CALIFORNIA LAWYERS ASSOCIATION
TAXATION SECTION
ESTATE AND GIFT TAX COMMITTEE

HELPFUL SUGGESTIONS FOR IMPROVING COMPLIANCE WITH INFORMATION REGARDING BENEFICIARIES ACQUIRING PROPERTY FROM A DECEDENT (FORM 8971) AND THE ASSOCIATED BASIS CONSISTENCY REQUIREMENTS

This proposal was written by Dennis I. Leonard, Esq. and Alison B. Arnold, Esq. for the Taxation Section of the California Lawyers Association.[1] The authors sincerely thank the formal reviewers, Patrick Kohlmann, Esq. of Temmerman, Cilley & Kohlmann, LLP, and Andrea Ross, Esq. of Bernstein Private Wealth Management, for their valuable insight and helpful comments in connection with the preparation of this paper.[2]

Contact Person: Dennis I. Leonard, Esq.
Ramsbacher Prokey Leonard LLP
125 S. Market Street, Suite 1250
San Jose, California 95113
Phone: (408) 293-3616
Fax: (408) 293-0430
Email: dil@rpllawfirm.com

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[1] The comments contained in this paper represent the individual views of the author(s) who prepared them, and do not represent the position of the California Lawyers Association or the Los Angeles County Bar Association.

[2] Although the authors and/or presenters of this paper might have clients affected by the rules applicable to the subject matter of this paper and have advised such clients on applicable law, no such author/presenter has been specifically engaged by a client to participate on this paper.

EXECUTIVE SUMMARY[3]

The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 (the "2015 Act")[4] requires: (1) that the income tax basis of certain property acquired from a decedent's estate be consistent with its finally determined value for federal estate tax purposes; and (2) that the executor of a decedent's estate (and certain subsequent transferees of estate assets) disclose specific information regarding estate assets to both the Internal Revenue Service (the "Service") and any persons acquiring certain assets from the decedent's estate.[5]

Information regarding certain estate assets must be reported using Form 8971 (Information Regarding Beneficiaries Acquiring Property From a Decedent) and Schedule A thereto.[6] Any person required to file a Form 8971 or Schedule A–including any person with an ongoing duty to supplement such forms, or any person involved in certain subsequent transfers of affected assets–is subject to penalties for: (i) failure to timely file; (ii) failure to file a corrected supplement; (iii) omission of required information; and/or (iv) inclusion of incorrect information.[7] Beneficiaries who receive affected assets are similarly subject to penalties, plus the possibility of "zero basis" in those assets.[8] Lastly, inaccurate compliance by an executor (or anyone with a duty to report) may rise to the level of a breach of fiduciary duty under applicable state law.[9]

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3 Dennis Leonard is a partner at Ramsbacher Prokey Leonard LLP. Alison Arnold is an associate at Ramsbacher Prokey Leonard LLP. The views expressed herein are those of the authors and do not necessarily reflect the views of the authors' firm. The information contained herein is general in nature and is not intended, and should not be construed, as legal, accounting, or tax advice or as an opinion by the authors' firm to the reader. The reader is also cautioned that the material may not be applicable to, or suitable for, the reader's specific circumstances or needs, and may require considerations of non-tax and other factors if any action is to be contemplated. The reader should contact his or her tax advisor prior to taking any action based on this information. Ramsbacher Prokey Leonard LLP assumes no obligation to inform the reader of any changes in tax laws or other factors that could affect the information contained herein.

4 H.R. 3236.

5 Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, Pub. L. No. 114-41 § 2004, 129 Stat. 443, 454-56 (2015).

6 Form 8971 and Schedule A thereto were most recently revised as of January 2016.

7 IRC § 6721(a)(2).

8 Prop. Treas. Reg. § 1.1014-10(c)(3)(i)(B), 81 Fed Reg. 11486-01 (March 4, 2016).

9 *See e.g.*, California Probate Code § 9600-9601.

These risks raise three primary concerns. First, the "basis consistency rules" were designed to raise $1.5 trillion of revenue.[10] Thus, examinations of Form 8971 and future income tax/fiduciary income tax returns involving property subject to basis consistency reporting seems likely. Second, there are certain ambiguities and open questions regarding Form 8971, Schedule A, their instructions, and the current and proposed regulations under Internal Revenue Code §§ 1014 and 6035, which impede optimal compliance. Third, the basis consistency rules impose continuing reporting obligations on successor fiduciaries, certain recipients of affected assets, and certain future transferees of such assets.[11] Those affected in the future may not be privy to the initial compliance (or may not even born yet), which creates the risk of undue burden and unfair penalties being imposed on such persons.

The Service deserves timely, accurate compliance both on the "frontend" (i.e., with respect to Form 8971 and Schedule A) and on the "backend" (i.e., with respect to supplemental informational reporting and income tax/fiduciary income tax compliance involving assets subject to basis consistency). Thus, it is good policy for Form 8971, Schedule A thereto, the applicable instructions, and governing regulations to be clear and easy to follow. This should reduce the time, expense, and risk for associated compliance, and result in more complete reporting to the Service.

This paper details some of the open issues affecting basis consistency reporting. There are currently risks and burdens for the Service, those tasked with "frontend" compliance, those tasked with ongoing reporting obligations, and those subject to basis consistency rules in connection with "backend" income tax/fiduciary income tax compliance. The risks to all could be mitigated through modest adjustments to Form 8971, Schedule A, and the accompanying instructions. Moreover, the authors understand that there is a current project to update and finalize certain proposed regulations affecting the basis consistency rules. Thus, we hope that this paper assists in the creation of additional guidance that is to the mutual benefit of the Service and taxpayers alike.

[10] Joint Comm. on Tax., U.S. Cong., JCX-105-15 (July 29, 2015).
[11] Prop. Treas. Reg. § 1.6035-1(f), 81 Fed Reg. 11486-01 (March 4, 2016).

DISCUSSION

I. BACKGROUND

A. Summary of Relevant Provisions of the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015

On July 31, 2015, President Barack Obama signed the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 (the "2015 Act") into law.[12] In relevant part, the 2015 Act imposes new reporting requirements with respect to both federal estate and income taxes.[13] More specifically, it requires that executors of estates disclose to the Internal Revenue Service (the "Service"), and to certain persons acquiring interests in the decedent's estate, specific information about property acquired from a decedent, including the value of each property interest received.[14] The purpose of this requirement is to ensure that the income tax basis of any property acquired from a decedent is consistent with the value of such property as finally determined for federal estate tax purposes.[15]

B. Basis Consistency Reporting Requirements

As a general rule, Internal Revenue Code ("IRC") § 1014(a) provides that the basis of property in the hands of a beneficiary of assets passing at death is the fair market value of the property at the date of the decedent's death. IRC § 1014(f)(1) provides that the basis of such property may not exceed its final value for estate tax purposes (subject to normal post-death basis adjustments). Where the final value has not been determined for estate tax purposes, the basis is the property's value as identified pursuant to the reporting requirements of IRC § 6035(a). IRC § 6035(a) works in conjunction with the basis consistency requirements of IRC § 1014(f)(1), requiring that the executor, and certain other persons acquiring any interest in the decedent's estate, furnish a statement to the Service (and other required persons) identifying the value of each property interest received from the decedent.

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[12] H.R. 3236.

[13] *See generally*, Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, Pub. L. No. 114-41 § 2004, 129 Stat. 443, 454-56 (2015).

[14] *Id.*

[15] Consistent Basis Reporting Between Estate and Person Acquiring Property From Decedent, 81 Fed Reg. 11486-87 (March 4, 2016).

Form 8971 (Information Regarding Beneficiaries Acquiring Property From a Decedent) and Schedule A thereto are the means to report all required information to both the Service and certain recipients of assets from the decedent's estate.[16] A fiduciary must include on Form 8971 and Schedule A certain property reported on the estate tax return that increases the value of the gross estate.[17] Form 8971 and Schedule A are also used to report subsequent transfers of property previously reported (or required to be reported) with a basis determined in whole or in part by reference to the value of the property in the gross estate (e.g., a gift, like-kind exchange, involuntary conversion, or sale that is disregarded for income tax purposes).[18] The proposed regulations include only four asset classes that are exempt from these general reporting requirements, namely: (i) cash (other than a coin collection or other coins or bills with numismatic value); (ii) income in respect of a decedent (as defined in IRC § 691); (iii) tangible personal property for which an appraisal is not required under Treas. Reg. § 20.2031-6(b); and (iv) property that has been sold, exchanged, or otherwise disposed of (and therefore not distributed to a beneficiary) by the estate in a transaction in which capital gain or loss is recognized.[19]

However, as written, Form 8971 and its accompanying instructions leave open several important questions that may expose executors (and other persons required to report) to potential penalties and liability for breach of fiduciary duties. There has been considerable commentary and speculation regarding: (i) to whom, and how, corrections and supplements to Form 8971 and/or Schedule A should be submitted; (ii) how penalties for filing errors are calculated; and (iii) when the duty to file exists.[20]

Many of these lingering open questions have caused both executors and practitioners to reevaluate how fiduciaries, beneficiaries, and transferees can both: (i) manage their exposure to penalties under the 2015

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[16] Prop. Treas. Reg. § 1.6035-1(a)(1), 81 Fed Reg. 11493 (March 4, 2016).
[17] *Id.*
[18] Prop. Treas. Reg. § 1.6035-1(a)(1), 81 Fed Reg. 11493 (March 4, 2016); Prop. Treas. Reg. § 1.6035-1(f), 81 Fed Reg. 11495 (March 4, 2016).
[19] *Id.*
[20] *See e.g.*, Steve R. Akers, Senior Fiduciary Counsel, Bessemer Trust, Basis Consistency Temporary and Proposed Regulations (March 8, 2016), http://www.bessemertrust.com/portal/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/Advisor/Presentation/Print%20PDFs/Basis%20Consistency%20Proposed%20Regulations%20Summary%2003%2008%2016.pdf.

Act; and (ii) assist the Service with clear and accurate compliance. Importantly, there is no statute of limitations for the Service to examine a previously filed Form 8971.[21] Further, any adverse income tax consequences may not arise for many years, leaving fiduciaries exposed for prolonged periods of time, and affecting beneficiaries who might currently be minors, or might not even be born yet. With several questions left unaddressed by the form or its instructions, and potentially lingering exposure for fiduciaries and beneficiaries alike, additional guidance would be helpful.

II. OPEN QUESTIONS WITH RESPECT TO FORM 8971 AND ITS INSTRUCTIONS

Form 8971 was intended to better ensure consistent basis reporting for income and estate tax purposes.[22] More specifically, the form provides beneficiaries and certain subsequent transferees with reported values of various assets from a decedent's estate tax return, which assists the Service in enforcing consistent reporting of such values on subsequent income tax returns.[23] However, as written, Form 8971 and its accompanying instructions leave open several important questions that may expose executors and other persons to potentially steep penalties and lingering liability. Eleven of these open questions are discussed in more detail below, together with suggested proposals on how best to address them.

A. Open Questions

1. How should property subject to a decedent's general power of appointment be reported on Schedule A to Form 8971?

The basis consistency rules seem to clearly apply to assets over which a decedent possessed a general power of appointment.[24] This is logical because a general power of appointment is reported on Schedule H of Form 706 and increases the decedent's gross estate in a way that can directly increase transfer tax liability.[25] Thus, anyone in receipt of

[21] *See generally*, Consistent Basis Reporting Between Estate and Person Acquiring Property From Decedent, 81 Fed Reg. 11486-01 (March 4, 2016).
[22] Consistent Basis Reporting Between Estate and Person Acquiring Property From Decedent, 81 Fed Reg. 11486-87 (March 4, 2016).
[23] *See generally*, Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, Pub. L. No. 114-41 § 2004, 129 Stat. 443, 454-56 (2015).
[24] IRC §§ 1014(a); 1014(b)(4); and 1014(f)(1).
[25] I.R.S. Instructions for Form 706, p. 29 (August 28, 2017); IRC § 2041(a).

assets subject to the decedent's general power of appointment would be obligated to use a consistent basis for income tax purposes.[26]

However, from a Form 8971 reporting perspective, assets subject to a general power of appointment do not always fit neatly within the information reporting rules. The current, proposed regulations do require an executor to report on Form 8971 and Schedule A, "all property reported or required to be reported on [Form 706]"[27] (with certain limited exceptions). No exception exists for property includible in the gross estate under IRC § 2035-2042 (which includes IRC § 2041 property subject to a general power of appointment). Thus, it appears that IRC § 2041 property must be reported on Schedule A. That said, there is need for additional guidance on how to report such property on Schedule A.

The reporting is straight forward when a decedent possesses a general power of appointment over a specific asset—the asset's final value would be reflected on a Schedule A, which would then be sent to any taxpayer with an interest in that asset. But often a general power of appointment is reflected either by reference to a specific dollar amount (e.g., the decedent's remaining applicable exclusion amount) or use of a formula that applies only to certain assets (e.g., only assets with built-in capital gain).

The instructions to Form 706 provide that the value of property for which the decedent possessed a general power of appointment must be reported on Schedule H.[28] Thus, executors often include on Schedule H only the value of the property over which such a power of appointment may have been exercised, without identifying any particular property. However, Schedule A to Form 8971 requires the executor to provide both a description of the specific property and its estate tax value.[29] Thus, the disconnect between the two forms may become an issue where the specific assets subject to the power of appointment are not identified within thirty days of the Form 706 being filed.

The current instructions to Schedule A do address a similar situation where the executor has yet to allocate particular assets to particular beneficiaries. In that situation, the executor is instructed to list,

[26] *See generally*, IRC § 6035(a)(1).
[27] Prop. Treas. Reg. § 1.6035-1(b)(1), 81 Fed Reg. 11493 (March 4, 2016).
[28] I.R.S. Instructions for Form 706, p. 29 (August 28, 2017).
[29] *See* Schedule A to Form 8971.

"all property acquired (or expected to be acquired) by a beneficiary"[30] on that beneficiary's Schedule A. "If the executor hasn't determined which beneficiary is to receive an item of property as of the due date of the Form 8971 and Schedule(s) A, the executor must list all items of property that could be used, in whole or in part, to fund the beneficiary's distribution on that beneficiary's Schedule A. (This means that the same property may be reflected on more than one Schedule A.)."[31] However, it does not appear that this approach can be extended to cover IRC § 2041 property.

Unlike the above example, with respect to IRC § 2041, only those assets which are subject to a power of appointment (whether or not exercised) will receive a stepped-up income tax basis, and are reportable on Schedule A to Form 8971.[32] Thus, if the executor were to include <u>all</u> property over which the power of appointment <u>might</u> be exercised, this would result in a reporting position that overstates the step-up in income tax basis. For example, if a decedent had a power of appointment over $5,000,000 of trust property, where the trust holds $10,000,000 of assets total, then reporting all $10,000,000 of assets on Schedule A would result in income tax basis distortions and predictable confusion among those with an interest in the assets.

When a general power of appointment exists over only a portion of trust assets, including in the case of a formula general power of appointment, it is often during the period of administration that the fiduciary determines how and to which assets the power is applied. This period of administration commonly extends beyond the time during which the Form 8971 must be filed. Thus, there may be a temporal disconnect between the Form 8971 reporting timeline and the actual administration of the estate.

PROPOSAL: Update the Instructions to Form 8971 and Schedule A to clarify how IRC § 2041 property should be reported on Schedule A. When the power exists over a specific asset, the reporting should be straightforward. However, when the power exists over less than all trust assets, or in the case of a formula general power of appointment, the instructions could specify: (a) that the existence and scope/amount of the power should be disclosed to anyone with an interest in the assets subject to the power; and (b) once it is determined which specific assets are affected by

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[30] I.R.S. Instructions for Form 8971 and Schedule A, p. 4 (October 4, 2016).
[31] *Id.*
[32] IRC § 2041; IRC § 6035(a)(1).

the power—and to what extent—the executor has an ongoing duty to supplement Form 8971 and Schedule A. Alternatively, this could also be addressed in connection with finalizing the applicable regulations.

2. *Does the executor's duty to report and/or supplement extend to estate assets that are outside of the executor's possession?*

The proposed regulations adopt the definition of "executor" found in IRC § 2203, but also include any other person required to file a Form 706.[33] IRC § 2203 defines an executor as, "the executor or administrator of the decedent, or, if there is no executor or administrator appointed, qualified, and acting within the United States, then any person in actual or constructive possession of any property of the decedent."

It is unclear who <u>must</u> file the Form 8971 and Schedule A where there is more than on potential "executor" or if there is an order of priority. There are circumstances where "Executor 1" is charged with preparing Form 706, but does not possess all assets includible in the decedent's gross estate. However, another person ("Executor 2") is in actual or constructive possession of such assets and qualifies as an "executor" within the meaning of IRC § 2203. As such, both Executor 1 and Executor 2 would appear to have a duty to file a Form 8971 and Schedule(s) A.

In such a case, it is unclear how to resolve the reporting requirements with the assets in the possession of Executor 2. For example:

- Is Executor 2 primarily responsible for filing a Form 8971/Schedule(s) A, or are both executors equally responsible for such filings?
- If Executor 2 files a Form 8971/Schedule(s) A, is Executor 1 responsible for supplementing or correcting those filings? Alternatively, does the duty to supplement/correct such filings attach only to Executor 2?
- If Executor 1 and Executor 2 submit competing filings, how would discrepancies be resolved?

[33] Prop. Treas. Reg. § 1.6035-1(g)(1), 81 Fed Reg. 11495 (March 4, 2016).

- Would Executor 1 be subject to penalties if he or she was without knowledge of the assets in Executor 2's possession and, as such, failed to report such assets?
- Is it acceptable to the Service for Executor 1 to report the assets in his or her possession, and for Executor 2 to independently report the assets in his or her possession?

PROPOSAL: The Instructions to Form 8971 and Schedule A could be updated to articulate the Service's position on this issue. Such guidance would assist executors and their tax advisors in better complying with the Form 8971/Schedule A compliance requirements.

3. Should Schedule A notify beneficiaries and "subsequent transferees" of their continuing duty to report and supplement Form 8971 and/or Schedule A?

The current, proposed regulations impose ongoing reporting requirements in connection with subsequent transfers of certain assets to related transferees.[34] More specifically, with regard to property that previously was reported or is required to be reported on a Schedule A, when the recipient subsequently distributes or transfers (by gift or otherwise) all or any portion of that property to a related transferee, in a transaction where the subsequent transferee's income tax basis is determined in whole or in part by reference to the transferor's basis, then the transferor is required to file and furnish supplemental information to: (a) the Service; (b) the executor (or successor executor) from which the recipient received his or her initial Schedule A; and (c) the related transferee to which the recipient made the subsequent transfer.[35]

As drafted, the proposed regulations require that Schedule A alone be provided to the initial recipient/beneficiary.[36] However, Schedule A does not notify the initial recipient/beneficiary that such person has an ongoing reporting requirement in connection with subsequent transfers to related parties.[37] On the one hand, the Service deserves timely and accurate supplemental reporting in connection with such subsequent transfers. On the other hand, the beneficiary/recipient of an initial Schedule

[34] Prop. Treas. Reg. § 1.6035-1(f), 81 Fed Reg. 11495 (March 4, 2016).
[35] *Id.*
[36] Prop. Treas. Reg. § 1.6035-1(a), 81 Fed Reg. 11493 (March 4, 2016).
[37] *See* I.R.S. Form 8971, Schedule A (January 2016).

A often has much less information than the executor, the rules are somewhat complex, and the beneficiary/recipient may not be represented by a tax professional.

Anyone in receipt of a Schedule A is subject to penalties from the Service and potential civil liability in connection with improper reporting of these transactions.[38] Thus, principles of fairness suggest that anyone receiving a Schedule A should receive notice of his or her ongoing reporting and compliance duties. Some practitioners have attempted to address this issue by disclosing the existence of ongoing reporting requirements in a transmittal letter to the beneficiary, included with the Schedule A. However, this is an inconsistent approach that does not position the Service for optimal compliance.

PROPOSAL: The bottom of Schedule A currently contains a "Notice to Beneficiaries." This notice warns recipients to use a consistent basis for income tax purposes. However, the notice does not warn of the ongoing duty to provide additional informational reporting to the Service, the executor, or subsequent transferees. Thus, updating the existing notice to include a warning with respect to the ongoing duty to report would provide a consistent method of communicating such information reporting requirements to every recipient/beneficiary. In addition, the notice might include a hyperlink to the Instructions to Form 8971 and Schedule A, which summarize the applicable regulations in a user-friendly manner.

4. What is the consequence for failing to provide a known beneficiary with Schedule A when it is impossible to do so?

Executors are required to furnish a Schedule A to each beneficiary who receives reportable property.[39] When a beneficiary cannot be located, the executor must still file a Form 8971 and Schedule A with the Service, and must explain the executor's efforts to locate the beneficiary.[40] Further, a supplement is required within 30 days of locating the beneficiary.[41]

[38] IRC § 6721(a)(2).
[39] Prop. Reg. § 1.6035-1(c)(1), 81 Fed Reg. 11493-94 (March 4, 2016).
[40] Prop. Reg. § 1.6035-1(c)(4), 81 Fed Reg. 11494 (March 4, 2016).
[41] *Id.*; *See also*, Prop. Reg. § 1.6035-1(e)(1), 81 Fed Reg. 11494 (March 4, 2016).

However, consider the scenario in which it is impossible to provide the beneficiary with Schedule A, such as when a beneficiary refuses to accept certified mailings. In such a scenario:

- Both the executor and the beneficiary (and subsequent transferees) may be exposed to penalties for failure to provide proper information reporting or required supplements;
- Beneficiaries (including subsequent transferees) may be subject to income tax penalties for using an inconsistent income tax basis in connection with such assets; and
- The executor may be exposed to liability for potential breaches of fiduciary duty if a beneficiary suffers economic harm because the executor failed to provide the necessary Schedule A.

The Instructions to Form 8971 and Schedule A provide broad flexibility with respect to the means by which executors may deliver Schedule A to a beneficiary, namely: (a) in person; (b) by email; or (c) by U.S. Mail, DHL, FedEx, UPS to the beneficiary's last known address. The instructions further clarify that executors should send notice via private delivery "to the beneficiary's last known address…"[42] Thus, proof that a Schedule A was sent timely to a beneficiary's last known address should constitute a "safe harbor" that falls within the "reasonable cause exception" to potential penalties, even if the beneficiary rejects receipt or otherwise claims to have not received the Schedule A. In addition, in light of the general flexibility in delivery method, it should also be permissible for the executor to deliver a Schedule A to a beneficiary's legal counsel, assuming the executor knows the beneficiary is represented by counsel.

PROPOSAL: Update the Instructions to Form 8971 and Schedule A to: (a) include "delivery to a beneficiary's legal counsel" as another acceptable method of delivering Schedule A; and (b) provide that sending a Schedule A to a beneficiary's last known address (via certified U.S. Mail or private delivery service) is an example of an action that falls within the "reasonable cause exception."

[42] I.R.S. Instructions for Form 8971 and Schedule A, p. 1 (October 4, 2016).

5. Is the beneficiary who receives a distribution from a trust a "related transferee," within the meaning of IRC § 2704(c)(2)?

As discussed above, the proposed regulations impose ongoing reporting requirements on certain subsequent transferors of estate assets who make transfers to "related transferees."[43] For this purpose, a related transferee is:

(i) any member of the transferor's family, as defined in IRC § 2704(c)(2);
(ii) any controlled entity (a corporation or any other entity in which the transferor and members of the transferor's family, whether directly or indirectly, have control within the meaning of IRC § 2701(b)(2)(A) or (B)); and
(iii) any trust of which the transferor is a deemed the owner for income tax purposes (e.g., sales to a "grantor trust").[44]

Interestingly, subsequent distributions from a trust to a beneficiary of that trust do <u>not</u> fall within any of the rules above, meaning that such a beneficiary does not appear to be a "related transferee." This very common fact pattern raises the following open questions:

- Should the trust beneficiary be treated as a "related transferee?"
- Does the trustee have a duty to provide the beneficiary with a Schedule A in connection with a trust distribution (assuming the basis of the distributed asset continues to be determined by reference to inclusion in the decedent's estate)?
- Assuming the trustee has no duty to provide the beneficiary with a Schedule A, is that beneficiary nevertheless still subject to the basis consistency rules, and does such beneficiary have ongoing informational reporting requirements in connection with a subsequent transfer to a "related transferee"

[43] Prop. Treas. Reg. § 1.6035-1(f), 81 Fed Reg. 11495 (March 4, 2016).
[44] *Id.*

(e.g., a later sale to a grantor trust, gift, IRC § 1031 transaction, involuntary conversion, etc.)?

The current guidance in this area is unclear. The Instructions to Form 8971 and Schedule A state: "the estate may, but isn't required to, file a supplemental Form 8971 and Schedule(s) A to specify the actual distribution of that property among the identified beneficiaries."[45]The proposed regulations state that supplemental filings "are not required to be filed or furnished…to specify the actual distribution of property previously reported as being available to satisfy the interests of multiple beneficiaries…"[46]

This is problematic in a trust context because the initial Form 8971 and Schedule A would have been provided by the "executor" to the trustee of the trust (but not to the beneficiaries of the trust).[47] Moreover, it is common for trusts to continue for years—sometimes even generations—after the date of the original decedent's death. During that time, the identity of the trustee may have changed, and new beneficiaries who were not alive at the trust's creation may have been born. Thus, additional guidance is required if such a beneficiary: (a) is subject to basis consistency with respect to the distributed assets; and/or (b) has continuing reporting requirements in connection with subsequent transfers to a related transferee.

PROPOSAL: Assuming a trust beneficiary is <u>not</u> a "related transferee" with respect to the basis consistency rules, then such a beneficiary should be specifically exempted from the basis consistency rules and the duty for continuing information reporting. Alternatively, if trust beneficiaries are intended to be subject to those rules, then either: (a) trustees should be mandated to provide trust beneficiaries with a Schedule A in connection with trust distributions; or (b) beneficiaries should be provided a means of contacting the Service to ascertain whether any Form 8971 or Schedule(s) A have ever been filed in connection with the trust from which such beneficiary is receiving distributions.

[45] I.R.S. Instructions for Form 8971 and Schedule A, p. 2 (October 4, 2016).
[46] Prop. Treas. Reg. § 1.6035-1(e)(3)(i)(B), 81 Fed Reg. 11494 (March 4, 2016).
[47] Prop. Treas. Reg. § 1.6035-1(c)(2), 81 Fed Reg. 11494 (March 4, 2016).

6. Does after-discovered cash that should have otherwise been reported on Form 706 receive a zero basis if the Form 706 is not supplemented within the 3-year statute of limitations?

As previously discussed, the executor must include on Form 8971 and Schedule A, all property reported on the estate tax return (with certain limited exceptions).[48] If the executor later discovers assets that were previously omitted from the estate tax return, the executor is required to file a supplement to Form 8971, reporting the assets.[49] The basis of all such property is the property's final value for estate tax purposes, or, if the final value has not been determined, the value reported on Form 8971.[50] However, if the executor fails to report after-discovered or omitted property on an initial or supplemental federal estate tax return filed prior to the expiration of the statute of limitations, the final value of the unreported property is zero.[51]

As discussed above, cash is an exception to the basis consistency rules, and therefore, does not need to be reported on Form 8971.[52] Moreover, the basis of cash is its face value.[53] However, if cash that should have been included on an estate tax return is later discovered and not reported on a supplemental Form 706 (because it is not required)[54], this rule suggests that such cash would receive a zero basis. The following questions arise: (1) whether cash can ever have a zero basis; (2) whether a zero basis in after-discovered cash is an intended consequence of the basis consistency rules; and (3) what would be the effect of spending zero-basis cash.

PROPOSAL: The authors suggest that assets otherwise exempt from the basis consistency requirements (e.g., cash) should be similarly exempt from the "zero basis" penalty. This creates a consistent policy with respect to the reporting requirements. Moreover, existing penalties with respect to omitting assets on a Form 706 serve as a sufficient deterrent. In this regard, punishing the beneficiary because of the executor's

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[48] Prop. Treas. Reg. § 1.6035-1(b)(1), 81 Fed Reg. 11493 (March 4, 2016).
[49] Prop. Treas. Reg. § 1.6035-1(e)(2), 81 Fed Reg. 11494 (March 4, 2016).
[50] IRC § 1014(f).
[51] Prop. Treas. Reg. § 1.1014-10(c)(3)(B), 81 Fed Reg. 11492 (March 4, 2016).
[52] Prop. Treas. Reg. § 1.6035-1(b)(1), 81 Fed Reg. 11493 (March 4, 2016).
[53] *See generally*, IRC § 1012.
[54] *See* Treas. Reg. § 20.6081-1(d).

omission seems unfair when the beneficiary was not otherwise required to use a "consistent basis" with respect to assets like cash.

7. *Additional guidance on how penalties are calculated would be greatly appreciated.*

IRC § 6721 imposes penalties for failing to file Form 8971, as required. The Instructions to Form 8971 and Schedule A clarify that:

- The penalty is "$50 per Form 8971 (including all Schedule(s) A)" if filed within 30 days after the due date, with a maximum penalty of $532,000 per year; and
- The penalty is "$260 per Form 8971 (including all Schedule(s) A" if filed more than 30 days after the due date, with a maximum penalty of $3,193,000 per year.[55]

The instructions further specify that:

> "Only one penalty will apply for all failures relating to a single filing of a single Form 8971 and the Schedule(s) A required to be filed along with it. Each filing of a Form 8971 with Schedule(s) A is a separate filing, regardless as to whether the filing is of the initial Form 8971 and Schedule(s) A or a supplemental Form 8971 and Schedule(s) A."[56]

Read together, these provisions suggest that each failure to file either an initial Form 8971 (and all Schedules A thereto), or a required supplemental form, would result in separate penalties. However, some aspects of the proper computation remain uncertain. For example:

- It would be helpful to have express confirmation that both the failure to file an initial Form 8971, and the failure to file a necessary supplemental Form 8971, may result in separate penalties.
- Does the failure to file an initial Form 8971 (or a required supplement) result in a single penalty regardless of how

[55] I.R.S. Instructions for Form 8971 and Schedule A, p. 2 (October 4, 2016).
[56] *Id.*

much time passes? Or alternatively, does each successive year of noncompliance result in an independent penalty?

- There is significant confusion as to how a $50 "per year" penalty could ever reach the stated maximum of $532,000 per year, per executor, or how the $260 "per year" penalty could every reach the stated maximum of $3,193,000 per year, per executor. In most cases an executor will only file one initial Form 8971 (and one or more Schedule(s) A), and perhaps a small handful of supplemental filings, in connection with a single decedent's estate in any given year.

PROPOSAL: Update the applicable Instructions to Form 8971 and Schedule A to offer additional clarification, including examples of how penalties are calculated under various circumstances (e.g., successive years of noncompliance, accurate initial compliance followed by failure to file required supplements, etc.), and/or an example illustrating how the maximum penalties could be achieved.

8. Are beneficiaries potentially subject to a 40% penalty for gross valuation misstatement under IRC § 6662(h) in connection with using an "inconsistent basis"?

A beneficiary's use of an inconsistent basis can result in income tax penalties.[57] The Instructions to Form 8971 and Schedule A state, "Beneficiaries who report basis in property that is inconsistent with the amount on the Schedule A may be liable for a 20% accuracy related penalty under section 6662."[58] It is conceivable that this could result from either overstating the basis in connection with a subsequent sale, or from the application of the "zero basis" rules for omitted/unreported assets. However, it is unclear whether such an error could also subject the beneficiary to the 40% penalty for gross valuation misstatement under IRC § 6662(h).

PROPOSAL: If beneficiaries can be subject to the 40% gross valuation misstatement under IRC § 6662(h), then that portion of the Instructions to Form 8971 and Schedule A addressing penalties could be adjusted to clarify that possibility.

[57] *See generally*, IRC § 6662.
[58] I.R.S. Instructions for Form 8971 and Schedule A, p. 2 (October 4, 2016); *See also,* IRC § 6662(k).

9. Are practitioners allowed, encouraged, discouraged, or precluded from including attachments or exhibits to Form 8971 and/or Schedule A thereto?

On October 4, 2016, the final, updated Instructions to Form 8971 and Schedule A were released. A prior draft of the instructions stated, "Do not add any attachments to Schedule A."[59] However, the final version of the instructions did not contain this sentence.[60] Because this sentence was removed, presumably, an executor may include attachments to Schedule A. But without additional guidance, it remains unclear whether the Service would allow, encourage, or discourage executors from including attachments to Schedule A. Such exhibits could be very helpful for example, where dozens of individual stock holdings need to be reported (e.g., in an Excel spreadsheet). In contrast, it is conceivable that the Service would discourage executors from attaching the entire Form 706 to Schedule A.

PROPOSAL: The Instructions to Form 8971 and Schedule A could be updated to articulate the Service's position on this issue. Such guidance would assist executors and their tax advisors in better complying with the Form 8971/Schedule A compliance requirements.

10. What is the proper treatment of IRC § 2035(b) adjustments for gift tax paid within three years of death?

A decedent's gross estate is increased by gift tax paid on gifts the decedent (or the decedent's spouse) made within three years of the decedent's death.[61] Such amounts are reported on Schedule G and increase the decedent's gross estate in a manner that directly increases the decedent's transfer tax liability.[62]

While perhaps bordering on obtuse, it is technically unclear whether such amounts are subject to Form 8971 reporting. The general rule in IRC § 6035(a)(1) is very broad, and the current proposed regulations cover "all property reported or required to be reported on a return under section 6018 [i.e., a Form 706]"[63] (with certain limited

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[59] I.R.S. Draft Instructions for Form 8971 and Schedule A, p. 1 (June 8, 2016).
[60] *See* I.R.S. Instructions for Form 8971 and Schedule A (October 4, 2016).
[61] IRC § 2035(b).
[62] *See* I.R.S. Instructions for Form 706, p. 27 (August 29, 2017); IRC § 2035(b).
[63] Prop. Treas. Reg. § 1.6035-1(b)(1), 81 Fed Reg. 11493 (March 4, 2016).

exceptions). IRC § 2035(b) adjustments are not among the four stated exceptions in Prop. Treas. Reg. § 1.6035-1(b)(1) or the accompanying examples.[64]

Common sense suggests that an IRC § 2035(b) adjustment does not represent an interest in "property" within the meaning of either IRC § 6035(a)(1) or the proposed regulations. Gift tax paid within three years of death does not pass to a beneficiary at the decedent's death and cannot be subsequently disposed of in a manner that would require basis consistency. Thus, it would seem that IRC § 2035(b) adjustments for gift tax paid within three years of death should not be required to be reported as part of the Form 8971 compliance under both the plain meaning of the word "property" and because such reporting would not serve the policy goals of the basis consistency requirements.

PROPOSAL: Update the applicable Instructions to Form 8971 and Schedule A to clarify that IRC § 2035(b) adjustments are not reportable "property" for purposes of Form 8971/Schedule A. This approach is consistent with the current instructions, which already contain a similar note stating that, "A cash bequest acquired (or expected to be acquired) by a beneficiary isn't considered reportable property for purposes of Form 8971/Schedule A."[65] Alternatively, this issue could be addressed in the final regulations by crafting a fifth category to the exceptions to the basis consistency rules (not entirely dissimilar in nature to the existing "income in respect of a decedent" exception).[66]

11. Do executors have a duty to supplement a Form 8971 or Schedule A that was filed, despite not being required to be filed?

Form 8971 is required where a Form 706 must be filed because the gross estate (plus adjusted taxable gifts) equals or exceeds the basic exclusion amount.[67] However, Form 8971 is not required every time a Form 706 is filed (e.g., a "protective" Form 706 filed despite the gross estate being less than the basic exclusion amount, Forms 706-QDT, 706-CE, 706-

[64] *Id.*
[65] I.R.S. Instructions for Form 8971 and Schedule A, p. 4 (October 4, 2016).
[66] *See e.g.*, Prop. Treas. Reg. § 1.6035-1(b)(1), 81 Fed Reg. 11493 (March 4, 2016).
[67] Prop. Treas. Reg. § 6035-1(a)(1), 81 Fed Reg. 11493 (March 4, 2016).

GS(D), and a Form 706 that is filed to make elections for purposes of generation-skipping transfer tax or portability).[68]

Regardless of the technical rules above, some tax practitioners and fiduciaries volunteer to file a Form 8971 and Schedule(s) A—even though unnecessary—as a means of communicating income tax basis information to beneficiaries. However, once "volunteer" Form 8971 and Schedule(s) A are filed, there is an open question as to whether the executor or recipient of such a Schedule A has an ongoing duty to supplement those forms (e.g., for omitted assets, incorrect information, changes to the identity of the executor, etc.), or to report subsequent transfers to related transferees.

PROPOSAL: The portion of the Instructions to Form 8971 and Schedule A addressing supplements to such forms could be updated to clarify that there is no duty to supplement a Form 8971 or Schedule A that was not required to be filed in the first instance (except where including an omitted or after-discovered asset would result in the affirmative duty to file a Form 706).

III. CONCLUSION

It would ultimately be helpful, cost-efficient, and good policy if additional guidance were provided regarding Treasury's and/or IRS' interpretation of the basis consistency rules so that taxpayers and advisors alike are in a better position to follow those rules without risking unintended consequences.

Please note that the authors are happy to offer assistance in drafting any proposed changes to the forms or instructions, or to assist in any related efforts aimed at addressing the issues identified herein.

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[68] I.R.S. Instructions for Form 8971 and Schedule A, p. 1 (October 4, 2016).