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Improving farm management skills one topic at a time

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Things to Consider When a Loved One Passes Away

When a loved one's health is failing, it doesn't seem like a time when you should be thinking about finances or accounting but the reality is there are some really important things that you should be aware of that could save you significant amounts of tax. It also doesn't seem like your accountant or attorney should be on the list of people to notify but they should be. For many clients with a long-term relationship we appreciate knowing from a personal standpoint but we can also help you navigate these times to make sure things are done in everyone's best interest.

Step Up In Basis

When an individual passes away, a tax provision called the Step Up in Basis comes into play. This allows most assets that are owned by the individuals to receive a new basis that is equal to the Fair Market Value on the date of death. This allow the heirs to sell the property with no income tax liability. Some assets that are considered Income in Respect to the Descendent (IRD), such as rent, IRA's, wages due or unpaid interest and dividends do not receive this new basis. When these income items are received, there will be an income tax due. This step up in basis is a big deal for any individual who passes away but there are special applications for a farmer who is still actively participating (typically filing a Schedule F) in the farming operation when he dies.

Depending on when an active farmer passes away, his or her balance sheet may include carryover grain or feeding livestock, prepaid expenses and potentially growing crop. Each of these assets are eligible for a step up in basis.

Grain and feeding livestock

Grain or feeding livestock that was produced in a previous tax year has zero basis when it is sold because all the cost to produce that crop were deducted on the previous tax return. If grain is sold prior to an active farmer's death, it is fully taxable (including self-employment taxes) on the final Schedule F. If it is sold after death, there is no tax due. As strange as it seems to think about, if a farmer is near death, not selling (including making contracts for future dates) grain or feeding livestock before he or she dies could result in a significant tax savings.

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Growing Crop

Once a crop is in the ground, we have to establish a value for it on the date of death. The closer the crop is to harvest, the higher the value. Essentially shortly after planting the crop is worth slightly more than the inputs and right before harvest it would be worth the value of the bushels minus a harvesting expense. Finding the value in between isn't always easy but the important thing in this context is that that value creates basis in the crop so when it is sold, there is a deduction for the value of the growing crop.

Prepaid Inputs

Until a recent court case (Backemeyer v IRS, December 2016) we did not have substantial authority on what to do if the farmer died between the first of the year and when the crop was in the ground. Since the case was final, we now can confidently take a step up in basis on inputs that were bought and deducted in a previous tax year by the decedent. Prepaid expenses such as fuel, fertilizer, feed, seed, chemicals, etc are assets that are subject to the estate tax and are eligible for the step up in basis. If these assets are still in the decedents' position on the date of death (the crops have not been planted), we can essentially re-duct them. One thing to consider if this applies is that the fair market value of the prepaid expenses are typically higher after the first of the year than they were when purchased because of early pay discounts, market price changes, etc. The new value of these assets is the value that is deductible.

Depending on the size of the operation, these strategies could save hundreds of thousands of dollars in taxes if we are able to plan around a looming death. Obviously, death is not always something we get warning for. When the unexpected happens, many of the same principles apply but some things may already be done and unable to change. One thing we can do after death is elect portability.

Portability

The Tax Cuts and Jobs Act of 2017 increased the Federal Estate Exclusion to $11.2 million for 2018 (indexed for inflation) per person. There is no requirement to file a Federal Estate Tax Return if your net worth is less than the exclusion amount but the exclusion is set to return to a level about ½ the current value in 2026. One important thing that we have the option to do is to elect Portability for the first spouse to pass away. This election allows any unused exclusion to transfer to the spouse who is second to die but it must be made on a timely filed Form 706 (Federal Estate Tax Return).

Example 1:

Fred and Pam Smith are married and have a net worth of $10 million. Fred dies in December of 2018. His estate is worth ½ of the $10 million or $5 million. He has no filing requirement and his share of the assets pass through to his heirs per his will.

Pam lives another 10 years and dies in 2028. During the past 10 years, her $5 million of assets have grown in value to $7.5 million. Also during that time, the increased exemption has gone away and is only $6 million (assuming inflation has raised the limit during that time). Pam has a taxable estate because she has net worth more than the federal exclusion. Her estate would owe roughly $600,000 in Federal Estate Taxes.

That tax could have been avoided entirely if the portability election had been filed when Fred died in 2018. He had unused exclusion of $6.2 million ($11.2 million Federal Exclusion - $5 million estate) which could have been transferred to Pam, making her Federal Exclusion in 2028 $12.2 million.

The portability election goes away if Pam was to remarry during those 10 years but it is a fairly simply way to pass on unused exclusions which we will see a lot of over the next 8 years. This example also assumed some estate planning was done by leaving ½ the estate to heirs instead of to the surviving spouse. If Fred had left everything to Pam, her estate would have been worth $15 million (assuming the same increase) and she would have had Fred's full exclusion of $11.2 Million plus her $6 Million and still been able to get it all tax free to their heirs.