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Accounting for Ag: Step Up While Passing Down

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By Austin Duerfeldt
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A major consideration in estate planning is the transfer of assets to the next generation. There might be corn in the grain bin, the prized family tractor, farmland and numerous other assets that are passed down in an estate.

First, we need to understand what basis in an asset is. Basis in any asset is simply what you paid for it, plus any capital improvements you've made, minus any depreciation you've expensed. Let's assume Dad buys land for $1,000 an acre. Dad didn't make any improvements to it and since land can't be depreciated, those factors don't come into play. Now Dad wants to sell that land and the current market value is $8,000 an acre. Obviously, Dad owes a bit of capital gains tax. What if Dad decides to hang on to that land and let his beneficiaries inherit it? The beneficiaries get the land at its fair market value on Dad's date of death. That's the step up in basis.

Let's assume we inherit the land and the value on Dad's date of death was $9,000 an acre. If we decide to sell the land for $9,000, we owe no tax. We're selling it for our basis in it after all. If we sell it for $10,000 an acre, we have a $1,000 per acre capital gain and we owe tax on this. It's also possible that land prices could fall. What if we hang on to the land and the value drops? If we sold the same piece of land for $8,000, we would take a $1,000 LOSS per acre on our tax return. Let's walk through this in more detail so we fully understand. The example will follow a married couple living in Nebraska.

Death of the first spouse

The initial step up in basis actually happens when the first spouse passes away. The Internal Revenue Service (IRS) looks at assets owned by a married couple, such as grain in the bin, as a 50/50 split between the couple. Let's assume we have 20,000 bushels of corn in the bin. According to the IRS, 10,000 bushels of corn belong to one spouse, while the remaining 10,000 bushels of corn belong to the other spouse. What that means at the time of the first spouse's death is that 10,000 bushels of corn inherited by the surviving spouse receives a step up in basis. If the price of corn was $3.45 on the date of death of the deceased spouse, the surviving spouse has the following: 10,000 bushels of corn with zero basis and 10,000 bushels of corn with a basis of $34,500. What happens if the surviving spouse sells the 20,000 bushels for $3.30? There would be a gain on the grain sale with zero basis of $33,000 and a loss of $1,500 on inherited property on the grain sale with a basis of $34,500.

The surviving spouse also inherits 50% of all the farm machinery and livestock. Let's assume that family tractor was purchased years ago and is fully depreciated. The remaining basis prior to death was zero, but now the surviving spouse gets to assume a new basis. That new basis is the fair market value in the deceased spouse's half of the tractor. If the fair market value is $40,000, then half would be $20,000. If the surviving spouse chooses to have a farm sale, they will be able to reduce the sale price of this tractor by their $20,000 basis on their tax return.

Farmland works the same way. Depending on how it's titled, the surviving spouse could inherit the deceased spouse's half of farmland at its fair market value on date of death.

Death of remaining spouse

Another step up in basis occurs when the second spouse passes away. For simplicity, we'll assume they had only one child that received everything, but it would work the same if the assets were split between multiple children, or even non-related parties. At this point, similar to what happened above happens again, but this time it's for the entire 100% of all assets. Let's assume that our one beneficiary is a farmer, and that the surviving spouse decided not to sell that tractor. The child inherits the tractor at its full fair market value at the date of death of the second spouse. They could choose to sell it as mentioned before, or if they decide to keep it for use, they could actually depreciate the tractor.

Estate of Backemeyer v. Comm., 147 TC 17, 2016

This Tax Court opinion out of Nebraska leads to some interesting options. The case dealt with an active, cash basis farmer who purchased customary amounts of prepaid expenses late in the year. Before those prepaid assets of seed, fertilizer, chemicals and fuel were used the following year, the farmer passed away. Mrs. Backemeyer took over the farm and used those assets to raise the crop in the year of death, filing her own Schedule F. She maintained that those prepaid assets should qualify for the step up in basis. In other words, the prepaid assets were routinely expensed in the year of purchase, but Mrs. Backemeyer held that they received the step up in basis which would allow her to claim the same costs again in the following year. The IRS initially disallowed Mrs. Backemyer's deduction. However, the tax court agreed with Mrs. Backemeyer and noted that "the estate tax intervened between the two deductions."

Current law not only supports the step up in basis for grain, livestock, machinery and land, but also for prepaid assets on hand. Considering this example, it may be beneficial to have plans in place to inventory remaining prepaid assets on hand on the date of death. For example, part of the seed may have been planted or part of the feed may have been consumed. For tax purposes, a beneficiary may be required to prove the remaining value of supplies.

Summary

Through this article, I hope you've gained a better understanding of the basics of a step up in basis. A step up in basis can be viewed as an opportune time to sell long held farm ground that appreciated in value, with little to no capital gain issues. It plays a vital role in estate planning. In the individual case of each farmer/rancher, how the step up in basis might work for your operation varies on many specific circumstances. Developing an estate planning team that includes professionals such as an attorney and accountant, as well as, investment and insurance advisors will help you develop a strategy that works best for you. If you have questions please feel free to reach out to me, Austin Duerfeldt – Nebraska Extension Agricultural Economist, at 402-873-3166.

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