusts should protect fiduciaries acting in good faith;
  - Basis consistency rules (especially the Zero Basis Rule) might create liability for beneficiaries through no fault of the fiduciary; and
  - In audit situations, consider relieving the trustee of the duty of loyalty when making decisions to compromise on the value of assets.

Updating Estate Plans for the New Basis Paradigm

The New Basis Paradigm

Updating Estate Plans for Clients with Previously Taxable Estates

- **Opportunity:** updated trust provisions can protect fiduciaries in light of the new basis rules (cont'd).

- **Fiduciary Fees:**
  - Fiduciaries that *may* have reporting obligations (a "borderline estate") will be required to perform significantly more work than they otherwise would due to the basis reporting rules.
  - ***Consider:*** modifying compensation provisions to provide additional compensation for fiduciaries
  - Keys:
    - The additional compensation should apply to both fiduciaries *and* their agents; and
    - Fiduciaries should be given the flexibility to file a "protective" estate tax return (beyond the abridged reporting required for portability) if they suspect the zero basis rule may apply.

Updating Estate Plans for the New Basis Paradigm

The New Basis Paradigm

Updating Estate Plans for Clients with Previously Taxable Estates

» **Opportunity:** updated trust provisions can protect fiduciaries in light of the new basis rules (cont'd).

» **Selective ("Pick and Choose") Funding:**

- Fiduciaries might be able to take advantage of the basis of certain assets and selectively fund various sub-trusts. Unfortunately, this might create liability if circumstances change.
- ***Consider:*** (i) specifically empowering fiduciaries to engage in selective funding and (ii) strengthening indemnification provisions to provide additional protection for fiduciaries that do so.
- Keys:
  - Make the power to engage in selective funding *express* and include a provision providing that the testator/grantor specifically intends that the fiduciary do so; and
  - Protect fiduciaries that engage in selective funding in good faith with indemnification provisions.

Questions?

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HIGHWAY (BILL) TO THE DANGER ZONE: A PRACTITIONER'S GUIDE TO THE NEW BASIS RULES OF SECTIONS 1014(f) AND 6035

By Patrick J. Duffey*

Editor's Note:

One of the most significant tax law changes affecting those involved with estate administrations or the preparation of Estate Tax Returns was the surprise introduction of new basis consistency and reporting requirements that were part of the Transportation Act last year. On top of the tax changes that were found in the Trade Bill, the changes in the Highway Bill will significantly complicate the administration of estates where estate tax returns are required to be filed. The various list serves dealing with estate planning and administration have been filled with questions, inconsistencies and other discussions about the basis consistency and reporting requirements of new Sections 1014(f) and 6035. It is clear from the fact that the Service has now delayed the effective date several times that they were as surprised as the planning community, but we all are going to have to adopt procedures to comply with the new requirements.

To help focus us on these decisions, Patrick Duffey has prepared an analysis of the new rules from the practitioner's standpoint. He reviews the statutory framework and Proposed Regulations, and points out some of the inconsistencies between them. He also reviews the first draft of the Form 8971, which will be how the basis reporting is accomplished, and the Schedule As that must be provided to each beneficiary. He then highlights the areas where there is significant uncertainty and some of the confusion that remains, and expresses the hope that revised Regulations are out prior to the first reporting date that will resolve some of these issues. But whether resolved or not, it is clear that those dealing with estate administrations must be familiar with these rules and be prepared to comply with them, or be subjected to significant penalties.

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Significant developments in the transfer tax realm often are the result of an extended deliberative process involving Congress, the White House, Treasury, and practitioners working together to craft a thoughtful instrument of public policy. The basis consistency and basis reporting requirements of Sections 1014(f) and 6035, Internal Revenue Code (collectively, the "Basis Rules"), are not products of such a process. The Basis Rules are a creature of convenience, contrived without meaningful input from affected parties apparently as a measure to classify the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015[1] (the "Act") as "revenue neutral" legislation. The effectiveness of these new rules in actually producing revenue remains to be seen. What is certain, however, is that the Basis Rules significantly complicate the preparation of an estate tax return, the administration of estates and trusts, and the receipt of property with a stepped-up basis.

TIMELINE

The Basis Rules apply to all estate tax returns *filed* after July 31, 2015. Though, in general, this means that the new law affects decedent's dying on or after April 30, 2014,[2] the law also applies to any untimely returns filed after that date. After passage of the Act, the Treasury Department almost immediately granted taxpayers reprieve until February 29, 2016, the full six month extension[3] available under Section 6081(a), to give the Service time to develop proposed regulations and a new form.[4] Before the expiration of that extension, the Service issued Notice 2016-19, which extended the due date for any reporting under Section 6035 that was due before

[1] SURFACE TRANSPORTATION AND VETERANS HEALTH CARE CHOICE IMPROVEMENT ACT OF 2015, PL 114-41, July 31, 2015, 129 Stat 443.

[2] That is, the date that is fifteen months before July 31, 2015—the maximum time period for a *timely* filed Estate Tax return.

[3] The extension is six months from August 30th, the day that such information would otherwise be due for a return filed on July 31, 2015. While the point might be an academic one, query whether the Service had authority to issue subsequent extensions.

[4] Notice 2015-57 (September 7, 2015).

March 31, 2016 until that date.[5] Most recently, before the expiration of the March 31 deadline and after receiving "numerous comments that executors and other persons have not had sufficient time to adopt the systemic changes that would enable the filing of an accurate and complete Form 8971 and Schedule A," the Service issued Notice 2016-27, which extended the due date for any reporting under 6035 that was due before June 30, 2016 until that date.[6] Thus, as of the date of this publication, June 30, 2016 remains the due date for Section 6035 reporting on all timely filed returns for decedents dying between April 30, 2014 and March 31, 2015.

STATUTORY FRAMEWORK

Section 1014(f).

In general, Section 1014(f) provides that the basis of property received from a decedent cannot exceed the value of the property as it is finally determined for Estate Tax purposes. I.R.C. §1014(f)(1)(A), (f)(3). Caveat is made as to property for which determination is not final (for example, because the limitations period on the Estate Tax return has not run); the basis of such property cannot exceed the value reported to the beneficiary under Section 6035. I.R.C. §1014(f)(1)(B). A much broader exception, which excludes any property that does not increase Estate Tax liability, also applies. I.R.C. §1014(f)(2).

Section 6035.

An entirely new provision, Section 6035 articulates the basis reporting requires that are designed to effectuate the basis consistency regime of Section 1014(f). In general, Section 6035 imposes a requirement upon executors to file a return with the IRS and furnish statements to the beneficiaries relating to "the value of each interest in such property as reported on such return and such other

[5] Notice 2016-19 (February 11, 2016).
[6] Notice 2016-27 (March 23, 2016).

information with respect to such interest as the Secretary may prescribe." I.R.C. §6035(a)(1). The return and statements must be furnished to the Service and beneficiaries on or before the earlier of (i) thirty days after the due date for the estate tax return or (ii) thirty days after the date an estate tax return is actually filed. Notably, Section 6035 *commands* the Secretary of the Treasury to prescribe regulations necessary to carry out the section; in contrast, the equivalent provision in Section 1014(f) is merely permissive. *Cf.* §6035(b) *with* §1014(f)(4). On March 2, 2014, the Service did just that and issued Proposed Regulations for both sections.

PROPOSED REGULATIONS

Treasury Regulation §1.1014-10.

Basis Consistency. In general, a taxpayer's *initial basis* in *1014(f) property* cannot exceed the *final value* of that property. The requirement applies whenever there is a taxable event with respect to that property (e.g., depreciation) and continues until there is a tax recognition event as to the entire property. Whomever owns the 1014(f) property—whether or not they received the property from the decedent—must comply with the basis consistency requirement. In effectuating this new regime, the Proposed Regulation introduces three new concepts: (1) 1014(f) property, (2) final value, and (3) initial basis. Understanding the regulatory structure is much easier with a good grasp of each of those concepts.

While "1014(f) Property" is not actually a term used in the Proposed Regulation, it is used here for purposes of convenience and brevity as a synonym for the term that is used: "property subject to the consistency requirement of §1.1014-10(a)(1)." In general, all property either includable in the decedent's Gross Estate or subject to the Estate Tax under Section 2106 (non-resident aliens) that actually generates estate tax liability after application of allowable credits is "1014(f) Property" for purposes of the Proposed Regulation. 1014(f) Property is a very broad concept and, in addition to covering all taxable gross estate property, also includes "any other property the basis of which is determined in whole or in part by reference to the basis of [1014(f) Property]." Prop. Treas. Reg. §1.1014-10(b)(1). Thus, property received by the estate as a result of a like-kind exchange with a third party would still be "1014(f) Property."

The most important exclusion from 1014(f) Property is property to which either the charitable or marital deduction applies. Prop. Treas. Reg. §1.1014-10(b)(2). Additionally, tangible personal property for which no appraisal is required under Section 20.2031-6(b) (i.e. property worth less than $3,000) is excluded from the definition of 1014(f) Property. Notably—and unlike the parallel exclusions in the Basis Reporting context of Section 1.6035-1(b)(1)—cash is not excluded from the definition of 1014(f) Property and, therefore, is still subject to the consistency requirement. While this would not typically be relevant, it could become an issue due to the application of the After-Discovered Property Rule, which is discussed in greater detail below.

Thankfully, the Regulations clarify that the consistency requirement does not apply to property received from non-taxable estates that file an estate tax return simply for portability or other reasons. Prop. Treas. Reg. §1.1014-10(b)(1) (the property must "generate a[n estate] tax liability" in excess of allowable credits). Keep in mind, though, that the application of the 1014(f) Property concept is essentially binary: if *any* portion of an estate actually generates an estate tax liability, the *entire* gross estate (other than excluded property) becomes "1014(f) Property." Prop. Treas. Reg. §1.1014-10(b)(3). In other words, the basis consistency rules would then apply to all property other than marital or charitable deduction property.

The "Final Value" of 1014(f) Property *that is reported on an Estate Tax return* is, in essence, its final value for estate tax purposes. Prop. Treas. Reg. §1.1014-10(c)(1). The

Regulations simply provide a framework to clarify that the Final Value of property is subject to adjustment from the value reflected on the Estate Tax return in the event that the IRS makes a binding determination of value, the value is determined by a binding agreement (presumably between the Estate and the IRS), or the value is determined by a court of competent jurisdiction. Prop. Treas. Reg. §1.1014-10(c)(1). That structure is virtually identical to the structure adopted by Section 1014(f)(3) of the Code, but with the addition of determination under a binding agreement.

Caveats apply all around. A value derived from the Estate Tax return is not a Final Value until the period of limitations for assessment has passed without contest by the IRS. Prop. Treas. Reg. §1.1014-10(c)(1)(i). Similarly, a value derived from an IRS adjustment is not a Final Value until the period of limitations has expired for a contest by the Taxpayer. Prop. Treas. Reg. §1.1014-10(c)(1)(ii). An agreement determining value must be final and binding on all parties. Prop. Treas. Reg. §1.1014-10(c)(1)(iii). Of course, a court determination of value also must be "final," which presumably means that the time for an appeal must have passed (or that an appeal is no longer possible). Prop. Treas. Reg. §1.1014-10(c)(1)(iv).

Before the Final Value of property is determined under Section 1.1014-10(c)(1), recipients must use the value reflected on the Schedule A (of Form 8971) that they receive from the Estate. Prop. Treas. Reg. §1.1014-10(c)(2). Where there is a subsequent change in the Final Value of the property, the recipient is *not* entitled to rely on the initially reported value and is subject to deficiencies and underpayment[7] resulting from the difference. Prop. Treas. Reg. §1.1014-10(c)(2).

[7] The Proposed Regulation is not express, but presumably the recipient would also be liable under IRC 6662(a) for a twenty percent (20%) underpayment penalty. See §1.6662-8(a).

The final key concept introduced by the Proposed Regulations is that of an *Initial* Basis. For purposes of the Proposed Regulations, a taxpayer's "Initial Basis" in 1014(f) Property is the Final Value of that property. Prop. Treas. Reg. §1.1014-10(a)(2). Though, in general, a taxpayer's Initial Basis may not exceed its final value, the Proposed Regulations clarify that post-death basis adjustments (e.g., depreciation) do not violate the basis consistency requirement. The Regulations make clear, however, that such property is still subject to the overall basis consistency requirement and, therefore, subject to associated penalties (discussed below) if violated. Thus, the purpose of this new concept appears to simply be easy reference to the date of death (or alternate valuation date) basis of the property.

The Proposed Regulations also adopt a number of proprietary definitions for new terms. An "executor" has its typical estate tax meaning under Section 2203 (i.e. the executor or administrator or, if none, the person in possession of the property), but also includes beneficiaries who are required under Section 6018(b) to file a return. Prop. Treas. Reg. §1.1014-10(d). An "Information Return" is the recently released Form 8971, but includes any necessary Schedules A required under that form. Treas. Regs. §1.6035-1(g)(2). A "Statement" is the Schedule A to Form 8971, which must be provided to each Beneficiary. Prop. Treas. Reg. §1.6035-1(g)(3).

Of note for practitioners dealing with the basis consistency rules is the peculiar way in which encumbered property is treated, nonrecourse debt in particular. Nonrecourse debt is dealt with in Examples 1 and 4[8] of the Proposed Regulations. Prop. Treas. Reg. §1.1014-10(e). As the examples point out, the debt affects Final Value and is therefore relevant to the basis consistency rules. Therefore, any debt associated with certain property should be expressly disclosed on the

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[8] In Example 1, the nonrecourse debt associated with real estate owned by a partnership ratably reduced the Final Value of the partnership interest, but ratably increased the basis of the beneficiary's interest in the partnership in excess of the Final Value. Similarly, Example 4 suggests that real estate encumbered by nonrecourse debt is properly reported on the Form 706 at net date of death value and on the Schedule A at gross date of death value.

Statement, even if the debt is not otherwise reflected on the return (as, for example, would be the case with entity debt). Some early commentators have suggested an attachment to the relevant Statements, which also would have the effect of alerting the IRS to the mismatch.

Undoubtedly, the most significant—and certainly the most commented upon—aspect of the 1014(f) Proposed Regulations is the addition of what has been dubbed the "Zero Basis Rule." *See* Prop. Treas. Reg. §1.1014-10(c)(3). The Rule deals with so-called after-discovered or omitted property and the Proposed Regulations introduce an entirely new regime to address such property. The Proposed Regulations take a 3-pronged approach:

1. If a supplemental return disclosing the new property is timely filed within the limitations period, the Final Value of the new property is determined under Section 1.1014-10(c)(1) or (2). Prop. Treas. Reg. §1.1014-10(c)(3)(i)(A).
2. If a supplemental return disclosing the new property is *not* timely filed within the limitations period, the Final Value of the new property is **zero**. Prop. Treas. Reg. §1.1014-10(c)(3)(i)(B).
3. If no return has been filed, and if the new property would have generated estate tax liability, the Final Value of *all* 1014(f) Property is **zero**, *until* a Final Value is determined under Section 1.1014-10(c)(1) or (2). Prop. Treas. Reg. §1.1014-10(c)(3)(ii).

In general, the limitations period (in which the supplemental return would need to be filed) is three years. If the after-discovered/omitted assets represent greater than twenty-five percent of the gross estate, however, the limitations period is six years. In the case of the "borderline" taxable estate, this structure perversely provides greater flexibility to the executor that did not file at all (i.e. 100% of assets were unreported) than the executor that filed for portability reasons and made a good faith—though unsuccessful—effort to report all assets. In general, though, the new rule encourages executors to file returns for “borderline” taxable estates because of the harsh treatment of *all* property (as opposed to only the newly discovered property) if no return is filed within the limitations period.[9]

One consideration for beneficiaries receiving 1014(f) Property is that the Income Tax statute of limitations period could close before the Estate Tax statute of limitations period closes.[10] Thus, if any such property is sold (or depreciation or amortizations deductions have been reported), the beneficiary should consider filing a protective claim for refund in the event the Final Value is increased. Protective returns would be appropriate for federal and state Income Tax where the federal basis is determinative of state basis.

<u>Treasury Regulation §1.6035-1: Basis Reporting</u>.

Section 6035 creates new reporting obligations relating to property received from—or received as a result of the death of—a decedent. Prop. Treas. Reg. §1.6035-1(a)(1). The new rules are designed to complement the newly created basis consistency requirement of Section 1014(f). In general, Section 6035 applies only to returns that are *required* to be filed. Prop. Treas. Reg. §1.6035-1(a)(2). As a result, returns filed solely to make portability or GST elections will not trigger reporting requirements.

The Proposed Regulations provide that an executor (defined in Prop. Treas. Reg. §1.6035-1(g)(1)) that is required to file an estate tax return, also must file the following:

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[9] Note, however, that the addition of an asset that would transform the estate into a taxable estate triggers all reporting requirements and, in the case of a tardy return, would also trigger late reporting penalties as to *both* the Form 8971 and all Schedules A. See I.R.C. §§ 6721 and 6722.

[10] This may be somewhat unlikely in the case where a return is actually filed, because most distributions in taxable estates would not be made before a return is filed.

- an "Information Return" (a Form 8971 plus all Schedules A) with the IRS;
- "Statements" (Schedules A to Form 8971) to all beneficiaries receiving property from the decedent or as a result of his death; and
- "supplemental Statements" to those beneficiaries in the event of certain enumerated (and, perhaps, unenumerated) "changes."

None of those requirements were particularly surprising, although some commentators have taken some issue with the supplemental statement requirement. What was not anticipated, however, was the imposition of an entirely new "subsequent transfer" reporting regime that implicates executors, beneficiary/recipients, and transferees. At the outset, though, an understanding of two new concepts is key: (1) 6035 Property and (2) Beneficiaries.

The term "6035 Property" is used herein in lieu of the phrase used by the Proposed Regulations "property to which the reporting requirement under paragraph (a)(1) of this section applies." Prop. Treas. Reg. §1.6035-1(b)(1). Generally, 6035 Property is all property that is reported—or is required to be reported—on the Estate Tax return, *except* for (i) cash, (ii) income in respect of a decedent ("IRD"), (iii) tangible personal property valued at less than $3,000,[11] and (iv) property that is disposed of during administration. Prop. Treas. Reg. §1.6035-1(b)(1)(i)-(iv). It is important to keep in mind that 6035 Property is not the same thing as 1014(f) Property and is, in fact, generally much broader in scope. The most significant difference is that 6035 Property encompasses property that does not contribute to the Estate Tax liability (such as charitable and marital deduction property), while 1014(f) Property does not. Like 1014(f) Property, it also includes "any other property whose basis is determined in whole or in part by reference to such property"—which brings in, for example, like-kind exchange property. Prop. Treas. Reg. §1.6035-

[11] That is, tangible personal property for which an appraisal is not required under §20.2031-6(b). §1.6035-1(b)(1)(iii).

1(b)(1). The Proposed Regulations clarify that, as to nonresident non-citizens, only property that is subject to the U.S. estate tax is 6035 Property. *Id.* Community property receives similar treatment: only the decedent's half is within the definition of 6035 Property. *Id.*

The second new concept is the proprietary definition that the Section 6035 Proposed Regulations adopt for the term "Beneficiary." For purposes of the Proposed Regulations, a "Beneficiary" is any person or entity receiving 6035 Property. Prop. Treas. Reg. §1.6035-1(c)(1). As anticipated, the Proposed Regulations do not apply a "look through" rule to entities, so trustees, executors, and business entities are considered Beneficiaries of property passing to trusts, estates, and business entities, respectively. Prop. Treas. Reg. §1.6035-1(c)(2). The Proposed Regulations specifically address life estates, providing that the life tenant is the Beneficiary of a life estate and the immediate remainderman is the Beneficiary of a remainder interest. Prop. Treas. Reg. §1.6035-1(c)(1). A contingent beneficiary is a Beneficiary, unless the contingency occurs prior to filing the Information Return. *Id.*

Generally, the Proposed Regulations impose a duty of "reasonable due diligence" to identify and locate all Beneficiaries. Prop. Treas. Reg. §1.6035-1(c)(4). If an Executor cannot locate a beneficiary by the due date of the Information Return, the Executor must report that in the return and include an explanation of the efforts taken to locate the Beneficiary. *Id.* Executors must furnish a Statement to any Beneficiaries that are subsequently located and file a corresponding supplemental Information Return with the IRS. *Id.*

Certain changes obligate Executors to file supplement Information Returns with the IRS and supplemental Statements with affected beneficiaries. In general, an adjustment requiring supplemental reporting is "any change to the information required to be reported on the Information Return or Statement that causes the information as reported to be incorrect or incomplete" except inconsequential errors or omissions. Prop. Treas. Reg. §1.6035-1(e)(2).[12] The specific examples provided in the Proposed Regulations of adjustments requiring supplemental returns are:

- The later discovery of property that should have been included on the Estate Tax return.[13] Prop. Treas. Reg. §1.6035-1(e)(2);
- A change in the value of reported property as a result of "an examination or litigation." *Id.*;
- A change in the identity of the Beneficiary (due to, for example, death or disclaimer). *Id.*;
- A pre-distribution disposition of property that results in the receipt of transfer basis property (for example, a like-kind exchange). *Id.*; or
- The pre-distribution occurrence of a contingency, if "the contingency subsequently negates the inheritance of the beneficiary." Prop. Treas. Reg. §1.6035-1(c)(1).

It is worth noting that the Proposed Regulations provide relief from the somewhat harsh rule set out in the Instructions regarding supplemental reporting for property with an undetermined beneficiary. The Executor, of course, has an initial responsibility to report that property to all Beneficiaries that *could* receive it. Prop. Treas. Reg. §1.6035-1(c)(3). After a determination has been made, the Proposed Regulations state that the Executor "*may*, but is not required to" file a supplemental Information Return. Prop. Treas. Reg. §1.6035-1(c)(3); *see also* Prop. Treas. Reg.

[12] The Proposed Regulations adopt the definition of "inconsequential errors or omissions" from §301.6722-1(b). Supplemental returns that reflect the actual distribution of previously undetermined property are another specific exception provided in §1.6035-1(e)(3)(i), but that exception is probably redundant given §1.6035-1(c)(3).
[13] Consider the effect of the Zero Basis Rule, discussed in greater detail above, on such property. *See* Treas. Regs. §1.1014-10(c)(3).

§1.6035-1(e)(3)(i)(b). In contrast, the Instructions provide that a supplemental Information return "*should* be filed once the distribution to each such beneficiary has been made."

The Proposed Regulations change very little with respect to due dates. As set out in Section 6035, the executor must file an Information Return with the IRS and provide Statements to Beneficiaries on or before the earlier of either (i) 30 days after the Estate Tax return is *due*, or (ii) 30 days after the Estate Tax return is actually *filed*. Prop. Treas. Reg. §1.6035-1(c)(1). The only addition is a reference to the Temporary Regulation (Temp. Regs. §1.6035-2T) providing relief for Information Returns due on or before March 31, 2016.[14]

Supplemental Information Returns and Statements must be filed on or before 30 days after (i) the date the Final Value of the asset is determined (if the supplemental reporting obligation stems from an adjustment to Final Value), (ii) the date the Executor discovers that reported information was incorrect or incomplete, or (iii) the date a supplemental Estate Tax return is filed. Prop. Treas. Reg. §1.6035-1(e)(4)(i). There is an exception for pre-distribution adjustments, in which case the supplemental reporting is due 30 days after the date the property is actually distributed. Prop. Treas. Reg. §1.6035-1(e)(4)(ii).

The most controversial—and perhaps the most complex—aspect of the Section 6035 Proposed Regulations is undoubtedly the subsequent transfer rules. *See* Prop. Treas. Reg. §1.6035-1(f). Those rules create additional reporting obligations in the case of certain post-distribution transfers of 6035 Property. The obligation is primarily imposed upon Beneficiaries that later transfer the received property in any non-recognition event to a related transferee. *Id.* The Beneficiary must file a supplemental Statement with the IRS and furnish a supplemental Statement

[14] That relief has, of course, since been extended to June 30, 2016 for all Section 6035 filings otherwise due on or before that date. *See* Notice 2016-27 (March 23, 2016).

to the transferee within 30 days after the date of the transfer. *Id.* The supplemental Statement[15] need not include the value of the property if the transfer occurs before the Beneficiary's receipt of the Statement. *Id.* If the transfer occurs before the Final Value of the asset is determined, the Beneficiary also must provide the Executor with a copy of the Supplemental statement (in which case the Executor would provide the Statement directly to the transferee). *Id*.

For purposes of the Proposed Regulation, a "related transferee" is any member of the transferor's family, any controlled entity, and any grantor trust. The Proposed Regulations adopt the definitions of "family" and "controlled entity" from Chapter 14. *See* I.R.C. §§2704(c)(2) (definition of "family") and 2701(b)(2)(a) or (b) (definition of "control"). Note that the definition of grantor trusts is *not* limited to irrevocable grantor trusts. Thus, funding an ordinary revocable trust (which, by definition, is a grantor trust) with 6035 Property will trigger additional reporting obligations for the Beneficiary.

FORM 8971, SCHEDULE A, AND INSTRUCTIONS

The first draft of Form 8971 ("Information Regarding Beneficiaries Acquiring Property From a Decedent") was released by the Service on December 19, 2015. The final Form 8971 and Instructions were released on January 29, 2016. While generally helpful, the Instructions lack clarity in some notable respects. For example, the Instructions adopt a very lenient standard with respect to the method by which an executor may "furnish" a Beneficiary with a Schedule A, but fail to specify exactly what the term "date provided" means.[16] Absent a definition, it seems natural

[15] Which, in this case, is paradoxically required to be filed with the IRS by the Beneficiary *before* the Statement itself is filed by the Executor.

[16] The executor must report the date each Schedule A is provided to each Beneficiary. *See* Form 8971, Part II, Column D. The Instructions unhelpfully provide that the Executor should "enter the date on which the executor gave Schedule A to the beneficiary."

to adopt the standard applicable to the return, which would be date mailed.[17] Though not required, practitioners should consider using a certificate of mailing to establish the date the Statement was mailed to the Beneficiary.[18] An effective alternative might be to enclose a receipt with the Statement that also includes an acknowledgment that the Beneficiary was advised of the various basis consistency and reporting obligations that may apply.

Another aspect of the Instructions lacking in clarity relates to the instructions for property in which a beneficiary is receiving less than an entire interest. The Instructions provide with respect to Schedule A, Part 2, Column B ("Description of Property") that executors should "indicate the interest in the property that the beneficiary will acquire." This implies that the property simply should be described as some fraction of the whole,[19] which does make sense in the context of a beneficiary receiving a partial interest. The problem is that there is no corresponding instruction with respect to Schedule A, Part 2, Column E ("Estate Tax Value"), which simply provides that the executor is to list the value reported on the Estate Tax return. Thus, the Instructions provide confusing information to a Beneficiary, who might quite reasonably conclude that the Column E value reflects the value of their interest in the property.

Finally, the Instructions do not address the reporting of marketable securities, which are typically held in brokerage accounts with financial institutions. Such assets most often are reported on estate tax returns as a single asset with a "gross" value (reflecting the value of the entire account), and an attachment reflecting the date of death value of each individual security. This method of reporting produces an undesirable result under the Instructions, because, of course, the

[17] The Instructions also permit hand-delivery and e-mail with respect to Schedules A.
[18] This is both a less expensive and less invasive method than certified mail, which requires that the recipient sign for the package.
[19] For example, "a fifty percent (50%) interest in Brokerage Account No. 123456."

"gross" value of such an account is entirely useless for purposes of basis.[20] Thus, an undesirable and unhelpful result is reached by following the Instructions and using the "same description . . . that the executor used for the property on the Form 706" and listing the same "value reported on [the] Form 706." Until clarification is provided, practitioners should be sure to attach a schedule that includes date of death values for each individual security.

PENALTIES

Potentially significant penalties are imposed for the failure to timely file both complete and correct Information Returns[21] and Statements.[22] The Proposed Regulations simply reiterate the existence of those penalties and note the existence of waivers. By way of example, a few relevant penalties are:

- $50 per timely filed (but incomplete or incorrect) Form 8971, including attached Schedule(s) A. The maximum penalty is $500,000 per year.
- $250 per untimely filed (and incomplete or incorrect) Form 8971, including attached Schedule(s) A. The maximum penalty is $3,000,000 per year.
- $50 per timely furnished (but incorrect) Schedule A. The maximum penalty is $500,000 per year.
- $250 per untimely furnished (and incorrect) Schedule A. The maximum penalty is $3,000,000 per year.

[20] As discussed in greater detail below, *any* reporting with respect to marketable securities is probably useless as a practical matter because of the basis tracking that is done by all financial institutions for regulatory compliance reasons.
[21] *See* I.R.C. §6721.
[22] *See* I.R.C. §6722.

ANALYSIS AND COMMENTARY

The Proposed Regulations go far beyond simply implementing the statutory provisions of Section 1014(f) and 6035. In so doing, the Proposed Regulations raise significant issues for practitioners relating to the nature of work performed for the executor in the context of an ordinary engagement to prepare an Estate Tax return. At the same time, the additional obligations and liabilities imposed upon beneficiaries raises the specter of at least some duty of disclosure to the beneficiaries on the part of the return preparer or the Executor. These are not insignificant issues and will likely need to be resolved at the state-law level.

The most obvious example of this overreach is the position taken by the Proposed Regulations with respect to property for which there has not yet been a determination of Final Value. The Proposed Regulations provide that before the Final Value of property is determined under Section 1.1014-10(c)(1), recipients must use the value reflected on the Schedule A (of Form 8971) that they receive from the Estate. Prop. Treas. Reg. §1.1014-10(c)(2). Where there is a subsequent change in the Final Value of the property, the recipient is *not* entitled to rely on the initially reported value and is subject to deficiencies and underpayment resulting from the difference. Prop. Treas. Reg. §1.1014-10(c)(2).

This position appears to be fundamentally inconsistent with the Statute, which provides that the basis of property for which there is no "final value" (i.e. "property not described in subparagraph (A)"), cannot exceed the basis provided on Schedule A. I.R.C. §1014(f)(1)(B). So long as there had been no final determination of value for estate tax purposes, a beneficiary would be in compliance with the statute by using the Schedule A value in computing gain but could, under the Proposed Regulations, later "have a deficiency and underpayment resulting from" the difference between the Final Value and the reported value. *See* Prop. Treas. Reg. §1.1014-10(c)(2).

While the typical Service challenge involves *increasing* the estate tax values of property, this mismatch could affect beneficiaries where the Service and Executor reach a compromise in which the value of some property is increased while the value of other property is decreased. It could also affect beneficiaries that sell property for a loss. Query whether the Executor—or even the Executor's advisors—might be liable to the recipient for "erroneous" reporting of value or even for settlements that disfavor certain beneficiaries. In any event, the Final Regulations should be consistent with the statutes on this key point.

The additional responsibility (and liability) created under Section 1.1014-10(c)(2)—and the associated reporting requirements—leads to a non-tax question that is just as important: is all of this additional work included in the preparation of an Estate Tax return? Although costs are certainly increased, it would be difficult to argue that preparation of the Form 8971 and Schedules A would not be included in that representation. The responsibility to prepare supplemental reporting required under Section 1.6035-1(e) and the associated liability created under Section 1.1014-10(c)(2) is much less clear. Thus, it probably would be best practice for preparers to specifically address this in the engagement letter and indicate to indicate that the preparer also will be available to prepare any needed supplemental forms, but will do so only at the express direction of the executor. States that provide schedules relating to compensation of Estate Tax return preparers[23] should consider adjusting those schedules to reflect the significant additional time needed to complete, prepare, and file a Form 8971 and associated Schedules A.

In addition to the new duties imposed upon practitioners with respect to their clients, practitioners ought to consider the additional duties imposed upon fiduciaries (and, perhaps preparers) with respect to Beneficiaries. Schedule A offers a prominent warning with respect to the basis consistency requirements of Section 1014(f) but makes no mention of, for example, the

[23] *See, e.g.,* Fla. Stat. §733.6171(4)(e).

subsequent transfer obligations imposed by Section 6035. Practitioners must decide the extent and nature to which it is appropriate to warn Beneficiaries of these issues, including the format such warning should take. Given concerns about misleading Beneficiaries as to the identity of an attorney's client in these circumstances, best practice may be a cover letter *from the filing fiduciary* that warns of the existence of "certain obligations" relating to the assets received from the decedent (keeping in mind that the assets may not be trust or probate property) and advises the Beneficiary to seek counsel in any transaction involving that property.

The tax policy aspects of the Proposed Regulations also are lacking. For example, the basis consistency rules do not apply to what is by far the largest single line item on Estate Tax returns: marital deduction property. The property is, of course, still subject to basis *reporting* requirements (including subsequent transfer rules discussed below), so the special treatment is limited. While the reasoning is left unexplained, the most significant aspect of this dichotomy is probably that a spouse that is not also an executor can still assert a basis position that is inconsistent with the return. One explanation for the mismatch may be that the Treasury felt limited by the terms of Section 1014(f) in imposing a basis consistency requirement on such property, but wanted to do so in the future and therefore included such property in the basis reporting regime. This thesis is supported by the 2017 Green Book, which proposes subjecting marital property to the basis consistency requirement. *See* Department of the Treasury, *GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2017 REVENUE PROPOSALS*, Page 179 (February 2016).

In the meantime, the mismatch between "Property" for Section 1014(f) and Section 6035 that currently exists is frustratingly inane for practitioners and beneficiaries. There does not appear to be a substantive reason to report marital property as it necessarily must be transferred, consumed, or otherwise disposed of during the life of the surviving spouse or included (via Section 2044) in her gross estate at death. *Inter vivos* disposition of the property would never result in the application of the basis consistency rules. While the property could eventually come under the basis consistency rules at the death of the surviving spouse, such property would have a stepped-up basis, so the need for basis reporting that relates to its previous basis is confounding. Ultimately, the current rules impose significant reporting costs and potential liability on Beneficiaries without the potential to generate any revenue.[24]

Another curious mismatch is the exception for cash in the basis reporting rules. *See* §1.6035-1(b)(1)(i). Inexplicably, there is no parallel exclusion in the basis consistency rules. *See* §1.1014-10(b)(2). On the one hand, this seems to make sense because a tax basis in cash is tautological, so seems to be no need for reporting (of course, using the same logic, there is also no need for basis consistency). On the other, consider that cash—as 1014(f) Property—would be subject to the zero basis rule if it was not reported on a return. Obviously this would be an unintended result of the rule that probably should be addressed in the final Regulations.

Perhaps the most significant aspect of the exceptions from Section 1014(f) and Section 6035 property is the omission of marketable securities held by federally regulated institutions. The Instructions also are silent as to exactly *how* basis information should be reported for marketable securities. As discussed above, typically, a gross figure of an entire investment account would be reflected on the Estate Tax return itself, with an attached schedule detailing exact information for each holding. That leads to the question of how to report such an asset on the Statement provided to beneficiaries. If the value of a brokerage account is reported as a gross figure, the information is essentially worthless for basis purposes. An attached schedule is a better, but still imperfect option because securities are fungible and any post-death, pre-distribution trading could cause significant confusion for beneficiaries relying on such a schedule.

[24] Other than, of course, penalties for non-compliance with the substantively hollow reporting requirements.

The most straightforward solution is simply to exempt such assets from reporting (but not consistency) requirements altogether. Marketable securities already are subject to strict Federal Regulations regarding the tracking and documentation of tax basis. The onus there is placed on the institution holding the asset, which is appropriate not only because it is in the best position to determine basis but also because it is likely being compensated in exchange for having custody of the asset. Technology already exists that keeps track of the tax basis within and among the various banking institutions, so subsequent transferees already have a system upon which they can rely and clear tax reporting methods are already in place. The Service should address this issue in the Final Regulations.