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IRS Clarifies Basis Consistency Rules: What Executors and Beneficiaries Need to Know

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On September 16, the Department of the Treasury issued final regulations regarding basis consistency. These regulations arrived eight and a half years after the initial proposal.

This article examines what the decision could mean for beneficiaries and estate executors.

What is basis consistency?

Under Internal Revenue Code Section 1014, the basis of inherited property is generally equal to its fair market value (FMV) at the date of the decedent's death. This is known as stepped-up basis or stepped-down basis, depending on whether the FMV is higher or lower than the decedent's original basis in the property. There are two exceptions to the general rule: 1) for property acquired from someone who dies in 2010, the estate can elect to use modified carryover basis rules and 2) an estate may elect to use the alternate valuation date (six months following the date of death) if it would lead to a lower estate tax.

For estate purposes, lower values reduce the estate tax liability. For income tax purposes, a higher value reduces the future income tax liability when there is a recognition event. Before the basis consistency rules, the estate tax system incentivized reporting lower asset values and the income tax system incentivized reporting higher asset values.

Previously, there was no requirement to use the same asset value for both estate and income tax purposes and there was no mandate for an estate to provide valuation data to a beneficiary. However, the courts had held that for reporting values there was a "duty of consistency that not only reflects basic fairness, but also shows proper administration of justice and dignity of the law."

The lack of consistency, though, was seen as a potential loophole, allowing for tax manipulation by undervaluing assets for estate tax purposes and overvaluing them for income tax purposes.

Reporting requirements introduced

To address these issues, Congress passed the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, adding Internal Revenue Code Sections 1014(f) and 6035. Those additions required the executors of larger estates (defined as those that were required to file an estate tax return) to report to a party acquiring property from a decedent's gross estate and that the beneficiary be bound by that value.

These new basis reporting rules were effective after July 31, 2015. The IRS released Form 8971 and its accompanying Schedule A in January 2016 for reporting purposes. The beneficiary receives Schedule A listing property and its basis. Form 8971 is sent to the IRS certifying that the Schedule A's were provided and providing copies of those schedules. These were substantial reporting requirements. Penalties for failure to comply were severe.

In March 2016, the IRS released proposed regulations regarding basis consistency reporting between an estate and persons acquiring property from a decedent. The good news: There were many exceptions to the reporting requirements. For example, cash, certain tangible property less than $3,000, income in respect of a decedent such as IRAs and assets that had been sold, exchanged, or otherwise disposed of were excluded.

The IRS clarified some situations where the basis consistency rules don't apply. For example, estate tax returns filed solely for portability of the deceased spouse's unused exclusion amount (DSUEA) or to allocate generation-skipping transfer (GST) tax exemption are not subject to these rules. However, many aspects of the regulations still required further clarification, and practitioners voiced concerns about some of the provisions.

Among the provisions in the temporary regulations were the rules that applied to assets that were omitted from the estate tax return when inclusion would have increased the estate's federal estate tax liability. If the property was not reported on an amended federal estate return before the expiration of the statute of limitations period, the income tax basis for undisclosed assets was deemed to be zero ($0). The beneficiary would have to pay tax on a subsequent sale using the zero basis. This was a harsh result.

The IRS anticipated 10,000 annual information return filings and that the average return would take 5.31 hours to prepare. Congress anticipated that the basis reporting requirement would generate $1.5 billion in additional revenue over 10 years. However, there was no evidence to suggest widespread abuse before the enactment of the new sections.

The final regulations

The final regulations are more thorough and generally viewed as favorable changes to the proposed regulations. Here are some of the more relevant changes:

Definition of acquire

The final regulations clarify the term "acquired by." Previously, that meant someone who may receive property. Now the beneficiary acquires such property when title vests in the beneficiary or when the beneficiary has sufficient control over or connection with the property and can take action related to the property for which basis is relevant for federal income tax purposes. A beneficiary's acquisition of property occurs upon an executor's or trustee's distribution of the property. If property passes by operation of law or contract, the beneficiary's acquisition generally occurs automatically upon death of the decedent.

Deadline for reporting

The final regulations allow executors to delay the reporting of assets until they determine the assets each beneficiary is to receive. This addresses a significant issue with the proposed regulations, which mandated reporting within 30 days of filing the estate tax return. That tight deadline created challenges when there was uncertainty about the final distribution of assets, leading to potential confusion and mismatched expectations for beneficiaries.

Zero-basis rule

Comments to the proposed regulations said these rules were "onerous, unduly harsh, and unfair" because the omission was likely inadvertent, and the proposed rule would punish the recipient. The final regulations omit this rule. The IRS has indicated that it will still go after executors who purposefully omit assets from the basis consistency report.

Subsequent transfers

Under the proposed regulations, if a beneficiary subsequently transferred the inherited property to someone else, the transferor was required to file a basis consistency report. The final regulations removed this requirement for beneficiary-transferors except for trustees who initially receive inherited property and then subsequently distribute it to another beneficiary.

Because of their experience, professional trustees should be aware of the rules, and this should not be too burdensome on them. Trustees can either:

- Wait to report it until it is acquired by a beneficiary, in which case the reporting would be due on January 31 of the year following the transfer of the property from the trust.
- Report the basis to the beneficiaries who might receive the property. If they ultimately acquire the property, or if the property is disposed of before distribution, then no further reporting is required.

Valuation issues

The IRS declined to create a process to allow the beneficiary to challenge the value reported by the executor on Form 8971. The final regulations do not address whether a beneficiary who disagrees with a reported value can challenge a valuation in a basis consistency report. The IRS is considering future guidance that could potentially allow a beneficiary to claim a new valuation.

These rules are immediately effective. Executors of estates large enough to be subject to estate tax, and professional trustees who inherit property, must familiarize themselves with these new rules.

For more information, please contact your advisor.

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About the Author

In her role, Tina Myers is responsible for managing the Central Planning Team and overseeing the Key Wealth Institute and any financial planning content distributed. She works with our Regional Planning Strategists to help facilitate our best thinking and advice delivery to clients.

Before joining Key, Tina worked in the public accounting industry, where she focused on taxes, specifically individual, trust, estate, and gift tax planning. She also held roles at a small public accounting firm, a regional firm, and the private client group of a large multi-national firm.

Tina earned an M.Tax from Virginia Commonwealth University and holds several industry-standard licensures. She received the Circle of Excellence Award for Key Private Bank in 2016 and 2018. She was selected to attend the 2024 Key Wealth Education Symposium, which recognizes top performance and extraordinary commitment to serving our clients and growing our business.