Tax Basis- Avoiding the Zero Basis Trap

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Take-Away: While we regularly talk about the 'right' to obtain an income tax basis *step-up* on the death of the asset's owner, it is important to remember that omitted assets, or assets that would have caused a federal estate tax liability but which were not timely reported on a federal estate tax return, may nonetheless carry an income tax basis of $0.00 due to the IRS's basis consistency rules.

Background: We are all acutely aware that the recipient of property from a decedent generally takes an income tax basis that is equal to the fair market value of property at the time of the decedent's death (or the alternate valuation date, 6 months after the decedent's death.) [IRC 1014(a).] However, it is important to remember that under the proposed 'basis consistency reporting rules' that were published in 2016, the inherited property may ultimately be determined to have an income tax basis of $0.00, much to the surprise of the heir who was told (or claims that they were told) they are entitled to claim a basis *step-up*.

Proposed Regulations: These Proposed Regulations under IRC 1014(f), which sadly remain *proposed* almost 8 years later, contain provisions that require consistency between the basis of inherited property in the hands of the recipient and the value of the property that is reported for federal estate tax purposes. IRC 1014(f) generally provides that the inherited property may not exceed the value of the property that is finally determined for federal estate tax purposes.

Final Value: The final value of property for federal estate tax purposes, per IRC 1014(f)(3) [Proposed Regulation 1.1014-10(c)] is: (i) the value that is reported on a filed federal estate tax return which is not contested by the IRS before the limitation period on assessment expires; (ii) or 3 years from the due date of an estate tax return [IRC 6501(a)]; (iii) or 6 years if there is an omission of 25% or more of the gross estate. [IRC 6501(e)(2).] More to the point, there is no statute of limitations on the period of assessment in the case where no federal estate tax return is ever filed.

Zero Basis: Zero ($0.00) income tax basis arises when property is discovered after filing the estate tax return or the property is otherwise omitted from the federal estate tax return, as well as in the case where a required estate tax return is not filed.

"Would Result in:" Yet it is important to remember that the consistent basis rules *only apply* to property whose inclusion in the gross estate would result in estate tax liability or the inclusion of which in the gross estate would result in an increase in federal estate tax liability. If the after-discovered or omitted property would have resulted in federal estate tax liability or an increase in federal estate tax liability had such asset been reported, Proposed Regulation 1.1014-10(c) provides: *"…if the after-discovered or omitted property is not reported before the expiration of the assessment period, the final value of the property is zero."*

> Too Late to File: A supplemental federal estate tax return may only be filed within the assessment period. Accordingly, in some situations, it may be too late to file a supplemental estate tax return and thus 'fix' the zero-tax basis 'trap.'
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> No Return Filed: In the situation where a required federal estate tax return is not filed, the Proposed Regulations make it clear that the final value of *all* property includible in the gross estate subject to the consistent basis requirement is zero ($0.00) until the final value is determined… generally requiring the filing of an estate tax return." [Proposed Regulation 1.1014-10(c)(3)(ii).]

Basis Traps: Therefore, the consistent basis reporting rules make it abundantly clear the importance of identifying and marshaling all assets of the decedent to be entitled to claim an income tax basis *step-up.*

> Example #1: Long after Clara's death and after the expiration of the period for assessing the federal estate tax, the Personal Representative of Clara's estate discovers an investment account held in Clara's name that was distributed directly to Clara's grandson Chad under a TOD beneficiary

designation. This TOD investment account was not reported on Clara's federal estate tax return which, if reported, would have increased the amount of federal estate tax due on Clara's death. The final value of the unreported property, i.e., the investments held in the TOD portfolio that Chad received directly from the broker, is zero ($0.00). If Chad sells any of the investments in that TOD account, he will be liable for tax on the full amount that he realizes on the sale of the investments, since the income tax basis in each of the investments is $0.00. [Proposed Regulation 1.1014-10(e).]

Example #2: Kirby dies owning several partnership interests in real estate. The Personal Representative of Kirby's estate should obtain appraisals of the underlying real estate as well as Kirby's partnership interest, even though they are hard-to-value assets without a readily ascertainable market values. The Personal Representative of Kirby's estate is pressured by Kirby's children to not pay for these appraisals since the children believe that Kirby's gross estate is less than his available applicable exemption amount that will shelter Kirby's estate from any federal estate taxes. The decision is reluctantly made by the Personal Representative to not obtain appraisals or file a federal estate tax return in the belief (hope?) that Kirby's gross estate is less than his available applicable exemption amount. Kirby's children later sell one of his partnership interests. The children then receive a request from the IRS to substantiate their basis claim associated with the sale of their inherited partnership interest. If the IRS determines the value of the partnership interest was sufficient to require an estate tax return that would have resulted in estate tax liability, the partnership interest may not only be assigned a zero-tax basis, unless and until an estate tax return is filed, but also penalties will be applicable and assessed for the failure to timely file and pay the federal estate tax. Obtaining an appraisal of the partnership property some years after Kirby's estate is concluded will be very challenging for Kirby's children.

Conclusion: It is incumbent on Personal Representatives and Trustees to carefully determine the assets of a decedent and their accurate values. In addition, these fiduciaries need to pay careful attention to the parameters for filing a federal estate tax return and identify the risks associated with not filing a return when the value of the decedent's assets approach the relevant level that requires a federal estate tax return to be filed. All of this will require educating the decedent's heirs who will claim that it is a waste of their inheritance in obtaining appraisals and filing federal estate tax returns when 'we do not need to.'