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Consistency in Reporting Tax Basis for Income and Estate Tax

In light of new rules, executors and estate tax preparers will have to be more cautious

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The process of determining the value of estate assets, and filing the required estate tax return, might all be complicated by recent law changes made by the Surface Transportation and Veterans Health Care Choice Improvement Act (the Act).[1] Those changes mandate consistency in the reporting of the income tax basis in assets. These rules make it more important for executors of estates affected to hire professional advisors to complete and file an estate tax return, document the income tax basis for the estate in each asset and inform beneficiaries of their income tax basis in asset received.[1] The new basis reporting rules are effective after July 31, 2015.

Prior Law

Prior to the Act, there was no requirement of reporting estate values to a beneficiary. When someone died, his assets tax basis (the amount on which gain or loss on sale is determined) would be changed:

- If the value of the asset on death was more than the tax basis (what was paid to purchase the asset, plus any improvements, less depreciation, etc.) then the asset will get a new income tax basis increased from the initial basis to the fair value at death.
- If the value of the asset on death was less than the tax basis, then the asset will get a lower income tax basis, reduced from the initial basis to the fair value at death.
- An estate may elect to value all assets at a date six months following the date of death if the overall valuation at that date results in a lower estate tax. Thus, the step-up or step- down in each assets tax basis may be determined at this later date, known as the alternate valuation date (AVD". Some assets may receive a step-up in basis, others a step-down, and each asset's value might differ under the AVD from what it would have been had a date-of-death value been used.
- The estates determination of income tax basis for estate tax purposes was, prior to the Act, not binding for income tax purposes on the beneficiaries receiving those assets. **Example**: Mom bequeaths a rental property to son and son later sells it. Mom's executor valued the house at the date of Mom's death at $2 million. Son, a month later, sells the rental property for $2.5 million and reports

the income tax basis at $1.5 million paying no capital gains tax. That may have been permissible under prior law; it's no longer acceptable.

Implications of New Law

This complex sounding change has important practical ramifications for anyone serving as an executor or personal representative of an estate or a trustee of a revocable trust subject to these new rules. It will also change the income tax reporting for anyone inheriting assets. These rules appear to be confined to only wealthy taxpayers subject to the estate tax, because they only seem to apply to estates subject to an estate tax.[2]

- Executors should exercise caution because the estate tax return may require including new information reporting forms to comply with the newly enacted basis consistency requirements.
- Income tax return filed by anyone who inherited property from a decedent or a revocable trust formed by a decedent, may include new reporting requirements mandating more disclosures concerning gain or loss on the sale or exchange of property acquired from a decedent. These rules will be designed to confirm the compliance with the new rules regarding income tax basis.
- Where will beneficiaries obtain that information? From the executors. So transmitting appropriate information to beneficiaries will be yet another issue executors will have to address. How can and should this new administrative burden be handled?

Uncertainty Remains

The basis consistency rule only applies to property that increases the estate tax liability of an estate. If no tax is due, will the mere fact that property reduces the portable exemption suffice? Will property that qualifies for the estate tax marital or charitable deduction be subject to this rule, or will it be excluded because property subject to those bequests won't increase the estate tax liability? What happens if an asset is discovered after the estate tax return is filed or even after the period for filing the return has passed?

The Act expressly provides that the Secretary of the Treasury may issue regulations providing exceptions to the application of income tax basis conformity rule. Thus, additional information may be forthcoming that could be important to the application of this new rule. More fun to come!

What's the Value of an Estate Asset?

An estate is required to report the date-of-death (or alternate-valuation-date) values of a decedent's assets. The paradigm for determining that value is the price a willing buyer and willing seller would negotiate. But, as everyone is aware, for non-marketable assets, there's a range of amounts that often exist for the valuation of non-marketable assets. The assumptions involved in determining the value of an interest in real estate or a non-controlling business are significant. Which comparable business or real estate assets should be used? What adjustments should be made to the values of these other assets to make them representative of the asset in the current estate being valued? What's the correct salary adjustment to reflect an arm's-length wage for the principal? What's the correct capitalization rate? What valuation methodologies are used? What the reasonable and acceptable range of values and underlying assumptions are appropriate?

Given the uncertainty in values, in the past some beneficiaries may have reported their interest in an inherited asset at a different value then what the estate used. Because there was no mandate for the estate to provide valuation data to the beneficiary, there may have been little choice to the beneficiary but to come up with his own value for the asset inherited.

Example: The estate values a vacation home at $1 million dollars. The home is bequeathed to the decedent's daughter. She sells the vacation home three months after the decedent died for $1.3 million and reports the income tax basis of the home as $1.3 million. The daughter may not have received valuation information from the estate. Further, if the house was sold so soon after the benefactor's death, a mere three months, the daughter's position might reasonably be that the real value at the date of death was the $1.3 million sale price. The daughter will have effectively received a basis step-up without the $300,000 differential being reported for estate tax purposes. The new rules seek to avoid this type of whipsaw to the federal fisc.

Now, the same beneficiary who might have taken a different position on his income tax return may have to challenge the valuation obtained by the executor if he disagrees with the outcome. Executors will have to exercise more caution in hiring a qualified appraiser to minimize this risk.

The problem with appraisal cost savers is that they establish the values to be used on the estate tax return and for the beneficiaries receiving assets.

Example: Consider the example above. The executor used a price from www.zillow.com for the decedent's house of $1 million, but the heir sold the house shortly after the decedent's death for $1.3 million. If the heir were stuck using a "cheap" guestimate of the value of the house the executor, or a CPA hired by the executor found on-line and that resulted in an otherwise avoidable $300,000 capital gains tax to the heir, the heir might well have an issue with the executor and in turn the executor with the CPA. Executors and estate tax return preparers will both have to be more cautious in light of these new rules.

Reporting to Beneficiaries

The executor or personal representative must provide information to each beneficiary as to the basis of assets distributed.[3]

How should this be done? In the past, few executors had sent an estate tax return, Form 706, to any beneficiary. While some executors might be tempted to send a copy of the entire return to each beneficiary to meet whatever disclosure obligation the Internal Revenue Service imposes, that quantum of disclosure may prove a significant mistake. That much information in the hands of each beneficiary might result in the executor being inundated with questions about valuation, dispositions and anything on the return. It might prove more prudent to have a schedule prepared for each beneficiary providing details as to the assets bequeathed to that particular beneficiary. This, however, will create more administrative costs and professional fees which executors might object to when they don't perceive a tax savings from the incremental efforts.

Executors will be required to report basis information to beneficiaries within 30 days after the due date of the estate tax return or from the date the return is actually filed.

A practical problem with this reporting is that if the executor is given discretion as to how to divide assets among different beneficiaries, that decision may not have been made by the reporting deadline. In the past, it didn't matter; now it may.

Burdens to Estate Administration

New consistency in basis reporting will add new burdens and responsibilities to executors, and the failure to handle them properly, and in many cases with appropriate care, could result in tax problems and angst with estate beneficiaries. IRC Section 6662 has been modified so penalty provisions can apply to inconsistency in basis reporting. Presumably, the IRS will provide more details and forms for executors to carry out these requirements. Until further clarification and forms are issued executors will face uncertainty as to how to comply. Unfortunately, even when the guidance and forms is provided, these rules will add to the burdens and costs of estate administration.

Endnotes

1. Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, P.L. 114-41; Section 2004 (the Act).
2. Act Section 2004, adding new Internal Revenue Code Section 1014(f).
3. New IRC Section 6035, "Basis Information To Persons Acquiring Property From Decedent."