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Effect of Late Adjustments to Values at Death for Purposes of Setting the Income Tax Basis

-by Neil E. Harl*

The dramatic increase in recent years of the level of the applicable exclusion for federal estate tax purposes1 to the current level of $2,000,000 per decedent for deaths in 2008,2 $3,500,000 per decedent for deaths in 2009,3 has added to the incentive in estates below the applicable exclusion threshold to value property at death4 or as of the alternate valuation date5 as high as possible in order to obtain the highest possible income tax basis for the estate and the heirs6 in order to reduce the amount of gain on later sale or exchange (or to increase the amount of any loss) and to increase the amount of depreciation claimable after death.7 That incentive is even greater where there is no state inheritance or state estate tax or where there is no liability for state inheritance or state estate tax as in states where property passing to lineal descendants is not subject to any state death tax.8

The rapid increase in farmland values in recent years has increased the temptation to boost date-of-death values as a matter of record retroactively.9 The question has been raised as to the legitimacy of such after-the-fact efforts to set the valuation higher than would be justified by actual date of death values.

The statutory framework

The governing statute is clear – the value of the gross estate for federal estate tax purposes, as to all property – real or personal, tangible or intangible – is determined as of the date of death10 or as of the alternate valuation date, up to six months after death.11 Likewise, the statute specifying how the income tax basis is determined after death makes it clear that the income tax basis of property “. . . in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall. . . be – the fair market value at the date of the decedent’s death. . .” except for valuation under the alternate valuation date rules,12 valuation under the special use valuation provisions,13 or in the case of land subject to a qualified conservation easement.14

For the alternate valuation date rules, which allow valuation to be made as of “. . . the date of distribution, sale, exchange or other disposition” of the property during the six month period after death or, if not distributed, sold, exchanged or otherwise disposed of, as of six months after death,15 the valuation established under those rules relates back to the date of death for purposes of valuation and for purposes of post-death income tax basis.16 Thus, it is clear that all values, for purposes of income tax basis determination, are made as of the date of death and changes in valuation after death are immaterial except for the alternate valuation date provisions.

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Time for filing the return

The statute is clear that in all estates where the gross estate exceeds the applicable exclusion amount for the calendar year which includes the date of death, a federal estate tax return must be filed.\(^\text{17}\) The statute is equally clear that the federal estate tax return, Form 706, “. . . shall be filed within 9 months after the date of the decedent’s death.”\(^\text{18}\) Reasonable extensions are authorized, but no extension is to be for more than six months.\(^\text{19}\)

However, just because the gross estate does not exceed the applicable exclusion amount, $2,000,000 in 2008, does not mean that the values of property owned by the decedent can be adjusted after death. Indeed, there is no authority for adjusting the value of property within the time for filing a return with extensions except as the valuations reflect date of death values or values under the alternate valuation rules. As the regulations state, “. . . the basis of property acquired from a decedent is the fair market value of such property at the date of the decedent’s death, or, if the decedent’s executor so elects, at the alternate valuation date . . .”\(^\text{20}\)

Penalties for over-valuation

A person preparing an appraisal of the value of property who knew or should have known that the value would be used in a return or claim for refund is subject to a penalty\(^\text{21}\) if the claimed value results in a substantial misstatement\(^\text{22}\) or a gross valuation misstatement.\(^\text{23}\) The penalty is the lesser of 10 percent of the amount of the underpayment attributable to the misstatement or $1,000, whichever is greater, or 125 percent of the gross income received by the person from the preparation of the appraisal.\(^\text{24}\)

The general rules for penalties on understatement of a taxpayer’s liability apply to tax return preparers.\(^\text{25}\) If the understatement was because of an unreasonable position\(^\text{26}\) or to willful or reckless conduct,\(^\text{27}\) a penalty may be imposed of the greater of $1,000 or 50 percent of the income derived (or to be derived) by the tax return preparer with respect to the return or claim.\(^\text{28}\)

Of course, the array of penalties for taxpayers could apply as well to misstatements or understatements of value resulting in underpayment of tax on sale or exchange of the property after death including the accuracy-related penalty\(^\text{29}\) and the fraud penalty.\(^\text{30}\)

In conclusion

In one reported instance, an inventory was filed by an estate small enough not to be subject to state or federal death taxes with values for the real estate established as of the date of death. A year later, the real estate was sold and the inventory was amended to make the values equal to the selling price after a double digit increase in values. That is clearly improper.

FOOTNOTES

\(^2\) Id.
\(^3\) Id.
\(^4\) I.R.C. § 2031(a).
\(^5\) I.R.C. § 2032.
\(^6\) I.R.C. § 1014(a).
\(^7\) Id.
\(^8\) See, e.g., Iowa Code § 450.9 (2007) (property passing to the spouse, lineal ascendants and lineal descendants of the decedent is exempt from tax).
\(^9\) See, e.g., Duffy, 2007 Iowa Land Value Survey: Overview, p. 1, December, 2007 (22 percent increase in average Iowa farmland values from December of 2006 to December of 2007).
\(^10\) I.R.C. § 2031(a).
\(^11\) I.R.C. § 2032(a).
\(^12\) I.R.C. § 2032.
\(^13\) I.R.C. § 2032A.
\(^14\) I.R.C. § 2031(c).
\(^15\) I.R.C. § 2032(a).
\(^17\) I.R.C. § 6018(a)(1).
\(^18\) I.R.C. § 6075(a).
\(^19\) I.R.C. § 6081(a).
\(^20\) Treas. Reg. § 1.1014-1(a) (Emphasis added).
\(^21\) I.R.C. § 6695A(a).
\(^22\) See I.R.C. § 6662(e).
\(^23\) I.R.C. § 6662(h).
\(^24\) I.R.C. § 6695A(b).
\(^25\) See I.R.C. § 6694(a)(1).
\(^26\) I.R.C. § 6694(a).2.
\(^27\) I.R.C. § 6694(b).
\(^28\) I.R.C. § 6694(a).1.
\(^29\) I.R.C. § 6662(a) (20 percent of the underpayment).
\(^30\) I.R.C. § 6663(a) (75 percent of the portion of the underpayment which is attributable to fraud).