

The Art Market Adjusts: Alternate valuation dates for estates

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An estate is typically valued for estate tax purposes on the date of a decedent's death. However, if a decedent passed away at the end of 2019 or early 2020, when the stock market was at a peak, executors may have watched the decedent's estate lose significant value. The tax code has a mechanism for accounting for such estate value changes: the alternate valuation date election. If estate art advisors anticipate any negative impact to the art market in the next few months, it would be worth having a conversation about the alternate valuation date election with executors, as it may be useful for estates with significant art collections to consider.

In this Q&A, my colleagues Jimmy Dougherty and Sarah Verano discuss the alternate valuation date election and its relevance in the current climate.

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Sarah: Jimmy, in light of the market fluctuations we have been seeing over the past month or so, can you explain what the alternate valuation date election is, and why it is something executors might have on their minds right now?

Jimmy: The general valuation rule for estate tax purposes is that all property is valued based on its fair market value as of date of death. If there are fluctuations in value after death it does not change the value for estate tax purposes. This means it is possible that the executors are paying the estate taxes on property based on a value higher than that which will pass to the beneficiary. The alternate valuation date election provides executors potential relief from this scenario if the fair market value of property drops after the date of death. If the election is made, instead of using the fair market value as of the date of death, the executor would report the fair market value as of the date six months after the date of death. If property is distributed from the estate prior to six months, then the distributed property is valued at its fair market value on the date of distribution. Given the recent decline in the market, it is more likely that this election will be available to an estate to provide relief and lower the tax liability.

Sarah: This sounds like a very useful tool, but are there any circumstances which might prevent an executor from making this election?

Jimmy: An executor may only make the election if doing so would 1) decrease the value of the overall estate and 2) lower the estate tax liability. Both requirements must be met and each possesses its own challenges in satisfying. When making the election, the alternate valuation date applies to all assets in the estate. The executor may not selectively choose which assets to revalue. However, in an economic environment like today where values are generally down for many asset classes, this test is easier to satisfy.

The second prong often proves more challenging. Many married couples have estate plans in place that defer the estate tax liability to the death of the second spouse by utilizing the unlimited estate tax marital deduction. When the first spouse dies, no estate taxes are owed due to the marital deduction and therefore making an alternate valuation date election cannot lower the estate tax liability. Similarly, clients with philanthropic goals who have estate plans that utilize the unlimited estate tax charitable deduction may run into a similar issue. It is possible for fiduciaries and beneficiaries to take certain actions which would trigger an estate tax liability in the absence of the election. This would make the estate eligible to benefit from the alternate valuation date election.

Sarah: It is a little surprising that this second prong would present a challenge, as it is not immediately obvious why an executor would want to make an election that would not reduce the estate's tax liability. However, the ability to make the election could be very useful in a situation where a decedent's estate plan funds a credit shelter trust with the maximum value that can pass free of estate tax, and leaves the excess value to the decedent's spouse, utilizing the marital deduction. This excess value would be taxable on the death of the second

spouse. If an election were permitted, a lower value for estate assets could potentially permit the decedent to fund the credit shelter trust with more assets, leaving fewer assets exposed to estate tax on the death of the surviving spouse. In essence, such an election could result in a lower total amount of estate tax due on the combined estates of the two spouses. Also, even though no federal estate tax may have been owed, there could have been a state estate tax liability. By maneuvering into a position to make the federal election, the election could reduce or eliminate the state estate taxes.

If an executor determines that it is both advantageous and possible to make the election, practically, how is this done? How much time does an executor have to decide to make the election?

Jimmy: For federal estate tax purposes, the election must be made on the federal estate tax return (Form 706). The election is not available if the return is filed later than one year after the estate tax return was due (including extensions). If the estate is not eligible for the election because it did not reduce the value of the estate or tax liability based on the information reported on the return, it can make a protective election, which would allow the estate the benefit of the election if circumstances changed upon audit that would make the estate eligible. Once the election is made on a return it is irrevocable.

Sarah: Are there any circumstances in which executors might be able to, but ought not, make the alternate valuation date election?

Jimmy: The election has more than just estate tax implications—it has income tax implications as well. When a person dies owning property or has property included in his or her estate for estate tax purposes, those assets receive a new basis for income tax purposes—the fair market value as of the date of death. If the alternate valuation date election is made, the values used will become the income tax basis instead of the date of death value. This can create a greater income tax liability upon the sale of the assets depending on when the assets will be sold and the effective tax rates at the federal and state level.

Sarah: Are there any downsides or other consequences executors should consider before making the election?

Jimmy: One drawback of making the election is that assets will need to be valued as of both the date of death and the alternate valuation date. For hard to value assets that require appraisals, this can increase the administrative costs to the estate to have multiple valuations. Another drawback can occur where beneficiaries are receiving different property and/or how estate tax are apportioned to them. Depending on an estate plan, a beneficiary may be more concerned about estate taxes than income taxes or vice versa. It is possible that the election could benefit one set of beneficiaries at the expense of another. As a result fiduciaries must exercise their powers carefully and with clear communication to all parties.

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