Basis Issues for Trusts and Estates: Form 8971, Removing Assets From Trusts, Upstream Gifting, Substantiating Basis

WEDNESDAY, FEBRUARY 24, 2021, 1:00-2:50 pm Eastern

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Basis Issues for Trusts and Estates: Form 8971, Removing Assets From Trusts, Upstream Gifting, Substantiating Basis

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Basis: An Overview

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What is Basis?

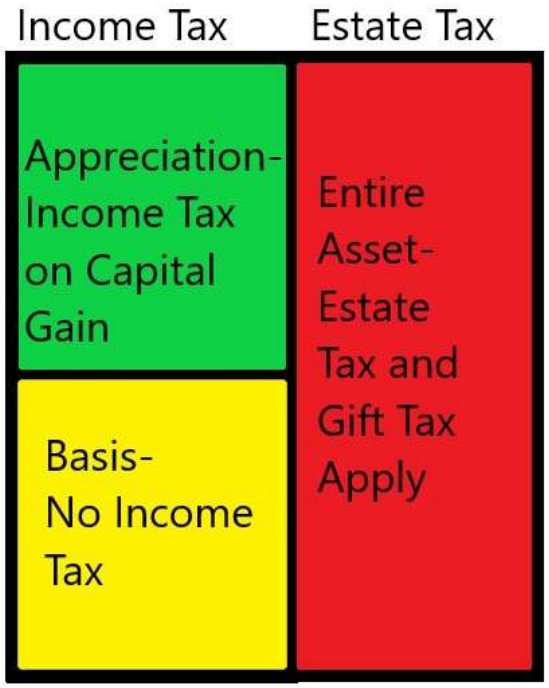
- It is an income tax measure of your unrecovered investment in an asset, whether used for investment purposes (such as a capital asset) or for the production of income (such as a wasting business asset)
- From an income tax perspective, your basis is recovered free of income tax, while only the appreciation is subject to income tax as ordinary income (in the case of inventory and most depreciation recapture) or as capital gain (in the case of net capital appreciation for the year, and some depreciation in 1231 property and real estate)
- The important note here is that basis is an INCOME TAX measure – generally the estate, gift, and generation-skipping transfer taxes do not depend on basis

So What is the Difference?

- Generally, I am going to refer to any federal estate, gift, or generation-skipping transfer (GST) tax as a "transfer tax"
- Transfer taxes are always assessed on the fair market value of a transferred asset at the time that the transfer becomes subject to a transfer tax (or the AVD in the case of the estate tax)
- This means that transfer taxes apply to both basis and appreciation

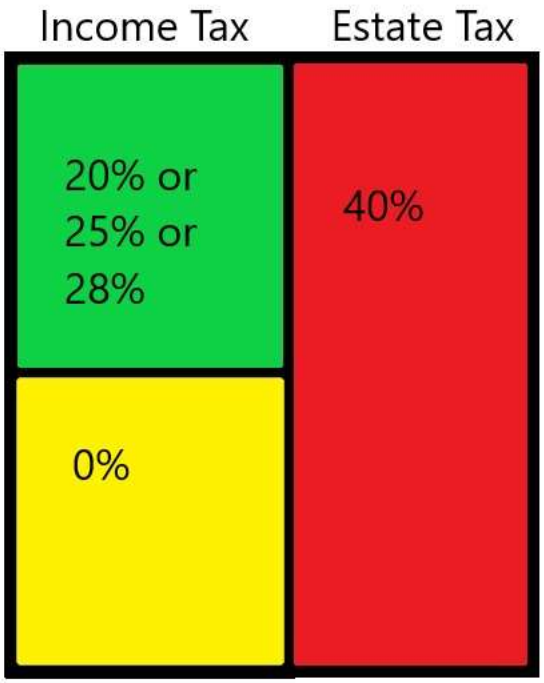
An Example

- Let's take, for example, a capital asset subject to estate tax:



An Example

- As you can see, the estate tax applies to both the basis and the capital gain, at differing rates

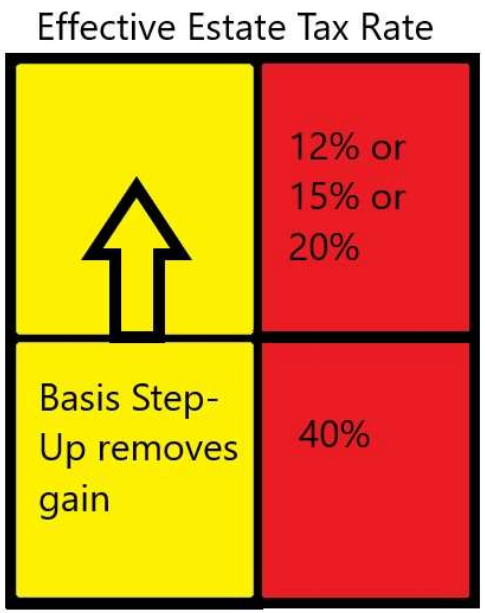


The Issue

- The problem with this illustration is that it could lead to double tax, for two reasons:
  - One, the estate tax is tax-inclusive, meaning the taxable estate (i.e., the gross estate minus all deductions) is reduced by the estate tax payable
  - Two, the heirs who receive the capital asset (after reduction for estate tax) could be taxed on the gain when they sell the asset
- There is relief which prevents this, in the form of an adjustment to basis for the estate tax value

Adjustment to Basis

- In our illustration, the basis gets stepped-up, removing the income tax on appreciation accruing during the decedent's life



Adjustment to Basis

- As an added bonus, for the truly inquisitive, you might see that the step-up in basis can be compounded in two ways:
  - One, on the appreciation component, it can reduce the effective estate tax rate by the difference between the capital gains rate and the estate tax rate
  - Two, it is not dependent on actual payment of estate tax – it can be applied to assets which are shielded by the applicable credit (which effectively excludes the first $11.7 million in assets in the taxable estate, plus lifetime taxable gifts, from estate tax

Adjustments to Basis

- This latter point (i.e., the granting of the step-up regardless of payment of tax) is important because in the case of other transfer taxes (gift and GST tax), in many cases there is only a step-up for the portion of gift or GST tax paid out of pocket on the appreciation in the transferred asset
- AND, while much of the focus (by media and thought leaders) in transfer tax reform is on the reduction of the exclusion of $11.7 million, a bigger deal may be the loss of a step-up in basis

Adjustments to Basis

- Generally, Code Section 1014 grants an adjustment to basis for assets acquired from a decedent
- While we will not cover all of the permutations of this, the general areas of focus are:
  - Assets owned by the decedent at death, or previously owned by the decedent but included in the gross estate
    - This includes the survivor's one-half interest in community property, even though only the decedent's one-half is included in the gross estate
  - Assets never owned by the decedent, but nonetheless treated as owned by the decedent (such as through a general power of appointment or QTIP election)

Adjustments to Basis

- Note that while this is colloquially termed a “step-up” in basis, it is really an adjustment of basis to the value of the asset for estate tax purposes
  - Can elect date-of-death FMV, or FMV at alternate valuation date (6 months after date-of-death) if a tax is owed
- So, if the value reportable for estate tax purposes is lower than the basis, then there could be a step-down in basis
  - For example, if you claim discounts in the estate tax value, this can reduce the basis as a trade-off for estate tax savings
- The adjustment is not dependent on payment of estate tax or even the filing of an estate tax return, which (as we will later discuss) can create substantiation issues

A Note on IRD

- Income in respect of a decedent (IRD) is not eligible for a step-up in basis
- The recipient of IRD steps into the decedent's shoes and is taxed on the income when received
- This generally represents income earned by the decedent during life but collected after death – biggest example would be a tax-deferred asset like an IRA
- But, to avoid double-tax, IRC 691(c) grants a miscellaneous income tax deduction for estate tax attributable to IRD
  - This is very taxpayer-friendly, treating IRD as last-dollar in the taxable estate and not tracking it to RMD rules

Planning for Change Under the New Administration

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- Current Estate Tax Exemption (2021) = $11,700,000
- Quarty v. US, 170 F.3d 961 (9th Cir. 1999)
  - Ninth Circuit Court of Appeals ruled that a retroactive tax increase does not violate the Constitution
  - Court held that the increase in the estate and gift tax was a rational means to raise revenue, noting that an increase in tax rate was merely an increase of an existing tax, not a wholly new tax, citing other court decisions as precedent
  - Reducing the exemption is not a new tax.

Planning for Change Under the New Administration

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- Included among the Biden tax proposals is his suggestion that there be no step-up in basis under IRC § 1014 for appreciated assets on the death of an individual.
- Death is a Realization Event
  - Under current law, the death of a taxpayer is not a taxable event.
  - The basis of property acquired from a decedent is stepped-up to the FMV at death, with the result that appreciation in the property during the life of the decedent is not subject to income tax.
  - Biden would treat death as realization event (Source: Richard Rubin, “How Joe Biden’s Tax Plan Could Affect You,” WSJ)
  - Result = Decedent would be treated as if she sold all of her assets for FMV at death and would be taxed on any unrealized appreciation at the rate applicable to long-term capital gains (i.e., for TPs with income over $1 mm, would be at a top federal rate of 39.6%)

Planning for Change Under the New Administration

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- Changing current § 1014 step-up in basis to treating death as a realization event and taxing built-in gain is just one of a litany of federal tax proposals previously suggested by now President Biden and VP Harris during the 2020 election cycle.
- Other Biden-Harris tax proposals include:
  - Raising top marginal individual income tax rate to 39.6%
  - Remove capital gains preference for individuals earning over $1 mm
  - Raise corporate tax from 21% to 28%
  - Reduce federal estate and gift tax exemption from $11.7 mm to $3.5 mm.
  - Raise top tax rate of the federal estate and gift tax to 45% (from 40%)

Planning for Change Under the New Administration

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- So, what does all of this mean for our clients today?
- Assuming clients are still out there who watched the GA election results come in, the inauguration, and are still sitting on their exemptions?
- Example: Betty is 80 years old, has an $11.7 mm remaining gift and estate tax exemption and $12 mm in assets. Betty could sell $9 mm in assets to a Dynasty Trust in exchange for a Note bearing interest at the long term AFR. Betty dies. At Betty's death, the Note is valued at $8 mm. Assuming Betty dies with only the Note in her taxable estate, and before any change occurs to the federal estate and gift exemption, the value of the Note will not require her estate to file a Form 706.

Planning for Change Under the New Administration

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(Of course, Betty could reduce her taxable estate even further if she contributes $9 mm worth of assets into an Asset Management Co. (LLC) and sells a non-voting interest in that LLC to a Dynasty Trust in exchange for a Note = $6.3 mm (30% discount.)

<u>But</u> if Betty's assets were low-basis, highly appreciated leveraged rental real estate?

$12 mm = .40 estate tax = 4.8 mm estate tax

But if her basis = $12 mm

$12 mm basis at death

vs

NO ESTATE TAX/NO STEP-UP

Planning for Change Under the New Administration

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- (Note: Other options may be available here, such as a self-canceling note (SCIN) or, if Betty was a bit younger, a private annuity.)
- (Note: Another option for Betty here could be to cancel, partially forgive, or gift the note while she is still alive.)

Planning for Change Under the New Administration

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- When does an income tax basis step-up become more valuable than the possible estate tax savings?
  - Rule: If property is included in a decedent's gross estate, it receives a new income tax basis = to FMV at death (or alternate valuation date).
  - Property, however, that is gifted during the decedent's life does not receive a basis adjustment upon the death of the decedent.
  - An inter vivos gift will only have a positive estate tax impact (i.e., savings) on the income and appreciation it generates after the gift is made.
  - No return on investment? Then no estate tax savings.
  - If decedent gifts appreciated property, unless the property generates a positive investment return before death, the loss of the basis adjustment will create a net tax disadvantage.

Planning for Change Under the New Administration

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Example: Bob owns shares of Apple stock with a FMV of $11.7 mm and an income tax basis of $1 mm. Bob gifts the stock to a Dynasty Trust for the benefit of his daughter and her children. If the stock is worth $12.7 mm on the date of Bob's death, Bob's gift saved his family estate tax of $400,000 (40% of $1 mm of appreciation).

Assume that the Dynasty Trust that holds the stock is in the top federal income tax bracket. When the stock is sold by the Trust, the Trust will pay tax of 23.8% on the gain, or $2,784,600.

The gift cost Bob's family an additional tax of $2,384,000. If, however, the gifted Apple stock had been included in Bob's estate at death, the estate would have paid an additional $400,000 in estate tax but would have saved income taxes of $2,784,600.

Planning for Change Under the New Administration

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- How quickly will changes come in the Biden Administration?
  - Prior to his inauguration, Biden unveiled a $1.9 trillion dollar stimulus plan that included a change to the Child Tax Credit and the Earned Income Tax Credit.
  - Other, significant changes may take some time
    - Jared Bernstein (Biden's economic advisor), "Tax increases are going to be very dependent on the economic conditions."
  - Other challenges to sweeping tax reforms include: political fallout from the impeachment trial; recovering economy due to COVID-19; and razor thin majority in U.S. Senate

Planning for Change Under the New Administration

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- Could we see a repeat of TCJA-like tax laws pass in Q4 2021?
  - Budget Reconciliation is the process whereby it takes only a simple majority of 51 votes to pass a bill.
  - Reconciliation may be quicker but it's complicated
    - Senate Finance Committee and other Senate committees create a budget.
    - Committees of the Senate then must reconcile each others' "draft" budget into a bill.
    - The final, reconciled bill must then pass the senate.
  - Reconciliation can only be used once per budget cycle.
  - Congressional Budget Act of 1974 lays out complex rules. President is supposed to submit budget for the next fiscal year by Feb. 1
  - If no budget resolution? Bipartisan Budget Acts, reconciliation may occur

Structuring Trusts for Flexibility

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Trusts – An Overview

- Trusts, when created for estate planning purposes, are often structured as revocable or irrevocable
  - Revocable trusts are not used for gift tax planning, but instead to reduce court interference through probate and/or conservatorship
  - Irrevocable trusts, if created during life, often are structured to treat transfers as completed gifts with the goal of freezing value of gifted assets for estate tax purposes
  - Trusts created at death generally become irrevocable, with a significant goal of spendthrift protection, but also with an eye towards using estate tax deductions or preventing inclusion in the gross estate of beneficiaries

Irrevocable Trusts

- There are two questions which many estate planners address:
  1. Will the trust be included in the grantor's gross estate?
  2. Will the trust be included in any beneficiary's gross estate?
- The first question has often been a sacred cow – it is avoided at all costs
- The second question has often only been deployed where a QTIP trust is involved, or where the trust is a GST non-exempt trust (more on this later)
- These attitudes were designed to avoid estate tax in a world where the exclusion was much smaller
  - The exclusion has increased almost twenty-fold in 20 years, from $675,000 at the start of 2001 to $11,700,000 at the start of 2021

What To Do?

- So, with many irrevocable trusts, we will be looking at these objectives:
  - Do we care any more if the grantor retains an interest in the trust at death?
  - Are we worried if a beneficiary has a general power of appointment?
- Because, ultimately, there is an opportunity to step-up the basis of up to $11,700,000 in assets for the grantor and each beneficiary at death
- The difference is how we get there, and whether the rug can be pulled out from under us

Irrevocable Trusts - Modification

- For existing irrevocable trusts, the trend (under the Uniform Trust Code) has been to allow modification
- If grantor is living, all relevant parties (grantor, beneficiaries, and trustee) can consent to modification
- If grantor is deceased, beneficiaries and trustee can consent to modification so long as the modification does not violate a material purpose of the trust
- There is even a UTC provision (Section 416) which allows for modification to achieve the grantor's *probable* tax objectives

Irrevocable Trusts - Modifications

- There are several issues with modifications, but for purposes of this discussion, this is our concern:
  - Is the IRS bound by a state-law modification to a trust?
- Traditionally, under the U.S. Supreme Courts' opinion in *Comm'r v. Estate of Bosch* (1967), the IRS is not bound by a trust modification unless it is approved by the highest state court
- There is a trend towards recognizing lower court decisions, especially when made pursuant to an authorizing statute (such as the UTC), but this often requires a private letter ruling to be safe

Examples

- Let's assume your client, Grant, wants to take the following actions:
  - Create an irrevocable trust, funded with $11,700,000, in which he retains the right to receive income along with his spouse and children
  - Give his parents, spouse, and children a testamentary general power of appointment over the trust assets
- Let's further assume that these are done in a way which would not cause any creditor issues
- What are our blind spots?

Example 1: Grantor Retained Trust

- Generally, for gift tax purposes only, a grantor-retained trust must be structured as a GRAT or GRUT to value the grantor's retained interest over zero (IRC 2702)
- But, in this case, Grant may not care – he wants to use up his entire $11.7 million exclusion in case it is lost
- Does this create an issue?

Example 1: Grantor Retained Trust

- At first glance, no. Even though the assets of this trust will be included in Grant's gross estate under IRC 2036 at date-of-death FMV, Grant anticipates that the trust will be depleted over his life expectancy
- Grant's attorney relies on IRC 2001(b)(2), 2001(g) and newly-issued regulations, which base the applicable credit on the higher of:
  - The exclusion amount available at death, or
  - The exclusion amount applied to lifetime gifts
- Grant and his attorney reason that even if the exclusion goes down, he can lock it in and keep an interest in the trust assets

Example 1: Grantor Retained Trust

- This could be an issue of substance over form. Even though this works on paper, Treasury reserved the opportunity for future comment on whether this arrangement could be abusive
- Grant's retained interest could make this abusive from the outset
- Even if not abusive, Grant's use of the trust assets over time could indicate an intent not to make a gift
- So, in the worst case, the IRS could deny the higher applicable credit at his death

Example 2: General Powers of Appointment

- The general powers of appointment (GPOA) to beneficiaries seem safer, as these would allow for a step-up in basis at each generation
- Importantly, if Grant's parents predecease him, the trust assets could get stepped-up at that point
- What are the issues here?

Example 2: GPOA and GST Tax

- The grant of a GPOA, especially to Grant's spouse, would likely cause an estate tax inclusion period (ETIP) which could prevent allocation of GST exemption (from Grant or any other beneficiary)
- If there is no ETIP, each time a beneficiary dies, the beneficiary's GST exemption could be allocated to the trust
- While this is outside of the scope of today's discussion, this causes a wasting of GST exemption across generations (whether or not there is an ETIP)
- But, we will be borrowing from GST guidance condoned by the IRS on the creation of formulas

Example 2: GPOA to Parents

- The grant of a GPOA to Grant's parents is known as "upstream" basis planning, and could be effective
- But, as we will see below with upstream gifting, this can cause issues such as a loss of the step-up in basis
- These issues are exacerbated by Grant's presence as a beneficiary of the trust

Example 2: GPOA to Spouse

- In addition to the ETIP issue above, the grant of a GPOA to Grant's spouse would not qualify the trust for the estate tax marital deduction, due to the presence of other beneficiaries
- This would also cause a wasting of the basic exclusion of $11.7 million, because the same assets would be taxed in Grant's estate and his spouse's estate
  - In other words, they would not be sheltering a combined $23.4 million from estate tax

Example 2: GPOA and Over-Inclusion

- For all beneficiaries, the GPOA could case over-inclusion in each beneficiary's taxable estate
- This could cause unnecessary estate tax, and hardship to each beneficiary's family
- What's worse is that if the beneficiary releases their GPOA, they must also release their beneficial interest in the trust in order to remove the assets from their taxable estate
  - This, in and of itself, could cause a taxable gift to the trust beneficiaries and still use the beneficiary's exclusion

Example 2: Simple Solutions?

- What if, instead of giving each beneficiary a general power of appointment over all of the trust assets (or their share of the trust assets), we limited it?
- The limitation could be equal to the positive difference (if any) between the value of their taxable estates (without the trust assets) and the value of their applicable exclusion available at death
- This formula approach has been respected by the IRS in marital deduction planning, and in GST exemption planning, so it may work here but there is no safe harbor upon which to rely
- Instead of granting a GPOA, Grant could leave it up to his kids to trigger the Delaware tax trap
  - However, this would require the actual exercise of a limited power of appointment
  - Depending on which state's laws apply to the trust and/or exercise of powers of appointment, this may not be available

Example 2: The Wild Card

- What if subsequent tax law changes eliminate or limit the step-up in basis? Do we still want beneficiaries to have general powers of appointment?
- Perhaps we could condition the GPOA on the existence of the step-up in basis
- Could we also limit the GPOA to appreciated, non-IRD, non-QSBS* assets? Perhaps, but as with the formula, there is no safe harbor for this level of detail

*QSBS – qualified small business stock, which may be eligible for a gain exclusion under IRC 1202

Removing Appreciated Assets from a Trust

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- As we saw with the previous example of Bob's gift of Apple stock, there can be instances when, long after the grantor funds a trust, that the grantor may subsequently decide to remove assets that have appreciated in value while held by a Trust in order to obtain a tax-saving step-up.
- There also may be instances where you want to get highly appreciated assets out of a trust so that the decedent's estate will benefit from the step-up in basis (assuming § 1014 remains law).
- This situation can be avoided in the first instance:
  - Avoid making large gifts of appreciated assets to younger family members
  - Consider making gifts of low-basis, highly appreciated assets to older family members.
    - Older family member would leave asset to the person who gifted it to them
    - Beware of § 1014(e)
    - Beware of Medicaid asset test and reach of creditors.

Removing Appreciated Assets from a Trust

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- Another way to remove appreciated assets is to incorporate swap powers under section 675(4)(c) in the Trust
  - Inclusion of a swap power is a common method to accomplish this
  - Many irrevocable trusts contain powers that allow a grantor to substitute non-trust assets for trust-owned assets

Removing Appreciated Assets from a Trust

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- Section 675 of the IRC provides the statutory authority to do the swap.
  - When exercising swap powers under § 675, the trustee must be under a fiduciary obligation to ensure that the assets substituted or swapped are of equivalent value
    - Rev. Rul. 2008-22
  - Transaction may not leave beneficiaries in a better or worse economic position
  - Trustee should document the value of the transferred assets to show they are equivalent value.
    - E.g. Apple stock for Facebook stock (may be a bad example, but you get the general idea…)

Removing Appreciated Assets from a Trust

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- In a swap, trustees must also evaluate characteristics of the swapped assets.
  - In an exchange of closely-held stock for assets, trustee must ensure that voting rights are held by the trust and not the settlor
  - If the settlor retains the voting rights for the property transferred to the trust, the settlor's taxable estate would include the assets received in the swap plus the stock transferred to the trust under § 2036(b).

Removing Appreciated Assets from a Trust

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- When contemplating a swap of assets, the trustee should also consider the timing of the swap.
  - For example, if the grantor has been diagnosed with a terminal illness and has little time to live.
  - In this scenario, swapping an asset with a high basis for an asset with a lower basis/higher value held by the trust may be desirable so long as § 1014 remains an option.
  - Be very aware when undertaking these types of transactions; be aware, as well, of state tax law!

Removing Appreciated Assets from a Trust

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- In addition to appreciated assets, there can be other reasons for executing a swap power.
- One reason to execute a swap power is capital gain/loss planning.
- Capital losses do not flow to trust settlors or beneficiaries of non grantor trusts.
- If grantors have capital gains, swapping assets before termination of grantor trust status may also be beneficial.

Removing Appreciated Assets from a Trust

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- Contributing rapidly appreciating assets to a trust can also produce favorable results
- In these circumstances, getting a rapidly appreciating asset out of an estate through a swap will parent further appreciation from occurring in the taxable estate.
- The reverse of this situation could likewise be true.
- Exercising swap powers does not amount to making a taxable gift, so long as the assets swapped are of “equivalent value.”
- Report the swap ANYWAY on the Form 709
  - Starts the SOL
  - Adequate substantiation required

Removing Appreciated Assets from a Trust

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- A few last points about the swap power…
- Language of the swap power matters.
- Closely consider the trustee's duty
  - Rev. Rul. 2008-22
  - Rev. Rul. 85-13
  - Rothstein v. US., 735 F.2d 704 (2d Cir. 1984)
- Proper value standards are critical
- Be careful!

Upstream Gifting: How to Go with the Flow

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- "Upstream gifting" describes the technique whereby a gift of appreciated assets is made "up" a family tree to parents or grandparents (rather than the more traditional "downstream" gifting that usually occurs from parents to children and grandchildren)
- Why would you make an "upstream gift"?
- At the death of the recipient, the appreciated assets will receive a step up in income tax basis (so long as § 1014 exists).
- In addition, those persons who then receive these assets at the bequest of these older persons should be able to sell the assets without incurring capital gains

Upstream Gifting: How to Go with the Flow

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Example: Judy is the wealthy daughter of George. George is not expected to use his entire $11.7 mm of lifetime exemption. Judy transfers stock with a basis of $1 mm and a FMV of $10 mm to George. At George's death, his estate will not actually owe any estate tax so long as he has enough exemption remaining.

- Because the gift is included in George's taxable estate, the income tax basis of the stock is stepped up at death to $10 mm.

Upstream Gifting: How to Go with the Flow

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- An upstream transfer can be structured in a host of ways.
- Gift, sale to a trust, GRAT = all options to construct the transfer
- Why swim upstream? Shouldn't Judy save her exemption for transfers to her children and grandchildren?
- Depending on all the facts and Judy's age, this transaction may have beneficial results for the Jetson family.

Upstream Gifting: How to Go with the Flow

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- There are some important caveats about doing an upstream gifting transaction.
- Gifted assets will not receive a step up in basis if George dies within one year of the gift and the assets revert back to Judy at that time.
- Note that this issue *may* be avoided if, instead of Judy, the assets were to pass at George's death to a trust established for Judy's children, or if the stock in this example passed directly from George to his grandchildren.

Upstream Gifting: How to Go with the Flow

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- There are certain risks that should be considered when evaluating whether upstream gifting is appropriate.
  1) George takes the stock and passes it on to his new wife or to his son, Elroy, who Jane has not spoken to in years
  2) George may have run into legal and/or financial trouble and the stock becomes reachable by his creditors.
- Jane could avoid these risks if she makes the gift to a trust for George's benefit rather than to George outright.

Upstream Gifting: How to Go with the Flow

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- If Jane makes the gift to a trust established for George's benefit, that trust agreement should be carefully drafted to ensure that the stock is included in George's estate.
- This is not typical and will feel ODD– but it is an essential component part of this transaction in order that it works.
- Finally, § 1014 could change (i.e., be eliminated) during the Biden administration and/or the amount of the lifetime exemption may change.

Basis Consistency Rules and Form 8971

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- Form 8971 is filed by the executor of an estate to report the final estate tax value of property distributed (or to be distributed) from the estate, along with a copy of every necessary Schedule A, which is used to report values to the IRS.
- One Schedule A is provided to each beneficiary receiving property from the estate.
- The executor(s) must provide each beneficiary with a copy of <u>that</u> beneficiary's own Schedule A.
- The executor <u>does not</u> provide the Form 8971 to any beneficiary (not attached to each beneficiary's Schedule A)

Basis Consistency Rules and Form 8971

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- Certain property received by a beneficiary may be subject to a consistency requirement.
- This means that the beneficiary cannot use a value higher than the value reported on Schedule A as the beneficiary's initial basis in the property.
- There are certain circumstances in which a Form 8971 is not required.
  1) Gross estate + taxable gifts is less than the basic exclusion amount;
  2) Form 706-QDT, -CE or –GS is filed;
  3) The only reason the Form 706 is filed is to make a GST allocation/election, or to elect portability of the DSUE.

Basis Consistency Rules and Form 8971

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- The Form 8971 (including all attached Schedule(s) A) must be filed with the IRS (and only the Schedule A provided to that beneficiary listed on it) no later than the earlier of:
  1) The date that is 30 days after the date on which Form 706 or Form 706-NA is required to be filed (including extensions) with the IRS; or
  2) The date that is 30 days after the date Form 706 or Form 706-NA is filed with the IRS.
- Form 8971 is a separate filing requirement from the Form 706

Basis Consistency Rules and Form 8971

ReedSmith

- The Form 8971 is filed at the Cincinnati, OH Service Center
- There are several acceptable ways that a beneficiary may be provided a copy of Schedule A including, by email.
- The executor of the estate must certify on Form 8971, Part II, Column D, the date on which Schedule A was provided to each beneficiary, and should keep proof of mailing, delivery, and/or acknowledgement of receipt.

Basis Consistency Rules and Form 8971

ReedSmith

- The value of property to be reported on the initial Form 8971 and the attached Schedule A is the FMV of the asset as reported on the Form 706
- The final value for purposes of the federal estate tax may differ from that reported on the Form 706
- A value is final when:
  1) The value of property shown on the Form 706 is not disputed before the SOL runs;
  2) The value is specified by the IRS and is not timely contested, or;
  3) The value is determined by a Court

Basis Consistency Rules and Form 8971

ReedSmith

- If information reported on Form 8971 and the Schedule(s) A provided to a beneficiary differs from the final value, the executor must file a Supplemental Form 8971 and Schedule(s) A, and must provide an updated Schedule A to each beneficiary within 30 days of the adjustment being made.
- Penalties may apply if an executor fails to file a correct Form 8971 timely.
  1) $50 per Form up to a max of $532,000 within 30 days of due date
  2) $260 per Form up to $3,193,000 after 30 days of due date
- Penalty structure may also apply for failure to provide correct Schedule(s) A to beneficiaries timely.

Basis Consistency Rules and Form 8971

ReedSmith

- Schedule A of Form 8971 does not require reporting of cash requests – this reporting is focused on basis consistency for property
- Asset descriptions listed in Column B of Schedule A should be uniform and consistent with Form 706
- Valuation dates on Column D will be DoD, unless alternate valuation date is used
- Only proportional amount of any values should be included in Column E of Schedule A

Basis Consistency Rules and Form 8971

ReedSmith

- Sections 1014(f) and 6035 of the IRC are known as the consistent basis reporting rules.
- The purpose of these rules is to address any perceived abuse when a decedent's estate reports the value of property included in the gross estate as being discounted to generate a lower federal estate tax, and the recipient of the property reports his or her basis in that property as being higher under § 1014 (a) in an effort to eliminate taxable gain when the property is later disposed of.

Basis Consistency Rules and Form 8971

ReedSmith

- Prior to the enactment of sections 1014(f) and 6035, the only 'check' available to the IRS was the "duty of consistency."
- Duty of consistency was based on the theory that the taxpayer has a duty to be consistent in reporting tax items.
- Section 1014(a) = recipient takes a basis = to FMV and DoD
- Section 1014(f) = recipient's basis shall not exceed the value of property as finally determined for federal estate tax purposes
- Under § 6035, if the final value has not been determined, the value reported on the Form 8971 is that required under the statute
- Schedule A of Form 8971 is the procedural product of the enactment of § 6035

Basis Consistency Rules and Form 8971

ReedSmith

- On March 3, 2016, the IRS issued proposed regulations referred to as the "Consistent Basis Reporting Rules."
- These regulations affect taxpayers who receive property from a decedent and whose basis in that property is determined under Section 1014.
- The regulations were long-sought after the issue of basis consistency first arose in Obama's 2010 Greenbook
- The impetus for these Regs was the enactment of § § 1014(f) and 6035, which are known as the consistent basis reporting rules, in 2015.

Basis Consistency Rules and Form 8971

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- Key provisions in the Proposed Regulations
- Initial Basis
  - Section 1014(f)
- Subsequent Basis Adjustments
  - Section 6662(k)
- Permissible Basis Adjustments
  - Section 6662(b)(8)
- Property subject to consistency requirements
  - Section 1014(f)(2)

Basis Consistency Rules and Form 8971

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- Exclusions from Consistency Requirements
  - Reg 1.1014-10(b)(2)
- Finality of Federal Estate Tax Value
  - Section 1014(f)(3)
  - Reg 1.1014-10(c)(i)
  - When there is no finality
- After Discovered or Omitted property
  - Section 1014(f)
  - Reg. 1.1014-10(c)(3)(i)

Basis Consistency Rules and Form 8971

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- Subsequent Transfers
- Surviving Joint Tenants or other recipients
  - Section 6035(b)(2)
  - Section 6018(b)

Substantiating Basis

Griffin Bridgers
Hutchins & Associates LLC
Denver, Colorado

Is 8971 Required?

- With the new basis consistency regime, a commonly-asked question is whether Form 8971 should always be filed as a matter of practice?
- This may not be a good idea, for several reasons:
  - You must file 706, which can be burdensome
  - There is no elective 706/8971 condoned for non-taxable estates if no DSUE or QTIP election is made
  - If there was a previous DSUE election by a deceased spouse, this could open up their estate's 706 to examination
  - This could limit beneficiary's ability to later challenge basis

So, What Should We Do?

- For one, good record-keeping is essential
- Even where not required, it is often a good idea when administering an estate to get formal appraisals of illiquid assets
- For publicly-traded securities, it may be easy to order an estate tax value statement from the custodian or broker
- Trustees and personal representatives have a duty to provide inventories and accountings to beneficiaries – could this include basis information?
  - While there is no active trend here, we could see activity on this front in the future
- Action item: If you are preparing a 1041, inquire as to status of appraisals

What if 706/8971 Basis is Changed?

- Where the 706 is subject to examination, one risk you run is the increase in basis for a previously-sold asset
  - This would cause overpayment of tax on gain by seller
- The seller of the asset (heir, beneficiary or trustee) may be beyond the limitations and refund period for this overpayment
- However, there is a remedy known as equitable recoupment, which allows for the seller to recoup this overpayment after the limitations period on seeking a refund
  - Always check if beneficiary has inherited an asset subject to 8971 reporting, and if so, check to see if it is subject to examination
  - Estate tax closing letter is good way to settle this, but a $67 fee is now required to request a closing letter

Basis Discrepancies

Griffin Bridgers
Hutchins & Associates LLC
Denver, Colorado

What if the 8971 is Wrong?

- We saw the issue with equitable recoupment, but what if you are preparing returns for a taxpayer who wishes to challenge the basis?
- Can beneficiary do anything? There likely is not a direct remedy to the IRS, so beneficiary would have to go to personal representative to request amended 706/8971 combo
- What if this request is turned down? Or, what if no 706/8971 is filed and the beneficiary wishes to contest reported basis?

Beneficiary Substantiation of Basis

- There are some elections to be sought, such as the 754 election for inherited partnership interests, which should be explored
  - There is generous late filing relief
- Otherwise, the longer from the valuation date, the more difficult it may be to get an accurate appraisal
- What if beneficiary gets their own appraisal? Does personal representative have duty to use that appraisal?

Beneficiary Uses Wrong Basis

- Where there was an 8971, the IRS can make an adjustment based on the discrepancy
- As tax preparer, make sure you ask for 8971 from beneficiary
- There could be risk of preparer penalties for “unreasonable” position, so for transactions applying basis, you may want to consider filing Form 8275 in case this information comes out of the woodwork

QUESTIONS?

- Thank you!