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DEATH AND TAXES:
SELECTED INCOME TAX ISSUES FOR DECEDENTS AND THEIR FAMILIES

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OVERVIEW

This outline provides a survey of selected income tax issues affecting decedents and their families. In a tax system based on voluntary self-assessment, filing a tax return has obvious significance. But age and infirmity may affect the practical ability to comply; death even more so. Marriage presents special tax opportunities for the couple, including the ability to file a joint return and share some tax attributes. Those joint returns present other concerns and complexities, including joint and several liability, which can affect a surviving spouse.

Married taxpayers retain a separate taxpayer status with regard to the measurement and utilization of certain tax attributes, including losses and basis. Death of a spouse affects not only the filing of returns, but also the tax attributes available to the survivor. Basis adjustments provide a significant source of complexity. New basis reporting rules applicable to taxable estates present new responsibilities and challenges.

Other tax attributes, including deductions, losses, and credits that may be carried forward or backward also deserve attention. A decedent's interest in an S corporation or partnership raises some additional issues involving tax attributes passing to a transferee, including the basis of that ownership interest and attributes that may pass through the entity. Some common issues are considered for both entities. The partnership discussion also includes an overview of the new audit regime for partnerships and the implications of this regime for estate planners and beneficiaries, who may include continuing partners or transferees of partnership interests from a decedent.

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I. Income Tax Return Obligations.

A. Civil Penalties.

Penalties help induce timely filing and payment. While criminal penalties may also apply, civil penalties are the most likely to be applied. Among these, the following are commonly encountered in connection with failing to file a return.

1. IRC § 6651(a)(1) imposes a penalty for a failure to timely file an income tax return. This penalty is 5 percent of the amount of tax due per month, up to a maximum of 25 percent.
 - a. As of 2016, failure to file within 60 days of the due date triggers a minimum penalty that “shall not be less than the lesser of \$205 [adjusted annually for inflation – see IRC § 6651(i)] or 100 percent of the amount required to be shown as tax on the return.”

- b. If the failure to file is deemed fraudulent, the monthly penalty increases from 5 to 15 percent, for a maximum penalty of 75 percent. IRC § 6651(d).
2. IRC § 6651(a)(2) similarly imposes a penalty for failing to timely pay tax due with the return. This penalty is 0.5 percent of the amount of tax due per month, up to a maximum of 25 percent.
3. Such penalties may be excused if that failure is due to “reasonable cause and not due to willful neglect.”
4. Other penalties may be imposed for failing to pay estimated income tax in a timely manner, which also involves a compliance issue. See IRC 6654.
5. Of course, additional penalties may also be incurred if the return that is filed is not accurate, including special enhanced penalties for valuation errors. See IRC § 6662. But this presumes the taxpayer has first cleared the hurdle of filing a return.

B. Filing.

1. A valid return requires making “a return or statement according to the forms and regulations prescribed by the Secretary.” IRC § 6011(a).
2. A signature requirement also applies, including execution under penalties of perjury. See IRC §§ 6061(signature); 6065(declaration under penalty of perjury). The signature, which may be electronically created, is essential for a valid return. See e.g., CCA 200923028 (6/5/09) and authorities cited therein.
 - a. The good news: an invalid return does not trigger a fraud penalty. See *id.*
 - b. The bad news: it is not a return at all. See *id.*
3. Signatures: a case study. *Reifler v. Commissioner*, TC Memo 2015-199, involved a putative joint return signed only by the husband and unsigned by the wife. The IRS rejected the return, and the couple signed and filed another one duplicating the information on the earlier return. The IRS then audited the couple, determining that the earlier failure to sign meant that there was no timely filed return, generating over \$900K in penalties.
 - a. The Tax Court upheld this determination and rejected the notion of intention based on testimony to overcome the lack of a signature. Signing is objective and clear, and there are simply too many valid reasons a spouse may choose not to sign a return.
 - b. Case law has sometimes allowed a valid joint return where a spouse purportedly signed it, but the return in *Reifler* was not signed at all.

Intention may have a role in this context, as a signature that is not the spouse's actual signature may not necessarily invalidate a return if the taxpayer can prove that both spouses intended to sign the return. See, e.g., *Estate of Temple v. Commissioner*, 67 T.C. 143, 164-65 (1976); see also IRC § 6064 (presumption of validity of signature). The court in *Reifler* would not extend this intention exception where no signature was made.

- c. In this case the IRS rejected the unsigned return. But according to the court, "an invalid return remains invalid even if the IRS accepts and processes it."

C. Returns made by agents: Treas. Reg. § 1.6012-1(a)(5).

1. If you are unable to file a return, an agent (including your spouse) may act on your behalf.
2. "Whenever a return is made by an agent it must be accompanied by a power of attorney (or copy thereof) authorizing him to represent his principal in making, executing, or filing the return. A form 2848, when properly completed, is sufficient." Treas. Reg. § 1.6012-1(a)(5).
 - a. Of course, Form 2848 requires a signature from the taxpayer. If a joint return, each spouse needs to complete his/her own POA.
 - b. An agent may file a return on behalf of the taxpayer using a POA only if there is disease or injury, absence from the United States for at least 60 days before the due date of the return, and for other reasons with permission from the IRS. (Query: given the ability to use electronic signatures, is absence still a valid reason?)
 - c. Form 2848 allows the taxpayer to designate authority, including authority for future tax years. But instructions to Form 2848 indicate that the IRS computer system will not honor a power of attorney after three years.
3. The regulations provide a special rule for married taxpayers that can circumvent this formality:

"In addition, where one spouse is physically unable by reason of disease or injury to sign a joint return, the other spouse may, with the oral consent of the one who is incapacitated, sign the incapacitated spouse's name in the proper place on the return followed by the words "By _____ Husband (or Wife)," and by the signature of the signing spouse in his own right, provided that a dated statement signed by the spouse who is signing the return is attached to and made a part of the return stating:

 - (i) The name of the return being filed,
 - (ii) The taxable year,
 - (iii) The reason for the inability of the spouse who is incapacitated to sign the return, and

(iv) That the spouse who is incapacitated consented to the signing of the return.” Treas. Reg. § 1.6012-1(a)(5).

4. The regulations do not seem to contemplate the modern reality of electronic signatures. Individual tax returns may be signed by an electronic signature using two methods. See generally IRS Publication 1345 at 20-24.
 - a. Self-select PIN, which uses AGI from a prior year (or a prior year PIN) to authenticate the taxpayer. This method can be paperless if the taxpayer enters the PIN to sign the return before submission. Otherwise, the electronic return originator (“ERO”) can enter the PIN for the taxpayer if authorized by the taxpayer.
 - b. Practitioner PIN, in which the taxpayer authorizes the ERO to generate and apply a PIN that authenticates the taxpayer.
5. Returns filed with electronic signatures under either of these methods still require a signature – which also may be electronic – on Form 8879. So ultimately, a signature of some kind is still required each year (unless a POA is being used and includes filing a return for a future tax year).
 - a. Note that ERO does not provide Form 8879 (or a similar one, Form 8878, used with extensions) to the IRS.
 - b. Note that an electronic signature can be made in a variety of technological formats. See *id.* at 22 (“No specific technology is required.”)
 - c. Could we apply the regulations for an “incapacitated” spouse by analogy, having the ERO keep the declaration with return materials?

D. Returns made by Fiduciaries: Treas. Reg. § 1.6012-3.

1. Living Persons Under Disability: “A fiduciary acting as the guardian of a minor, or as the guardian or committee of an insane person, must make the return of income required in respect of such person unless, in the case of a minor, the minor himself makes the return or causes it to be made.” Treas. Reg. § 1.6012-3(b)(3).
 - a. A fiduciary has broader authority than an authorized representative under a power of attorney. See IRC § 6903, which states in part that “such fiduciary shall assume the powers, rights, duties, and privileges of such other person in respect of a tax imposed by this title”.
 - b. Form 56 is filed with the return to notify the IRS of this relationship. If applicable, judicial proceedings may be required.

2. Decedents have two potential alternatives if they have a surviving spouse:
 - a. Fiduciary: “The executor or administrator of the estate of a decedent, or other person charged with the property of a decedent, shall make the return of income required in respect of such decedent. For the decedent’s taxable year which ends with the date of his death, the return shall cover the period during which he was alive.” Treas. Reg. § 1.6012-3(b)(1).
 - i. Short period return for taxable year of the living, which includes only that income received during that short period.
 - ii. Return may also be required for estate and IRD received after death. See Treas. Reg. § 1.6012-3(a).
 - iii. Note: if you are acting as a fiduciary, instructions on Form 56 indicate that separate forms should be filed for the final return of the decedent and for returns on behalf of the decedent’s estate.
 - b. Surviving Spouse: “Section 6013(a)(2) provides that a joint return may be made for the survivor and the deceased spouse or for both deceased spouses if the taxable years of such spouses begin on the same day and end on different days only because of the death of either or both.” Treas. Reg. 1.6013-1(d)(1).
 - i. Note that this may avoid the need to allocate income between periods as returns, which would be required for returns prepared by fiduciaries.
 - ii. But note: if an executor or administrator is appointed, up until the time for which an extension may be granted, the executor or administrator must join the surviving spouse in order to file a joint return. See id. -1(d)(4).
 - iii. A fiduciary appointed after a return has been made can disaffirm a joint return within one year after filing. See id. -1(d)(5).
 1. Disaffirmance transforms the joint return, excluding items from the decedent, into a separate return for the surviving spouse.
 2. But this also means that penalties now can apply for the decedent’s return, which was not timely filed. See id.
 3. Why disaffirm? Joint and several liability, perhaps? See innocent spouse relief, below.
 - iv. Remarriage during the taxable year means you cannot file a joint return with your deceased spouse – but you could file one with your new spouse. See id. -1(d)(2).
 - v. A surviving spouse may continue to file a joint return for the next two years following the spouse’s death if these conditions are met: no remarriage; maintains a household with child or stepchild; taxpayer is entitled to dependent deduction for that child or stepchild. See Treas. Reg. §1.2-2(a).

1. Note tax bracket expansion benefit from joint return filing, even if there is no income from deceased spouse.
2. Head of household status could be an alternative for those ineligible to file a joint return (if maintaining abode that includes one or more dependents). See *id.* §1.2-2(b).

E. Relief for Disability.

1. As noted above, disability due to infirmity or disease may require an agent or fiduciary to act on one's behalf. But what happens when no one intervenes, returns are not filed by prescribed deadlines (and properly)?
2. Civil penalty relief for reasonable cause/not willful neglect.
 - a. Regulations provide: "a taxpayer who wishes to avoid the addition to the tax for failure to file a tax return or pay tax must make an affirmative showing of all facts alleged as a reasonable cause for his failure to file such return or pay such tax on time in the form of a written statement containing a declaration that it is made under penalties of perjury." *Treas. Reg. § 301.6651-1(c)*.
 - b. "If the taxpayer exercised ordinary business care and prudence and was nevertheless unable to file the return within the prescribed time, then the delay is due to a reasonable cause." *Id.*
 - c. A lack of access to records does not constitute reasonable cause where estimates may be used. See *Estate of Vrinotis v. Commissioner*, 79 T.C. 298, 311 (1982) (citing *Beck Chemical Equip. Co. v. Commissioner*, 27 T.C. 840 (1957), involving a delay based on a failure to access information on partnership income)). But see *Fleming v. Commissioner*, T.C. Memo 1984-130 and *Connor v. Commissioner*, T.C. Memo 1982-302 (finding reasonable cause for failing to file returns reporting half of community income when spouse relied upon husband to comply and requests for information were rebuffed). For additional rules on relief for filing regarding community income, see *IRC § 66(b),(c) & Treas. Reg. § 1.66-4*.
 - d. Not even incarceration provides reasonable cause! See *Llorente v. Commissioner*, 74 T.C. 260 (1980); *Labato v. Commissioner*, T.C. Memo 2001-243; *Kalinowski v. Commissioner*, TC Summ. Op. 2010-30.
 - e. Illness or disability of the taxpayer or a close family member can be considered in this assessment. For IRS policy, see *IRM 20.1.1.3.2.2.1 (11/25/11)*.

- i. Significantly, reasonable cause due to illness or disability caused by emotional distress is a product of case law, rather than a provision recognized in the Code or Regulations.
 - ii. Generally speaking, the illness or disability has to be sufficiently continuous and significant to affect the period for tax filing, and filing is expected to occur after the disability is removed. See, e.g., *Stine v. United States*, 106 Fed. Cl. 586 (2012) (citing authorities).
 - iii. Doing other significant things while selectively not filing tax returns does not count. See, e.g., *Evans v. Commissioner*, TC Memo 2016-7 (working while receiving counseling after daughter's death demonstrated ability to file return; citing numerous cases where emotional distress does not link to inability to file return).

 - f. Given the ability for one spouse to act for another (see above) in a situation of temporary disability in filing a joint return, it is not surprising that courts will not excuse the failure to file based solely on one spouse's claim. See, e.g., *Labato v. Commissioner*, T.C. Memo 2001-243 (noting that spouse was not incarcerated and could have filed on time). Moreover, a spouse could also elect to file a separate return.

 - g. But note: caring for a spouse can itself become a basis for reasonable cause, which may provide reasonable cause for both spouses. See, e.g., *Wesley v. United States*, 369 F. Supp 2d 1328, 1334 (N.D. Fla. 2005) (joint return filing may have been excused based on wife caring for husband during heart attack and heart surgery, causing reduced work hours). See also *Orr v. Commissioner*, TC Summ. Op. 2010-55 (citing authorities involving emotional distress as basis for penalty relief).
3. Refund Claims: Financial disability.
- a. IRC § 6511(a) provides the following rule regarding claims for credit or refund of an overpayment of tax: "Claim for credit or refund of an overpayment of any tax imposed by this title in respect of which tax the taxpayer is required to file a return shall be filed by the taxpayer within 3 years from the time the return was filed or 2 years from the time the tax was paid, whichever of such periods expires the later, or if no return was filed by the taxpayer, within 2 years from the time the tax was paid."
 - b. The statute of limitations may be tolled during a period when an individual is "financially disabled". See IRC § 6511(h). This provision was codified in 1998 in response to the Supreme Court's decision in *United States v. Brockamp*, 519 U.S. 347 (1997), that "equitable tolling" was not applicable to refund claims. See *Estate of Rubenstein v. United States*, 119 Fed. Cl. 658, 668 (2015).

- c. Financial disability occurs “if such individual is unable to manage his financial affairs by reason of a medically determinable physical or mental impairment of the individual which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months.” IRC § 6511(h)(1).
 - i. The duration requirement will reduce the scope of relief for many physical conditions.
 - ii. Note that if a spouse or another person is authorized to act, no relief is available. See IRC § 6511(h)(2). (For example, a spouse could file a refund claim for a joint return.)
- d. The Code also imposes a strict proof requirement: “An individual shall not be considered to have such an impairment unless proof of the existence thereof is furnished in such form and manner as the Secretary may require.” IRC 6511(h)(1).
- e. Rev. Proc. 99-21, 1999-17 IRB 18, provides that two statements must be submitted along with a claim for refund or credit that claims financial disability in order to obtain relief:
 - “(1) a written statement by a physician (as defined in section 1861(r)(1) of the Social Security Act, 42 U.S.C. section 1395x(r)), qualified to make the determination, that sets forth:
 - (a) the name and a description of the taxpayer's physical or mental impairment;
 - (b) the physician's medical opinion that the physical or mental impairment prevented the taxpayer from managing the taxpayer's financial affairs;
 - (c) the physician's medical opinion that the physical or mental impairment was or can be expected to result in death, or that it has lasted (or can be expected to last) for a continuous period of not less than 12 months;
 - (d) to the best of the physician's knowledge, the specific time period during which the taxpayer was prevented by such physical or mental impairment from managing the taxpayer's financial affairs; and
 - (e) the following certification, signed by the physician:
I hereby certify that, to the best of my knowledge and belief, the above representations are true, correct, and complete.

(2) A written statement by the person signing the claim for credit or refund that no person, including the taxpayer's spouse, was authorized to act on behalf of the taxpayer in financial matters during the period described in paragraph (1)(d) of this section. Alternatively, if a person was authorized to act on behalf of the taxpayer in financial matters during any part of the period described in paragraph (1)(d), the beginning and ending dates of the period of time the person was so authorized.”

F. Relief for an “Innocent Spouse”

1. Filing a joint return can present significant advantages for a married couple in the right circumstances. But it can also impose the specter of joint and several liability for tax obligations that would otherwise be attributable to one’s spouse. See IRC § 6013(d)(3). Those obligations deserve careful attention from the estate planner.
2. First, was a joint return filed? As noted above, a spousal signature is required. Was that signature given under duress? If so, there is no joint return and no joint and several liability.
 - a. Such a return is deemed adjusted to reflect only the income of the individual who voluntarily signed it and taxes due are computed based on a separate return. See Treas. Reg. § 1.6013-4(d); Notice 2012-8, 2012-4 IRB 309.
 - b. But that may mean the spouse who involuntarily signed the return has not filed a return.
3. Relief from joint and several liability for liability on a past return may be available under IRC § 6015, which is requested by filing Form 8857. See generally IRC § 6015(b).
 - a. Relief is available from liability for unpaid taxes, interest, and penalties attributed to the nonrequesting spouse.
 - b. The spouse seeking relief must establish a lack of actual or constructive knowledge of an understatement of tax arising from the nonrequesting spouse.
 - c. The spouse seeking relief must also show that it is inequitable to be liable for the tax.
4. After the death of a spouse, requesting spouses may be eligible for relief under IRC § 6015(c), which is limited to taxpayers “no longer married”. This provision may allow joint liability to be allocated between the spouses, thus separating the responsibility for payment. See IRC § 6015(d).

5. Note that relief under IRC § 6015(b), (c) only affects an understatement or deficiency; it does not affect an underpayment of tax reflected on the return. See Rev. Proc. 2013-34, § 2.04, 2013-43 IRB 397.
 - a. Section 6015(f) (or section 66(c) involving community property rules affecting taxable income) provides for equitable relief that could also affect an underpayment.
 - b. The full specter of considerations for innocent spouse relief is beyond the scope of this outline. For more details, see Rev. Proc. 2013-34, 2013-43 IRB 397.
6. If innocent spouse relief is granted, this does not necessarily negate liability as a transferee. See Treas. Reg. § 1.6015-1(j).
 - a. Example: H and W filed jointly in year 1. In year 2, H dies and the executor of his estate distributes H's assets to W. In year 3, the Service asserts a deficiency on the year 1 return, which is attributed to items of income and expense that belong to H, and about which W knows nothing. What result for W, assuming she is eligible for innocent spouse relief?
 - b. The Service may still seek to collect the deficiency from W on the ground that she is a transferee of the estate. See Treas. Reg. § 1.6015-1(j)(2).
 - c. Note: An executor may apply for a discharge of personal liability for income taxes on the decedent. But this discharge does not remove liability for assets of the estate. See Treas. Reg. § 301.6905-1.
7. The relevant statute of limitations may provide some strategic considerations in filing for innocent spouse relief.
 - a. The good news: filing a request for relief provides an automatic stay of any levy or collection proceeding against the requesting spouse for 90 days. See IRC § 6015(e)(B).
 - b. The bad news: the statute of limitation is suspended during the time a petition for relief is considered plus sixty days thereafter. If you are close to the end of the collection period, do you want to file a claim for relief?
 - c. Note that an executor may also seek to file a request for an expedited assessment to shorten the limitations period for a decedent. See Treas. Reg. §301.6501(d)-1(b). But if a joint return is involved, the surviving spouse may remain subject to a longer limitations period. See Rev. Rul. 72-338, 1972-2 C.B. 641.

G. Application: Some Case Studies.

1. Taxpayer claimed that his daughter's death cause emotional distress sufficient to excuse his filing of tax returns. Following her death, he had to receive counseling to cope with his suffering and that he lost motivation to fulfill basic personal commitments, including the filing of tax returns. But this taxpayer found ways to carry on other activities, including full-time employment in managing real estate projects.
 - a. Result: "Although we are sympathetic to Evans's suffering, the record does not demonstrate that Evans's distress was the cause for the filing delay. *Evans v. Commissioner*, TC Memo 2016-7.
 - b. "See also *Stevens Bros. Found. v. Commissioner*, 39 T.C. 93 , 130 (1962) ("[A]n acceptable reason for failure to file a return will excuse such failure only so long as the reason remains valid."), *aff'd in part, rev'd in part on another issue*, 324 F.2d 633 (8th Cir. 1963). Compare *Williams v. Commissioner*, 16 T.C. 893, 906 (1951) (no reasonable cause where taxpayer failed to show that physical incapacity resulting from stroke was ongoing when returns were due), and *Peterson v. Commissioner*, T.C. Memo. 2015-1, at *27-*28 (no reasonable cause where link between illness and death of taxpayer's parents and late filing was too tenuous), with *Tabbi v. Commissioner*, 70 T.C.M. (CCH) at 849 (reasonable cause existed where taxpayers were continuously attending to their dying son and filed their returns soon after his death)." *Id.*
2. Taxpayer argued that she was prevented from timely filing a joint return for 2003 until February 2005, which was after a six-month extension had been granted. She had experienced various calamities, including "her husband's death, the destruction of their home, personal health problems and depression, employee embezzlement from [their business], and the fact that she was required to assume responsibility for obligations that were previously shared between her and her husband, including the care of their granddaughter."
 - a. Result: "These were certainly tragic and difficult events for [Taxpayer] to endure, but [Taxpayer] did not show that she exercised ordinary business care and prudence or that circumstances prevented timely filing." *Estate of Stuller v. United States*, 811 F.3d 890, 899 (7th Cir. 2016).
 - b. Taxpayer was able to file the 2002 return during this same time frame. Moreover, she also continued to manage their business and to attend and compete in horse shows. She had also hired a personal assistant during this time. See *id.*
 - c. This taxpayer also tried to rely on missing trust and probate records – but the court found that the accountant could have completed the tax return

based on bank statements, which could have easily been obtained from the bank, even if their house had been destroyed.

- d. According to the court, “[Taxpayer’s] difficulties, while no doubt distressing, did not involve a combination of severity and timing that would have made it "virtually impossible" for her to comply with the filing requirements, Matter of Carlson, 126 F.3d 915 , 923 (7th Cir. 1997), especially considering that Stuller had already sought and received an extension until October 2004. Stuller failed to satisfactorily show that she exercised "ordinary business care and prudence," and the district court did not clearly err in finding that she lacked reasonable cause for her untimely filing.
3. Taxpayer was elderly but maintained a significant investment portfolio. For some years, he was assisted by his son in filing federal income tax returns. For 2001, Son prepared the return and gave it to his father for review and filing. But Taxpayer failed to file it. A rift developed between father and son, so that the son no longer prepared the tax returns for 2002-2004. Taxpayer failed to file returns for 2001-2004, but he made estimated tax payments for each of the years. Son did not discover these problems until after his father’s death in 2005, as he was administering his father’s estate. Son properly filed tax returns on his father’s behalf for the 2001-2005 tax years. However, the 2001 return included an overpayment of \$48,489, which would have resulted in a refund. However, a refund claim would have been time barred unless Taxpayer was eligible for relief under 6511(h). Tax was owed in 2002, but according to the Service, the 2001 overpayment could not be credited against this liability, as the refund limitations period had run.
 - a. The Court of Federal Claims ruled against the taxpayer, finding that the facts did not support disability. Estate of Rubenstein, 119 Fed. Cl. 658 (2015), appeal filed (Fed. Cir. April 1, 2015).
 - b. Among other things, the court noted that the decedent was active in stock trading, amassing a portfolio of more than \$6 million after his retirement and keeping track of details for each transaction in a “basis book” that he maintained. Some of these transactions included bank demutualization, which required financial savvy.
 - c. A family physician provided expert testimony, but there were discrepancies. On one hand, the physician submitted a letter to the IRS indicating that the decedent was not competent to govern his affairs due to dementia. However, he had also provided another letter to the Maryland Motor Vehicle Administration in which he stated that Decedent’s memory loss had not changed for years and that he did not have Alzheimer’s disease. The Court found the prior assessment to the MVA to be more credible, making the later report to the IRS unreliable. If indeed the

Decedent had been impaired, he would have presented a grave risk to his doctor by representing that he was fit to drive.

- d. Although the failure to file the return could have been from memory loss, “it is also possible that the decedent did not file the tax returns because of general neglect, recalcitrance, normal aging, and/or a belief that he had already met his tax obligations because he had made payments toward his liability.” The court found based on his doctor’s testimony that Decedent was capable of taking a box of financial information to a preparer. The taxpayer could not meet its burden to suspend the limitations period, and thus the claim was dismissed. (But an appeal has been filed.)

II. Income Tax Attributes Affected by Death.

A. Basis.

1. Perhaps the most significant tax attribute change involves the adjusted basis for property held by the decedent, which is generally adjusted to the fair market value of the property at the date of the decedent’s death. See IRC § 1014(a)(1).
 - a. Alternative valuation dates may be appropriate, depending on the valuation used for estate tax purposes. See IRC § 1014(a)(2),(3) (citing IRC §§ 2032 and 2032A).
 - b. A special anti-abuse rule denies a fair market value basis to certain property if the decedent acquired it by gift within one year of death and that property is reacquired from the decedent by the donor or the donor’s spouse. See IRC § 1014(e).
 - c. Property acquired from a decedent may include property other than that which was acquired by bequest, devise, or inheritance, or by the decedent’s estate from the decedent. See generally IRC § 1014(b).
 - d. Income in respect of a decedent (IRD) is not adjusted under section 1014. See IRC § 1014(c).
2. Basis in property acquired from a decedent is important for many income tax purposes, including subsequent gifts, charitable donations, computing gain or loss, and computing current deductions for depreciation. Changes to the Code enacted in 2015 (see generally section 2004 of Pub. L. No. 114-41, 129 Stat 443 (2015)) are designed to ensure that basis determinations are consistent with the final value reported on the estate tax return.
 - a. Taxpayers may have different incentives to value property differently for estate and income tax purposes. For example, in *Janis v. Commissioner*, 469 F.3d 256 (2nd Cir. 2006), an estate had negotiated a substantial

discounted valuation for artwork based on the likelihood of depressing the value if all of the works were offered for sale. However, for income tax purposes, the beneficiary sought to use the full appraised value, without using the discount. The Second Circuit required consistency, upholding the Tax Court.

- b. Information reporting requirements are now imposed on fiduciaries, so that basis information must be provided to the Service on Form 8971 and to persons acquiring an interest in property included in a decedent's estate on Schedule A of Form 8971. These information returns are required for estate tax returns filed after July 31, 2015. See IRC §6035.
 - i. The Service has provided transitional relief from this new requirement in a cascading series of notices and temporary regulations. See Notice 2015-57 (extending compliance deadline to 2/29/16); Temp. Reg. § 1.6035-2T (extending deadline to March 31, 2016).
 - ii. At this time this outline was being prepared, the latest notice was Notice 2016-27, 2016-15 IRB 576, which stated in part: "The Treasury Department and the IRS have received numerous comments that executors and other persons have not had sufficient time to adopt the systemic changes that would enable the filing of an accurate and complete Form 8971 and Schedule A. Accordingly, statements required under sections 6035(a)(1) and (a)(2) to be filed with the IRS or furnished to a beneficiary before June 30, 2016, need not be filed with the IRS and furnished to a beneficiary until June 30, 2016."
 - iii. Failure to comply with information reporting means a penalty of \$250/return. See IRC § 6724(d)(1)(D) and (d)(2). As discussed below, other problems may also be created.
 - c. The Code now also requires taxpayers who receive the property to utilize consistent basis reporting for income and estate tax purposes. See IRC § 1014(f). Determining a greater initial basis than reported in connection with the estate tax return could result in an accuracy penalty. See IRC § 6662(b)(8) (penalizing "inconsistent estate basis"); 6662(k) (defining "inconsistent estate basis" by reference to section 1014(f)).
3. Proposed regulations (REG-127923-15, 81 Fed. Reg. 11486 (March 4, 2016)) provide guidance and background on the implementation of the reporting rules and the valuation of property for purposes of section 1014(f).
- a. The consistency requirement in section 1014, which affects a taxpayer's initial basis in the property, applies "whenever the taxpayer reports a taxable event with respect to the property" and it continues to apply until the property is sold, exchanged, or disposed of, or otherwise adjusted

pursuant to other provisions of the code, such as those affecting adjustments to basis under section 1016. See Prop. Reg. § 1.1014-10(a).

- b. The consistency requirement and related information reporting only affects property passing from a decedent when that property is valued for estate tax purposes and increases the estate tax due. See IRC § 1014(f)(1),(2).
 - i. Proposed regulations clarify that this means “any property that is includable in the decedent’s gross estate under section 2031, any property subject to tax under section 2106, and any other property the basis of which is determined in whole or in part by reference to the basis of such property (for example as the result of a like-kind conversion) that generates a tax liability under Chapter 11 of subtitle B of the Code (chapter 11) on the decedent’s estate in excess of allowable credits, except the credit for prepayment of tax under chapter 11.” Prop. Reg. § 1.1014-10(b)(1).
 - ii. Property qualifying for a charitable or marital deduction is specifically excluded from the consistency requirement because such property does not generate a tax liability. See Prop. Reg. § 1.1014-10(b)(2).
 - iii. Tangible personal property that does not require an appraisal under Reg. § 20.2031-6(b) is also excluded, as it is deemed not to create an estate tax liability. See *id.*
- c. Consistency is based on the “final value” of property reported in connection with the estate tax return. Prop. Reg. § 1.1014-10(c)(1) provides that final value means:
 - i. The return value if the period for assessment has expired without adjustment by the IRS;
 - ii. The adjusted value determined by the IRS if that remains uncontested by the estate;
 - iii. The value determined in a binding settlement (presumably with the IRS); or
 - iv. The value determined in court after the judgment becomes final.
- d. If property is omitted and it would have generated an estate tax, then the executor may file an amended statement and return, which then provides the source of initial basis. If no return is filed before the expiration of the assessment period, then the final value (and basis) is zero. See Prop. Reg. § 1.1014-10(c)(3).
 - i. A zero valuation may be designed to incentivize reporting, but allowing the statute of limitations to expire and avoiding an estate tax burden (plus interest and penalties) is likely to prove a better

option than a fully taxable sale of inherited property at capital gains rates. (*i.e.* estate tax $(.4x) >$ income tax on entire proceeds $\{(.20+.038)x\}$).

- ii. But note: if the recipient of that property claims a basis that is greater than zero, an accuracy penalty may be assessed.
- e. What if the executor overstates the value?
- i. The taxpayer “may not rely on the statement” and “may have a deficiency and underpayment resulting from this difference.” Prop. Reg. § 1.1014-10(c)(2).
 - ii. Should a taxpayer face an accuracy penalty for “inconsistent estate basis” when there is good faith reliance upon what the executor provided?
- f. What should a taxpayer do about initial basis during the interim period, before an executor files the estate tax return? For example, suppose Decedent passes away in December. Beneficiary receives property, which she sells that year. If Beneficiary must file her return before the estate tax return has been completed, what basis should she use?
- i. The zero valuation only applies if no return is filed before the end of the assessment period. The proposed regulations do not appear to require the basis to be zero if there is uncertainty about what value the executor will determine.
 - ii. The proposed regulations state in part: “Prior to the determination ... of the final value of property ..., the recipient of that property may not claim an initial basis in that property in excess of the value reported on the statement required to be furnished under section 6035(a).” Prop. Reg. § 1.1014-10(c)(2).
 - iii. Presumably, if beneficiary determines a basis that is ultimately greater than the basis reported by the executor, she may face an accuracy penalty, but only for a deficiency resulting from any excess valuation. The proposed regulations do not address circumstances that might be entitled to relief. See Prop. Reg. § 1.6662-8, 81 Fed. Reg. at 11496.
 - iv. Note that comments to the proposed regulations rejected a proposal to create a new federal procedure to challenge a valuation used by the executor. See 81 Fed. Reg. at 11490. Valuations must therefore be challenged under applicable state law. See *id.*
4. As noted above, proposed regulations also provide guidance for executors to comply with their obligations under section 6035. (REG-127923-15, 81 Fed. Reg. 11486 (March 4, 2016)).

- a. Reporting is required only when an estate tax return is required under section 6018. There is no reporting requirement when a return is filed only for the purpose of making the portability election under section 2010(c)(5) or when making a GST election or exemption allocation, as these are not required under section 6018. See 81 Fed. Reg. at 11489; Prop. Reg. § 1.6035-1(a)(2).
 - b. Property that need not be reported includes cash (other than coin collections with numismatic value), IRD, tangible property for which an appraisal is not required under Reg. § 20.2031-6(b), and “[p]roperty sold, exchanged, or otherwise disposed of (and therefore not distributed to a beneficiary) by the estate in a transaction in which gain or loss is recognized.” Prop. Reg. § 1.6035-1(b)(1).
 - i. The estate, not a transferee, makes the basis determination in that situation, thus negating any need for transferee reporting.
 - ii. What about subsequently acquired property in a taxable transaction? Prop. Reg. 1.6035-1(b)(2) indicates, through an example, that stock acquired by the estate in a taxable exchange is not subject to the reporting requirements.
 - iii. Query: won’t the beneficiary need to know the basis for this property if it is received from the estate? Doesn’t such an exclusion undermine the purpose of reporting in this context?
 - c. The proposed regulations also address some problems in reporting to beneficiaries, including situations in which the beneficiaries are not yet determined by the due date of the return or when the property to which they are entitled is not yet determined. Multiple reporting and supplemental reporting approaches are adopted. See Prop. Reg. § 1.6035-1(c).
 - d. It should be noted that in addition to an executor, a subsequent transferee may also have a reporting obligation if that transferee distributes or transfers such property to a related transferee. See Prop. Reg. § 1.6035-1(f).
 - e. False reporting is subject to civil actions for fraud under IRC § 7434. (Don’t be vindictive.)
5. Despite this recent attention on basis reporting, which will affect a fraction of the property in the small fraction of the population who are required to file an estate tax return, most beneficiaries and devisees will therefore be making basis determinations without the benefit of an information return filed by an executor.
- a. Brokers are subject to information reporting rules, which include the adjusted basis for covered securities. See IRC § 6045(a); T.D. 9504, 75

Fed. Reg. 64072 (October 18, 2010) (stocks); T.D. 8713, 809 Fed. Reg. 13233 (Mar. 13, 2015) (interest and other debt issues); T.D. 9750, 81 Fed. Reg. 8149 (Feb. 18, 2016) (other debt issues).

- b. When a federal estate tax return is not required, valuations used for state inheritance tax purposes may also be binding. See Treas. Reg. § 1.1014-3(a); *Duerr v. Commissioner*, 30 TC 944, 948 (1958) (approving predecessor regulations indicating that inheritance tax value “shall be deemed the fair market value at the time of death”); *Hawkinson v. Commissioner*, T.C. Memo 1972-32 (following *Duerr*, but recognizing possibility of treating regulation as “mere evidentiary presumption”).
 - c. However, other authorities suggest, as in *Hawkinson, supra*, that the regulations provide an evidentiary presumption. See generally James Edward Maule, *Income Tax Basis: Overview and Conceptual Aspects*, 560-3d TM at A-48 to 49, § III.B.3.c.(2). Query whether those authorities survive the deferential status given to Treasury Regulations under post-*Chevron* law.
6. An interesting oddity: when a beneficiary acquires an option from the decedent’s estate, that beneficiary gets to value the FMV of the option at the date of death. If the beneficiary exercises the option, the consideration paid plus the FMV of the option becomes the new basis of the acquired asset. See Rev. Rul. 67-96, 1967-1 C.B. 195.
- a. While the fair market value basis for the option as a separate item of consideration is consistent with the spirit of section 1014, it departs from the ordinary rules applicable to acquisitions through options, which simply combine the consideration paid for the option with the consideration paid when the option is exercised in determining the basis of the acquired property. Thus, no gain or loss is recognized on the option itself when it is exchanged for the property, thus avoiding any determination of the value of the option when it is exercised.
 - b. According to the ruling, no loss is allowed if the option is not exercised. But this seems arguably inconsistent with the receipt of separate property, as noted above. Is the failure to exercise simply a disclaimer? Or a response to changing market conditions?
 - c. Moreover, if the option covers assets in the estate, the ruling indicates that the fair market value of the covered property will be affected by the option price. See *id.* (citing *Delone v. Commissioner*, 6 T.C. 1188 (1946)).
 - d. Query: if an option is granted, which has an independent value, could the sum total of the option and the underlying property be greater than that of the property itself? The ruling suggests not. See *id.* (citing *United States*

v. Land, 303 F.2d 170 (5th Cir. 1962), cert den. 371 U.S. 862 (limiting total value to underlying property).

B. Home Ownership.

1. Home ownership provides a special set of problems and opportunities for married decedents and their families. The basis rules in 1014, coupled with a potential gain exclusion from the sale of a principal residence under section 121, require careful attention.
2. In a common law state (like Nebraska), joint tenancy with a right of survivorship confers property ownership upon the survivor, but death also changes the basis in the combined property.
 - a. Joint tenancy property presents some enigmatic qualities regarding basis.
 - i. Section 1014(a) extends the fair market value basis regime to property “passed from a decedent”. Section 1014(b)(9) includes property “acquired from the decedent by reason of death, form of ownership, or other conditions ... if by reason thereof the property is required to be included in determining the value of the decedent’s gross estate ...”
 - ii. See Rev. Rul. 56-215, 1956-1 C.B. 324, ruling that an estate tax return is not required to trigger a step-up in basis.
 - iii. As for the portion of jointly owned property properly included in the value of the decedent’s estate, different rules have emerged that depend on who owns the property and when the interest emerged.
 - iv. For “qualified joint interests” created after December 31, 1976, the Code provides a simple rule regarding joint tenancy or tenancy by the entirety when spouses are the only owners: half the property is included in the estate of the first to die. See IRC § 2040(b).
 - v. But joint interests created before January 1, 1977, required a default position of inclusion in the decedent’s estate in its entirety, except to the extent of consideration furnished by the other owner. See Hahn v. Commissioner, 110 T.C. 140 (1998), acq. IRS AOD 2001-06, 2001-42 IRB 319 (Oct. 15, 2001) (discussing legislative history). For a complex example, see Rev. Rul. 56-519, 1956-2 CB 123 (adjusted basis for tenancy by the entirety involving different contributions, earnings, and depreciation deductions).
 - vi. This determination based on who provided consideration remains operative if the joint interest is not “qualified”, as when the surviving spouse is a noncitizen or in nonspousal situations. See generally Reg. § 20.2040-1(c) for examples. Notably, the estate tax considerations for inclusion depend on contributions, not on prior gifts.

- vii. When a property is financed by a mortgage on which both owners are liable and the consideration regime applies, each owner's actual mortgage payments are tracked for purposes of computing their respective contributions. However, half the balance of the mortgage at the death of the first owner may be treated as a contribution of the surviving owner. See Rev. Rul. 79-302, 1979-2 C.B. 328 (applying rules to context outside the scope of qualified joint interests).
 - viii. Moreover, note that Reg. § 20.2040-1 applies only to joint interests with right of survivorship, not to tenancies in common.
- 3. In a community property state, if the home is held as community property, both halves of the property will be entitled to a step-up in basis (assuming appreciation, of course). See IRC § 1014(b)(6); Treas. Reg. § 1.1014-2(a)(5).
 - a. While the Code requires that at least half of the community property must be included in determining the value of the decedent's gross estate for estate tax purposes, there is no requirement that the decedent's estate must be taxable. See *id.*
 - b. Community property status thus confers a step-up in basis for the entire property, rather than only a portion of the property deemed owned by the decedent spouse, as in a joint tenancy situation.
 - c. Of course, this affects many other assets, not just a home. See, e.g., Rev. Rul. 92-37, 1992-1 C.B. 195 (applying 1014(b)(6) to adjust the basis for an oil and gas interest held as community property for purposes of computing depletion deductions).
 - d. For a recent critique of the advantaged status of community property under section 1014(b)(6), see Paul Caron & Jay Soled, *New Prominence of Tax Basis in Estate Planning*, TAX NOTES, March 28, 2016.
 - i. Caron and Soled found no empirical evidence of migration to community property states for tax purposes.
 - ii. Query whether the relevant population for inquiry should not be spouses with significant age disparity? Spouses who are close to the same age at death may expect to gain the benefit of a step-up in basis when the second spouse dies, thus diminishing the income tax incentive for them.
 - iii. Note that a step up may be a step down, too. In areas of the country where housing markets have declined, these perceived advantages become disadvantages in some circumstances.

4. While section 1014 affects the step-up in basis for appreciated property acquired from a decedent, the surviving spouse may also benefit from the gain exclusion permitted by section 121.
 - a. Property owned and used by the taxpayer as a principal residence may also be eligible for gain exclusion of up to \$250K (single) and \$500K (married filing jointly).
 - b. The 500K exclusion is available if:
 - i. Either spouse owns the property;
 - ii. Both spouses used the property as their principal residence for 2 of the last 5 years;
 - iii. Neither spouse has previously accessed the exclusion within the past 2 years before the sale. See generally IRC § 121(b)(2).
 - c. A surviving spouse is eligible to maintain the \$500K exclusion level for up to two years after the date of death if the requirements listed in item 4.b., immediately above, are satisfied. See IRC § 121(b)(4).
 - i. After that period passes, presumably the exclusion reverts to \$250K for a single person, unless the surviving spouse remarries and her spouse lives in her house, thereby meeting the requirements stated above.
 - ii. As discussed in part I, above, a surviving spouse may be eligible to file using married filing jointly status for up to two years after the death of a spouse if she remains unmarried to a new spouse and meets other eligibility requirements. However, this language appears to confer authority to use the \$500K exclusion even if she files in a single or head of household status.
 - iii. Remarriage and filing a joint return with a new spouse thus may create a new kind of “marriage penalty” – a “remarriage penalty”?
 - d. The surviving spouse can utilize the ownership and use period of the deceased spouse in computing whether the property meets the requirements for the exclusion. See IRC § 121(d)(2).
5. Some examples.
 - a. A and B are unmarried individuals who live together and buy a home for \$100,000, which they hold as joint tenants. A pays a \$20,000 down payment, and thereafter, A makes all mortgage payments.
 - i. If A predeceases B at a time when the home is worth \$150,000, B takes a tax basis of \$150,000.

- ii. If instead B predeceases A, then A will continue to have a basis of \$100,000 in the home.
 - iii. If A and B both survive until they agree to sell the home two years after it was originally acquired for a selling price of \$600K, the tax treatment of the sale will presumably depend on how the parties allocate the original basis. Did A intend a gift? If not, A may have a larger basis than B in the process. Moreover, each will be entitled to exclude up to \$250K of gain.
 - iv. Note also that A and B may have other advantages that a married couple does not have. For example, assume A and B purchased the home for \$2 million. As a married couple, they would be restricted to mortgage interest of \$1 million under IRC § 163(h). As unmarried individuals, each could potentially claim \$1 million of mortgage debt for purposes of computing a mortgage interest deduction, assuming both are jointly responsible for the debt. See *Voss v. Commissioner*, 796 F.3d 1051 (9th Cir. 2015), *reversing* *Sophy v. Commissioner*, 138 T.C. 204 (2012).
 - 1. Note that the Tax Court will generally follow its own precedent (*Sophy* was a regular decision) unless a contrary circuit decision applies. So that means no “single advantage” on mortgage interest outside the 9th Circuit.
 - 2. But query whether other circuits will follow the logic of the 9th Circuit in this case. For some analysis, see Anson H. Asbury, *Through a Glass Darkly: Sophy, Voss and Statutory Interpretation of the Internal Revenue Code*, 32 *Financial Planning Journal* 59 (March 15, 2016).
- b. H and W are married. They live together and buy a home for \$100,000, which they hold as joint tenants. Both are US citizens. H pays a \$20,000 down payment from his own funds, and thereafter H makes all mortgage payments from his earnings. The couple thus has a tax basis of \$100,000 in the property.
- i. If H predeceases W at a time when the house is worth \$150,000, W will take a basis of \$125,000 in the property (i.e., her half, having a basis of \$50,000, which is half the initial basis of \$100,000, plus his half, reflecting fair market value at death of \$75,000).
 - ii. If W predeceases H, H will have a basis of \$125,000 – the same as if W predeceases him.
 - iii. Suppose H and W hold the property until it appreciates to \$600,000, after which they sell it after holding it and living in it together for two years. H and W may exclude the \$500K gain from their gross income assuming compliance with section 121.

- c. H buys a home for \$100,000. After owning and living in the home for two years, H marries W. The couple decides to change the title of the home to joint tenancy. They leave for their honeymoon, and unfortunately, H dies. W, H's grieving widow, immediately decides that she should sell H's house, which has appreciated to \$600,000 at the time of his death. A buyer closes on the house one month after H's funeral. W never lived in the house.
 - i. W is entitled to a basis of \$350,000 in the house. Although she has not personally met the ownership and use requirement in the house, she can claim to have met that ownership and usage requirement through her deceased spouse. See IRC § 121(d)(2).
 - ii. If she is deemed to have met the ownership and usage requirements on account of section 121(d)(2), does that mean she also gets to claim a \$500,000 exclusion? See IRC § 121(b)(2)(A) (requiring either spouse to meet the ownership requirement and both spouses to meet the use requirement).
 - iii. Note that if H survived and the couple decided to sell the house instead of making it their joint home, only H would have met the use requirement and thus could only claim a \$250,000 exclusion. See IRC § 121(b)(2)(B). (This rule thus incentivizes marriage followed by death! Yikes!)

- d. H and W, a married couple, buy a home together for \$100,000. The couple lives in the house together for five years until H passes away. At this time, the house is worth \$600,000. As noted above, W takes a basis of \$350,000 in the house.
 - i. If W sold the house within two years of H's death, she would be entitled to exclude up to \$500,000 of gain. Thus, the house could appreciate to \$850,000 without triggering an income tax liability.
 - ii. Suppose that W (who remains unmarried) holds on to the house for two years. She then has a change of heart about living in the house, deciding to sell the property two years and one day after H's death. At this time, the selling price is \$850,000. W is only eligible to exclude \$250,000, so that an additional \$250,000 of gain will be taxable.
 - iii. If W had a different change of heart -- remarrying after H's death and before selling their house -- the usage of her new spouse would be relevant to determining whether a \$500,000 exclusion would be available.
 - 1. Her new spouse (New H) would have to live there with her for two years to benefit from the full exclusion. See IRC §§121(b)(2)(B) (entitlement to \$500,000 exclusion requires ownership and use requirements); 121(b)(4) (applying the

- \$500,000 exclusion to surviving spouses for a sale by an “unmarried individual”).
2. Note, however, that New H would not need to become a co-owner with W in order to benefit from the \$500,000 exclusion – only one spouse needs to own the property. See IRC §§ 121(b)(2)(A)(i) (“either spouse” meets ownership); 121(b)(2)(B) (“each spouse shall be treated as owning the property during the period that either spouse owned the property”).
- e. Suppose that instead of joint tenancy, H and W owned the house as community property. At H’s death, the fair market value is \$600K.
 - i. W takes a basis equal to \$600,000. See IRC § 1014(b)(6).
 - ii. Thus, the house may appreciate to \$1.1 million without triggering taxable gain, assuming she remains unmarried and sells the home within two years of H’s death.
 - iii. Note the disparity between the common law and community property states in this regard. See Caron & Soled, *supra*, for a similar example.
 - f. If you use an installment contract to finance the sale of your principal residence, don’t forget about *Debough v. Shulman*, 799 F.3d 1210 (8th Cir. 2015), which holds that pursuant to section 1038(e), a taxpayer loses the benefit of the section 121 exclusion if he repossesses the property and fails to resell it within one year thereafter.

C. Other Tax Attributes.

1. As illustrated in section 121, above, some Code provisions expressly deal with the matter of a surviving spouse’s entitlement to tax attributes connected with a joint return. In other cases, the matter is not so clear. Some significant additional tax attributes and their implications for tax planning appear below.
2. As the Tax Court in *Vichich v. Commissioner*, 146 T.C. No. 12 (2016), recently explained: “Marriage affords its entrants certain benefits, among them the option of filing joint returns. The Code treats married taxpayers who file jointly as one taxable unit; however, it does not convert two spouses into one single taxpayer. Joint filing allows spouses to aggregate their income and deductions but “does not create a new tax personality”. *Coerver v. Commissioner*, 36 T.C. 252, 254 (1961), *aff’d*, 297 F.2d 837 (3d Cir. 1962); accord *Rodney v. Commissioner*, 53 T.C. 287, 307 (1969); *Michelson v. Commissioner*, T.C. Memo. 1997-39; see also *Dolan v. Commissioner*, 44 T.C. 420, 428 (1965) (“[H]usband and wife remain separate taxpayers, even though they file a joint return.”)

- a. Outside of marriage, tax attributes are generally not transferable. *Vichich*, supra.
 - b. Joint filing “generally does not permit either spouse to inherit or otherwise retain after the marriage ends a tax benefit that was originally conferred upon the other spouse.” Id.
3. Net operating losses attributed to one spouse may be used to offset the income of the other spouse to the full extent of their combined income. See id. (citing Treas. Reg. §§ 1.172-7(c); 1.175-3(d)). But outside the period of marriage, complexities arise.
 - a. A NOL attributed to one spouse before marriage may not be used to offset income attributed to another spouse after marriage. See id. (citing *Calvin v. United States*, 354 F.2d 202 (10th Cir. 1965)).
 - b. Likewise, a surviving spouse who incurred a NOL after her husband’s death was not permitted to carry those back to joint returns during their marriage, in which all income belonged to her husband. Id. (citing *Zeeman v. United States*, 395 F.2d 861 (2nd Cir. 1968)).
 - c. When a spouse shares the risk as an equal partner with her husband, she may carry forward half of the NOL reflected in a joint return to offset her own income after her husband’s death. Id. (citing *Rose v. Commissioner*, T.C. Memo 1973-207 and following Rev. Rul. 74-175, *infra*).
 - d. In the year of death, operating losses and any NOL from business operations can be deductible only on the decedent’s final return filed on his behalf. Unused amounts are not deductible by the decedent’s estate. See Rev. Rul. 74-175, 1974-1 CB 52. (The same is true of capital losses, including unused carryforwards.)
4. The Tax Court in *Vichich* also notes that excess charitable contributions are personal to the taxpayer who made the contributions. Charitable contributions are subject to limitations based on gross income, with excess contributions carried forward for up to five future tax years. See IRC § 170(d)(1). If a husband and wife file joint returns, those contribution limits will be computed based on the aggregate income of the couple. Conversely, if separate returns are filed, each spouse ascertains his/her own income and deduction limitations.
 - a. If an excess contribution amount is carried forward from a joint return year to a future taxable year in which the couple files separate returns, the separate returns must allocate the excess contribution amount as though it would have been reported on a separate return. See Treas. Reg. § 1.170A-10(d)(4)(i).

- b. Conversely, an excess contribution based on a separate return can be aggregated for purposes of computing the allowable deduction in a future year if the couple files a joint return. See Treas. Reg. § 1.170A-10(d)(4)(ii).
- c. For a deceased spouse, the regulations provide in part: “In case of the death of one spouse, any unused portion of an excess charitable contribution which is allocable in accordance with subdivision (i) of this subparagraph to such spouse shall not be treated as paid in the taxable year in which such death occurs or in any subsequent taxable year except on a separate return made for the deceased spouse by a fiduciary for the taxable year which ends with the date of death or on a joint return for the taxable year in which such death occurs.” Treas. Reg. § 1.170A-10(d)(4)(iii).
 - i. Per an example in the regulations, the deceased spouse’s allocable share of the unused contribution carryforward is extinguished.
 - ii. This suggests that filing a joint return to expand the contribution base, thus using as much of the carryforward as possible, is advisable, not only in the final year, but in all years affected by an excess contribution.
 - iii. Couples filing joint returns and making contributions to charity should also carefully consider how their contributions are documented in light of the above guidance.
 - 1. The regulations presuppose that contributions are tracked specifically for each spouse, along with income earned by each spouse, for purposes of computing a separate limitation for each spouse. (Community property situations will present different considerations).
 - 2. Consider a couple in which only one spouse (H) earns income that is deposited into a joint bank account. If W writes checks to charity from that account, will the donation be allocated to W? That may save the excess contribution from perishing with H if H dies first. But if W dies first, then the couple may have an excess contribution that perishes with her.
 - iv. Allocating deductions proportionally to income likely reduces the risk of extinguishing a carryforward benefit, particularly if one cannot predict whether H or W will die first.
- 5. The Tax Court in *Vichich* determined that credits generally are to be treated similarly to deductions, as both are matters of legislative grace. Accordingly, an AMT credit attributed to an ISO earned by the husband prior to their marriage could not be used by his surviving spouse after his death.
- 6. As noted above, capital loss carryovers likewise expire at death to the extent they are not utilized on the final return. See Rev. Rul. 74-175, 1974-1 C.B. 52.

- a. When a deceased spouse has a capital loss during his final year or a capital loss carryforward, the surviving spouse may be able to utilize that tax attribute by filing a joint return and attempting to create gains to offset the loss by selling her separate property.
 - b. For example, assume that H has a capital loss carryforward of \$100,000. Pursuant to IRC § 1211(b), the couple could only use \$3,000 of that loss to offset ordinary income in the final return, leaving \$97,000 to expire. However, assume W and H held property in joint tenancy in which W now has a basis of \$300,000 (under the applicable basis rules discussed above) and a FMV of \$400,000. If W chooses to sell this property, she may be able to utilize the carryforward to avoid tax on the gain.
 - c. Note also that wash sale rules for securities only apply to losses, not gains. See IRC § 1091. Presumably nothing would prevent the surviving spouse from reowning the stocks she sold to capture the otherwise expiring tax attribute.
7. Passive activity losses. If a taxpayer with an interest in a passive activity experiences losses, those losses may be suspended (deferred) under IRC § 469(a) and carried forward to a future tax year to reduce passive activity income in those years.
- a. Rental activities (other than engaged in by a qualified real estate professional) are presumptively covered. See IRC § 469(c)(2). A limited exception is also available for up to \$25,000 of deductions attributable to rental activities in which an individual actively participated, subject to a phase-out beginning at \$100,000 of AGI. See IRC § 469(i).
 - b. If a taxpayer disposes of an entire interest in a passive activity in a fully taxable transaction that does not involve a related party, suspended losses are treated as a loss which is not from a passive activity to the extent that those losses exceed other passive gains. See IRC § 469(g)(1)(A), (B).
 - c. A disposition by death is subject to a special rule that coordinates with the adjusted basis rules in section 1014.
 - i. Any suspended loss in the year of disposition is reduced by the step-up in basis that occurs in the hands of the transferee. See IRC § 469(g)(2)(A).
 - ii. This reduction in the suspended loss is disallowed and may not be deducted by anyone. See IRC § 469(g)(2)(B).
 - iii. If any suspended loss remains after this reduction, then the loss may be taken as a deduction on the decedent's final return and may

be used to offset nonpassive income. See FSA 200106018 (2/9/2001).

- d. Note that passive activities retained by an estate or held in trust can also generate passive activity losses. For analysis of material participation by fiduciaries, see Michael S. Jackson and Jared S. Szychter, Planning for the Net Investment Income Tax: Tax Court's Decision in Aragona Provides some Answers, but Many Questions Remain, 39 ESTATES, GIFTS & TRUSTS JOURNAL 157 (July 10, 2014).

III. Some Special Tax Attribute Problems of Partnerships and S Corporations Affected by Death of an Owner.

Business entities organized as partnerships and S corporations can create complex tax problems when an owner dies. While a comprehensive discussion could take up a separate program, here are a few interesting problems that affect tax attributes for decedents and their families owning interests in S corporations and partnerships.

A. S Corporations.

1. While S corporations are legal entities with unlimited life and separate identities from their owners, a decedent who owns S corporation stock is nevertheless treated as though he or she owns some tax attributes of the corporation. The Code requires that the decedent's share of IRD must be taken into account in the same manner as if the decedent had directly held the item of income. IRC § 1367(b)(4)(A). The basis in stock acquired from the decedent otherwise established under section 1014 must also be reduced by the amount of IRD. See IRC § 1367(b)(4)(B).
 - a. S corporation regulations provide only limited guidance regarding this particular problem. See Treas. Reg. § 1.1367-1(j) (referring to applicable regulations under section 691 regarding IRD).
 - b. Note that a decedent with an interest in an S corporation may also have loaned money to the S corporation. S corporation rules allow a separate basis in stock and debt. If losses occur, causing the shareholder to reduce basis in debt, see IRC § 1367(b)(2), section 1014 presumably applies to increase that debt basis to its applicable fair market value. The regulations do not require any adjustment to debt basis on account of IRD. Presumably, the fair market value of stock will include the expected IRD, thus allowing a reduction in basis (but not below zero), and no such reduction would be required.
2. Death effects a disposition of the S corporation stock, in which pre- and post-disposition income will be allocated to the decedent and to the transferee (which

could be the estate). Regulations provide in part: “If the shareholder dies (or if the shareholder is an estate or trust and the estate or trust terminates) before the end of the taxable year of the corporation, the shareholder’s pro rata share of these items is taken into account on the shareholder’s final return.” Treas. Reg. § 1.1366-1(a)(1).

3. If a loss is incurred, the loss is allowable to the shareholder only to the extent of the basis in stock and debt of the S corporation. See IRC § 1366(d)(1).
 - a. Excess losses disallowed because of this basis restriction can be carried over indefinitely if the shareholder continues ownership, or in the limited case of a shareholder who makes an *inter vivos* transfer to a spouse, who continues ownership. See Treas. Reg. § 1.1366-2(a)(6)(ii).
 - b. For other transfers, suspended losses do not fare so well. The regulations provide in part: “Except as provided in paragraph (a)(6)(ii) of this section [i.e., an inter vivos transfer to a spouse or former spouse], any loss or deduction disallowed under paragraph (a)(1) of this section is personal to the shareholder and cannot in any manner be transferred to another person. If a shareholder transfers some but not all of the shareholder’s stock in the corporation, the amount of any disallowed loss or deduction under this section is not reduced and the transferee does not acquire any portion of the disallowed loss or deduction. If a shareholder transfers all of the shareholder’s stock in the corporation, any disallowed loss or deduction is permanently disallowed.” Treas. Reg. § 1.1366-2(a)(6)(i). Death thus extinguishes the deferred loss, except to the extent the decedent can take advantage of this tax attribute in the final return.
 - c. Note that an election to terminate the tax year could, if applicable, affect the amount of income allocated to a decedent and thus the ability to offset that income by utilizing the carryover of a disallowed loss. See IRC § 1377(a)(2); Treas. Reg. § 1.1377-1(b)(1). A death of a shareholder is potentially a terminating event because it results in the complete disposition of the shareholder’s interest. See Treas. Reg. § 1.1377-1(b)(4).
 - i. The procedures for election are found in Treas. Reg. § 1.1377-1(b)(5). All affected shareholders, including the executor or administrator of the estate of the deceased shareholder, must agree. See *id.* (Query how the relevant shareholder agreement addresses this possibility.) (Note that the election under 1377(a)(2) takes precedence over an election based on a disposition under Treas. Reg. 1.1368-1(g). See *id.*)
 - ii. If this termination election occurs, the share of income allocated on the per-share, per-day method will be limited to that amount occurring during the short taxable year ending on the date of termination. Alternatively, if the termination election does not

occur, the share of income allocated will depend on the pro-rata share of the entire year's taxable income. That could be a big difference as, for example, when seasonal items occur late in the tax year. (Consider, for example, a Christmas tree farm).

- iii. Note that because the election is made when the S corporation files 1120S, hindsight could be used in determining whether to make this election. But bear in mind, all the relevant parties must agree – and this means potentially different current taxable income for the distributive share allocated under this computation. There could be winners and losers from termination.
 - iv. The election could also be made if losses are incurred later in the year, thus potentially keeping those losses “alive” by allocating them to the living shareholder if the decedent would otherwise lack sufficient basis to utilize his share of the loss.
- d. Transferees facing disallowed losses have some consolation, however, based on the fact that the transferee can take a stepped-up basis in stock and debt. (This will usually be the case, as the fair market value of the decedent's total investment is likely to exceed an adjusted basis of zero at death which accompanies disallowed losses.)
4. Unlike the partnership, discussed below, the S corporation retains the same basis in its own assets. Accordingly, while the basis in S corporation stock may be increased in the hands of a decedent's transferee, the transferee may nevertheless experience some negative tax consequences on this account.
- a. Assume ACME, an S corporation, has two shareholders who hold equal shares. A transferred Property A (Basis =0, FMV=\$100) in a good section 351 transaction and B transferred \$100 in cash. Property A appreciates to \$200, after which A dies, and his spouse, A', inherits the stock. A' is an eligible shareholder who continues ownership. Assume ACME has no income for year 1, so there is no need to go through the allocation problems discussed above.
 - i. A' acquires a FMV basis in the ACME stock at the date of A's death, which we will assume is \$150 (i.e., total assets valued at \$300, including Property A plus \$100 cash). No IRD affects the basis here. ACME's basis is not affected by A's death, but remains at zero – the same basis A had when he transferred Property A to ACME. See IRC § 362.
 - ii. In year 2, ACME decides to sell Property A for \$200. ACME recognizes gain of \$200 (i.e., the amount realized minus its zero basis). That gain is allocated equally on the per-share, per-day method to A' and B.
 - iii. Thus, A' now receives \$100 of taxable income from the S corporation. She would not have had any taxable income from the sale if she had owned this property directly, rather than through the

S corporation. As a consolation prize, her basis in the S corporation stock increases from \$150 to \$250 pursuant to section 1367(a).

- b. If ACME liquidated in the same year, distributing \$150 of cash to each shareholder, A would recognize an offsetting loss of \$100 as though she sold the stock to the corporation (i.e., amount realized of \$150 less adjusted basis of \$250 in stock). See IRC § 331(a). If A' can convince B to liquidate, A might recognize an offsetting loss equal to the gain she recognized. But if a loss occurred during a future year, it might be subject to loss limitations under IRC § 1211(b), or, heaven forbid, might disappear if A' passes away before she can utilize the loss.
- c. As discussed below, subchapter K provides relief from this problem for partners, which is not available to the S corporation shareholder.

B. Partnership Basis Adjustments.

1. Partnerships are also rich environments for IRD issues, which could affect decedents and their transferees. Below are a few intriguing counterpoints that can be used in comparison to the S corporation provisions discussed above. As noted above, it is not a comprehensive discussion.
2. Rather than the rigid per-share, per-day allocation method of Subchapter S, Subchapter K allows partnerships to vary allocations by agreement. See IRC § 704(a). Allocations pursuant to those agreements must satisfy the requirement of substantial economic effect. See IRC § 704(b). Those agreements may also be overridden by other provisions of the Code. See, e.g., IRC § 704(c).
3. Section 706(a) provides a general rule: “Except in the case of a termination of a partnership and except as provided in paragraph (2) of this subsection, the taxable year of a partnership shall not close as the result of the death of a partner, the entry of a new partner, the liquidation of a partner's interest in the partnership, or the sale or exchange of a partner's interest in the partnership.” IRC § 706(c)(1).
 - a. Paragraph (2) provides in part: “The taxable year of a partnership shall close with respect to a partner whose entire interest in the partnership terminates (whether by reason of death, liquidation, or otherwise).” IRC § 706(c)(2).
 - b. Although death may cause a dissolution of a partner under state law principles (see, e.g., Uniform Partnership Act § 31), for federal tax purposes termination occurs only when specified conditions occur. These include when “no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership”. IRC § 708(b)(1)(A).

- i. If a decedent owns an interest in a two-member partnership, this could potentially trigger termination for tax purposes. But note that regulations provide in part: “Upon the death of one partner in a 2-member partnership, the partnership shall not be considered as terminated if the estate or other successor in interest of the deceased partner continues to share in the profits or losses of the partnership business.” Treas. Reg. § 1.708-1(b)(1)(i). See also Treas. Reg. § 1.736-1(a)(6) (retiring partner or a deceased partner’s successor in interest receiving payments under section 736 are regarded as partners until the entire interest is liquidated; partnership tax year does not close with respect to either partner until that time).
 - ii. The partnership may also terminate if 50 percent or more of the interest in partnership capital is sold or exchanged in a 12 month period. See IRC § 708(b)(1)(B). But a surprise lurks here, as regulations provide in part: “Such sale or exchange includes a sale or exchange to another member of the partnership. However, a disposition of a partnership interest by gift (including assignment to a successor in interest), bequest, or inheritance, or the liquidation of a partnership interest, is not a sale or exchange for purposes of this subparagraph.”: Treas. Reg. § 1.708-1(b)(2).
 - iii. Thus, in a multiple member partnership, the death closure rule noted above means that the partnership year closes only for the deceased partner, and then only when that interest is finally liquidated or transferred to a successor; it does not close for all partners. In contrast, if a termination occurs, the partnership year closes for all the partners.
 - c. When variations in partnership interests occur, including variations caused by a transfer or liquidation of a partnership interest, partners may use a segmenting approach, coupled with permissible conventions (i.e., choosing a calendar day, monthly, or semi-monthly period), to account for the partner’s share of income attributed to those variations. Extraordinary items, which include “any item which, in the opinion of the Commissioner, would, if ratably allocated, result in a substantial distortion of income in any return in which the item is included”, must be allocated separately (unless a “small item” exception applies).
 - i. New detailed rules were announced in regulations published in 2015. See Treas. Reg. 1.706-4, T.D. 9728 (Aug. 3, 2015), as amended at 80 Fed. Reg. 68243 (Nov. 4, 2015).
 - ii. Planning opportunities exist due to the potential for agreements among the partners, but the environment is more complex than Subchapter S.

- iii. Ultimately, the decedent's interest in partnership income for the portion of the partnership tax year before death is included in the decedent's final return, while the post-death share of income is reported by the transferee. Of course, distributive shares must satisfy the requirements for substantial economic effect under section 704.
4. Like Subchapter S, Subchapter K provides that losses passed through to partners are limited on account of the partner's basis in the partnership interest. See IRC § 704(d); Treas. Reg. § 1.704-1(d). Suspended partnership losses are presumably treated similarly to other losses, and therefore lost to the extent they cannot be used by the decedent in his final return. See, e.g., Elliott Manning, *Partnerships – Disposition of Partnership Interests or Partnership Business*, 718-2d T.M. at § II.B.1.(d) (suspended losses are “apparently lost”).
 5. Debt of the partnership allocated to the deceased partner adds complexity to valuing the partnership interest, which is not present in subchapter S. While the partnership interest may be valued net of the allocated debt for purposes of section 1014, that partner's share of the debt should be taken into account in determining the basis of the partnership interest in the event of sale or liquidation, as that share of debt is also taken into account as part of the amount realized when the partnership interest is sold or liquidated.
 - a. Sometimes, even the government regulation writers get this wrong. See Prop. Reg. § 1.1014-10(e) Example 1, in which a partnership interest in an equal partnership is correctly valued at \$4 million when the partnership assets are worth \$10 million and subject to \$2 million in liabilities. In the example, the beneficiary sells the interest for \$6 million in cash. According to this example, the gain is \$1 million, which apparently takes into account a \$1 million allocation of debt.
 - b. While it is appropriate to include the debt in assessing the gain, it must be taken into account on both sides of the computation. In other words, the amount realized should include the allocated share (assume \$1 million) of partnership liabilities, as the transferee is relieved of these liabilities under section 752. She got cash of \$6 million plus \$1 million in debt relief, for total consideration of \$7 million. Moreover, the transferee's share of liabilities should also be included in the basis of the partnership interest for purposes of the sale, as the beneficiary is treated as contributing an amount equal to the allocated share. The correct gain should thus be \$2 million in this case.
 - c. Since S corporation debt is not included in the basis of an S corporation shareholder's stock (even if a guarantee is executed, unless an actual payment is made on the guarantee – see Treas. Reg. § 1.1366-1), this complexity is avoided for an S corporation shareholder.

6. Subchapter K offers one other advantage over subchapter S: the ability to make a section 754 election to adjust the inside basis of assets held by the partnership, thereby affecting the gains and losses that pass through to the transferee of the partnership interest.
 - a. Section 754 permits an eligible partnership to file an election that requires an adjustment to the basis of partnership property upon the transfer of a partnership interest (section 743(b)) and upon the distribution of partnership property (section 734(b)).
 - b. The election is made with the partnership's timely filed return. See Treas. Reg. § 1.1754-1(b)(1). Once the election is made, it extends to future tax years until it is revoked (only with permission of the Service) or the partnership terminates. See Treas. Reg. § 1.754-1(a), (c). Since the election requires adjustments of basis upward (producing the good result of avoiding taxable income) or downward (producing the bad result of losing the benefit of a loss), the continuing effect of an election deserves consideration.
 - c. In the case of a transfer of a partnership interest caused by death, the partnership with a section 754 election in place adjusts the basis of partnership property to reflect the excess of the transferee's basis in the partnership interest over the transferee's proportionate share of the basis in partnership property. See IRC § 743(b)(1). Alternatively, where the basis of the transferred partnership interest is below the proportionate share of the partnership's basis in partnership property, the adjustment can go downward. See IRC § 743(b)(2).
 - d. This basis adjustment affects only the transferee partner. See Treas. Reg. § 1.743-1(j)(1). Thus, when the partnership computes the distributive share of partnership items of income, loss, deduction, and credit associated with partnership property, the share allocated to the transferee partner is modified to reflect this adjustment.
 - e. A simple example: A, B & C form an equal partnership, each contributing \$100 in cash. The partnership then purchases Blackacre for \$300, which they hold for investment. Blackacre increases in value to \$600, while the partnership basis remains at \$300. C dies and D is the transferee. Assume that C's interest is worth \$200 at the time of her death, reflecting one-third of the fair market value of Blackacre.
 - i. Under section 1014, D takes a basis of \$200 in the partnership interest.
 - ii. If the partnership makes a section 754 election, the partnership has an adjustment of \$100 under section 743. This adjustment will be

allocated to D in the event that any tax effect results. It does not affect D's capital account.

- iii. Assume that the partnership sells Blackacre for \$600. Due to the 754 election, the partnership will offset the selling price of \$600 against a new adjusted basis of \$400, producing gain of \$200. Because the effect of the adjustment is allocated to D, D receives no distributive share of the gain, while A and B will have \$100 each. As a result, D retains her basis of \$200 in the partnership while A and B receive an adjustment from \$100 to \$200. See IRC § 705(a)(1).
- iv. If no 754 election is filed, the partnership would not adjust the inside basis in Blackacre. See IRC § 743(a). As a result, the gain realized on the sale would be \$300, not \$200, and each partner would receive an equal allocation. (Of course, D steps into the shoes of C when it comes to the holding period and characterization determined by the partnership.) Consequently, D would be taxed on the gain from that sale measured by the partnership, with a consolation prize of a basis adjustment under IRC § 705(a)(1), which would increase her basis to \$300.
 - 1. Recall the above example from the S corporation. The consolation prize is not that consoling, unless the partnership liquidates and D is able to recognize an offsetting loss on liquidation (i.e., assuming she receives \$200 cash against the adjusted basis of \$300 in this case).
 - 2. Thus, without the 754 election, the transferee of the partnership interest is in much the same position as the S corporation shareholder – recognizing pass-through income from entity level transactions that do not reflect the step-up in basis in the ownership interest in the entity.
 - 3. One other difference is worth noting. Liquidation of the partnership will only trigger loss recognition if the partnership distributes money, unrealized receivables, and inventory. See IRC § 731(a)(2). Otherwise, the basis in the partnership interest will be allocated to other property received, see IRC § 732, so that loss will be deferred rather than recognized currently. This is a potentially significant difference from the corporate context, which is indifferent to the form of consideration received in liquidation.
- f. Note that a partnership with a “substantial built-in loss” (i.e., basis in property exceeds the fair market value by more than \$250,000), a basis adjustment is required regardless of whether a section 754 election is made. See IRC § 743(a), (d). Such lost basis would be similar to that experienced if the seller had owned an interest in the property directly rather than through a partnership.

C. Partnership Audit Adjustments: New Concerns.

1. One more partnership attribute deserves attention: new partnership audit provisions enacted late in 2015 may effectively impose liability on the partnership in connection with past audit adjustments. Shifting tax consequences could potentially affect a transferee partner or continuing partners after liquidating or acquiring the interest of a former partner.
2. The Bipartisan Budget Act of 2015, Pub. L. No. 114-74, 129 Stat 584 (Nov. 2, 2015), included Title XI, “Revenue Provisions Related to Tax Compliance”. Section 1101 enacted several important changes to provisions affecting partnership audits.
 - a. The Joint Committee on Taxation scored these audit changes as a \$9.325 billion revenue raiser for the period 2016-25, with all of the net revenue generated in 2019-25 following negative adjustments in 2016-18. See JCX-135-15 (10/28/15), available at <https://www.jct.gov/publications.html?func=startdown&id=4846>
 - b. The effective date for most firms, except those who elect early application, is return years beginning after 12/31/17. Presumably, the positive effects of audit adjustments will take time to implement under the applicable rules. But this shows: the new rules are predicted to be bad for taxpayers, good for government revenues, once they become effective.
 - c. Negative revenue effects in 2016-18 reflects the likelihood that firms electing to apply these rules for tax years ending after 11/2/2015, the date of enactment, might actually benefit from the audit rules. (Why else would you make an affirmative election to apply them before you have to do so?)
 - d. Commentators suggest that eligible small partnerships – generally speaking, those with fewer than 100 partners and no ineligible partners (see new section 6221) – may want to elect out of these rules. See, e.g., Michael G. Wasserman, A Fix Too Fast: Anomalies in the New Legislation on Partnership Tax Audits, J. TAX’N 118, 120 (March 2016). That election out is made with the partnership tax return. See new section 6221.
3. The audit rules are significant because they potentially turn the partnership into a taxpaying entity with respect to an audit adjustment, unless the partnership elects to pass through the adjustments to partners. The foundations for this liability and election are contained in new IRC § 6225. (Note that until the effective date, these rules will presumably be found in the Bill or in notes to the Code, not in the Code itself. Old section 6225 remains in place until the effective date. For

convenience, citations below are to the new Code provisions added by the legislation, rather than to the enacting legislation).

- a. Section 6225(a)(1) imposes the payment obligation on the partnership with regard to any “imputed underpayment” attributed to an adjustment.
 - b. That imputed underpayment results from applying “the highest rate of tax in effect for the reviewed year under section 1 or 11” by the net audit adjustment. See § 6225(b)(1).
 - c. Presumably the underpayment also includes interest and penalties. See Wasserman, *supra*.
 - d. Note that this payment is computed based on adjustments from the “reviewed year”, which predates the year of payment. It could be higher or lower than the tax due for a particular partner, if that tax was assessed on the partner for that tax year. (That is, the highest rate under sections 1 or 11 for the reviewed year --which would be 39.6% or 35% based on current rates -- may be higher or lower than the marginal rate for the individual partner after taking into account all personal tax attributes. See Wasserman, *supra*, at 119.) The new code allows for regulations to modify the rates for capital gains and qualified dividends for individuals, as well as certain rates for C corporation partners, but none have yet been promulgated. See § 6225(c)(4).
 - e. If an adjustment does not produce an underpayment, the adjustment item is apparently treated as a reduction in nonseparately stated income or an increase in non-separately stated loss. See § 6225(a)(2). But query: what if the item was a capital gain or loss or qualified dividend? Does this mean the partner will want to file an amended return to capture these amounts? Or could an increase in a capital loss become a “nonseparately stated item”, thereby benefitting the taxpayer? There may be errors lurking here that require correction.
4. Significantly, the “reviewed year” may have different partners than the current year, or different partnership shares. If the partnership makes the payment, the payment itself is likely not deductible for the current partners (though interest may be, and perhaps a state tax component which may be added on by local authorities), but it obviously has an adverse economic effect on them.
 5. There may be a partial solution to this inequity, but it is not entirely clear how this will work. A partnership may make an election under new section 6226 that takes it out of the regime of section 6225, described above, by notifying the Secretary and furnishing to each partner of the partnership for the reviewed year “a statement of the partner’s share of any adjustment to income, gain, loss,

deduction, or credit (as determined in the notice of final partnership adjustment).” § 6226(a)(2).

- a. In this case, the Partner adjusts tax due on the return for the year in which the statement is received, not the year under audit. See § 6226(b)(1).
 - b. The amount of the tax adjustment is apparently recomputed starting in the reviewed year and going forward. See § 6226(b)(2). Tax attributes are likewise adjusted. See § 6226(b)(3).
 - c. But what if the partner in the year the statement is received is not the partner in the reviewed year or any of the intervening years? How could a transferee partner figure out the tax consequences on the transferor? This option has not been well thought out.
 - d. Regarding penalties and interest, it should be noted that the partner must pay penalties in this option and that interest is computed from the due date for the tax return to which the tax increase is attributable (presumably, the taxpayer will have to show calculations for each year) and that the underpayment rate is increased by two percent – an additional “penalty” for electing this approach. See § 6226(c).
6. One other option exists to track to the tax liability for a partner based on the year that partner earned the income: a partner may file amended returns reflecting all adjustments allocated to him for the reviewed year and (presumably) other affected years. See §6225(c).
- a. If this happens, the “imputed underpayment” for the partnership will be modified to take into account those payments. Apparently, some mechanism for partnership notification will be required to implement this approach.
 - b. Legislative corrections may be needed here, as the literal language suggests that one amended return for the reviewed year must include all the tax due for subsequent years. See Wasserman, *supra*, at note 13. More than likely, separate amended returns for each intervening year (as there may be more than one year under audit) would be required. Moreover, it is not clear whether or how penalties would be addressed. See *id.* at 120-121. Statute of limitations issues are also presented. See *id.* at 121-22. Many other uncertainties are presented in this legislation, which will not be addressed in detail here. For example, will these rules trigger strategic exits and partnership terminations to avoid past liabilities? How will successor liability rules apply in this context? If a partner elects, will that partner escape economic effects of the remaining tax burden if it is imposed on the partnership?

7. Estate planners will need to consider the implications of these audit rules for clients that hold partnership interests in large partnerships, or in small partnerships that are not eligible to elect out of the new regime.
 - a. Watch for amendments to partnership agreements to seek indemnification for transferred liabilities among partners, or to require an election to amend prior returns. The economic impact of the tax shifting problem here is a prime target for private ordering. But note the practical challenges in extracting this kind of agreement from former partners, as well as in collecting on an indemnification from a partner who has exited, particularly after death.
 - b. Note potential valuation effects from partnership audits. If the partnership elects to pay the tax or pass through the tax to partners in the adjustment year, then the decedent's estate could be burdened by past liabilities if it is still considered to be a partner. Alternatively, that approach could exonerate the estate from past liability by shifting it to current partners, depending on conditions.
 - c. Potential elections to amend prior returns and pay the tax due instead of shifting the obligation to a future partner may present interesting new fiduciary challenges for executors of estates with partnership interests, as taxes paid may affect different classes of beneficiaries.
 - d. Partnership audits and these processes under the new rules generally take time – which will add to uncertainty in connection with the administration of the estate.
 - e. Query whether tax concerns will trigger strategic partnership exits? And once one partner heads for the exit, should the others follow? Form counts here, as liquidating distributions from the partnership could transfer past tax liabilities from the exiting partner to the remaining partners, while a sale of the partnership interest will shift them to the transferee without necessarily affecting the remaining partners.
 - f. Termination may become a more attractive option if it means potentially avoiding a past tax liability, but whether termination may be effective for this purpose is uncertain. Termination can be tricky. For example, if some form of the business continues to be owned by two or more of the former partners, that may be deemed a continuation of the former partnership. See, e.g., CCA 201315026 (March 4, 2013) (following Rev. Rul. 66-264 and ruling that merely getting a new EIN for a new entity that carries on former business does not mean a termination has occurred). Following termination, some tax attributes will follow the new partners. See, e.g., Treas. Reg. 1.708-1(b)(4). But others will not. See, e.g., IRC §

168(i)(7). Query how a partnership's tax liabilities from an earlier year (including those as yet unassessed) will be treated?

- g. Assessing tax risks in this context present other practical problems. Are there fiduciary obligations for disclosing tax risks to other partners/LLC members? What do those obligations look like? We have much to ponder from this legislation.

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