

February 10, 2009

- by Roger McEowen*

Overview

The presence of unharvested crops in a decedent's estate raises income tax and, if the estate is large enough, estate tax issues. The matter can be complicated if the decedent's farmland was rented and crop rent had accrued but had not yet been received as of the date of the decedent's death.

There are several possible ways to determine the value of unharvested crops.¹ One approach is to arrive at a value by discounting the crop by the amount of risk involved between the date of death and harvest with the amount of risk tied to the type of lease involved. Alternatively, the crop could be valued by the amount of a loan, secured by the crop that could have been negotiated as of the date of death. Or, perhaps the simplest (and least beneficial to the decedent's estate) approach would be to pro-rate the allocation of the crop proceeds between the pre-death and post-death periods. It is this pro-rata approach that IRS utilizes to address both estate tax and income tax issues involving unharvested crops in a decedent's estate. In addition, some states (such as Iowa) follow the pro-rata approach for purposes of state-level taxes.

Character of Income and Basis Issues.

General rule. Under the general rule, property interests of a decedent that the decedent owns at death are valued for estate tax purposes at their fair market value as of the date of the decedent's death.² For income tax basis purposes, the basis

of property that is included in a decedent's estate equals the value of the property as of the date of the decedent's death.³ This is generally known as the "stepped-up" basis rule, although it is also possible that property values could have declined as of the date of death. The rule operates to eliminate any taxable gain in the property upon later sale by an heir at the date of death value.

Exception. Income in respect of decedent (IRD) property does *not* receive any basis step-up.⁴ IRD is taxable income that is received after a taxpayer has died – it is income the taxpayer earns before death, but is not included on the decedent's final income tax return because the taxpayer was not eligible to collect the income before death. IRD is subject to both income tax and (for large estates) estate tax. So, while IRD does not receive a basis step-up by virtue of being included in the decedent's estate, the recipient of the IRD is entitled to a deduction for the federal estate tax that is attributable to the IRD as a result of its inclusion in the decedent's estate.⁵

Application of the IRD Rule

The IRD issue turns on the status of the decedent at the time of death. Two questions are relevant – (1) was the decedent an operating farmer or a farm landlord? and (2) if the decedent was a farm landlord, was the decedent a materially participating landlord or a non-materially participating landlord?

Operating farmers and materially participating landlords: For operating farmers (including a materially participating farm landlord) unsold livestock, growing crops and grain inventories are *not* IRD.⁶ The rule is the same if the decedent was a landlord under a material participation lease.⁷ Those assets are included in the decedent's gross estate and receive a new basis equal to their fair market value as of the decedent's death.⁸ No allocation is made between the decedent's estate and the decedent's final income tax return.⁹

Non-materially participating landlords: For non-materially participating farm landlords that die during a rent period, the matter is more complex. If a cash basis landlord rents out land under a non-material participation lease, the landlord normally includes the rent in income when the crop share is reduced to cash or a cash equivalent, not when the crop share is first delivered to the landlord. In this situation, a portion of growing crops or crop shares or livestock that will be sold post-death will be IRD and a portion will be post-death ordinary income to the landlord's estate. That is the result if the crop share is received by the landlord before death, but is not reduced to cash until after death. It is also the result if the decedent had the right to receive the crop share, and the share is delivered to the landlord's estate and then reduced to cash. In essence, an allocation is made with the portion of the proceeds allocable to the pre-death period (in both situations) being IRD in accordance with a formula set forth in Rev. Rul. 64-289.¹⁰ In these situations, IRD is not incurred until the crop share is sold. However, if the landlord received the crop share and sold it *before* death, the income realized is includable on the landlord's final return and is not IRD.¹¹

Note: If the estate sells grain inventory within six months after death, the income from the sale is treated as long-term capital gain if the basis in the crops are not IRD (in other words, if the basis in the crops was determined under the I.R.C. §1014 date-of-death fair market value

rule).¹² Also, while the sale of raised crops or livestock in the estate of an active farmer usually triggers ordinary income, the sale by the estate of land with growing crops results in capital gain treatment for the income that is attributable to the crop.¹³ The same result can be achieved when the crops are harvested during the process of liquidating the farming operation and the land is sold. But, ordinary income treatment occurs if the crop is being raised on land that is leased to a tenant.¹⁴

The allocation formula set forth in Rev. Rul. 64-289 splits out the IRD and estate income based on the number of days in the rental period before and after death.

Example:

On February 4, 2008, Jerry Mander leased his farm to a tenant on a 60/40 crop share lease (i.e., Jerry gets 40 percent of the crop and pays for 40 percent of the expenses). The lease ran from March 1, 2008 through February 28, 2009, and was for the growing of corn and soybeans on Jerry's farm. Jerry died on July 4, 2009. The tenant harvested the corn on October 15 and sold it later the same day for \$135,000. The soybeans were harvested on October 7 and stored. The soybeans were later sold on January 27, 2009, for \$40,000.

The allocation formula would operate as follows: The lease period was for 365 days (March 1 to February 28) and Jerry was alive for 126 of those days. Thus, 126/365 of the amount that the estate received for the corn is IRD - \$18,641.10 (.4 x \$135,000 (126/365)). The balance of the amount received by the estate (\$35,358.90) is taxable to the estate as ordinary income. The entire amount that the estate received for the soybeans (\$16,000) is taxed to the estate as ordinary income.

Note: Expenses attributable to IRD items are deducted as an expense on Schedule K of Form 706 (federal estate tax return) and are deducted as an expense item on the income tax return of the person or estate when the expense item is paid.

Note: If Jerry had died *after* the crop shares were sold (but before the end of the rental period), the proceeds would have been reported on Jerry's final return. No proration would have been required.

Note: If Jerry had received his crop share in-kind and held it until death with the heirs selling it after death, the sale proceeds would be allocated between IRD and ordinary income of the estate under the formula set forth above.

For crop share rents of a non-materially participating landlord that are fed to livestock *before* death, if the animals are also owned on shares, IRD results. If the decedent utilized the livestock as a separate operation from the lease, the in-kind crop share rents (e.g., hay, grain) would be treated as any other asset in the farming operation – included in the decedent's gross estate and entitled to a date-of-death fair market value basis.

Crop share rents fed to livestock after the landlord's death are treated as a sale at the time of feeding¹⁵ with an offsetting deduction.

State-Level Taxation

Some states have specific rules for handling unharvested crops at death for tax purposes. In Iowa, for example, the Iowa Department of Revenue (IDOR) follows the pro-rata approach. Thus, growing crops owned by a decedent at death are valued via a formula.¹⁶ Under the

formula, the cash value of the crop realized upon sale is prorated by attributing a portion of the value to the period before death and a portion to the period after death. The amount attributed to the pre-death period is the value for Iowa inheritance tax purposes. The numerator of the ratio expresses the number of days the decedent lived during the growing season (corn and soybeans) – which is considered to be May 15 through October 15 (153 days). The 153-day period is the denominator. The ratio is multiplied by the number of bushels realized upon harvest with that result multiplied by the local elevator price at the time of maturity. However, if the estate sells the crop within a reasonable time after harvest in an arm's length transaction, the selling price can be used as the fair market value basis. The regulation provides the following example:¹⁷

Example:

The decedent raised corn and beans and died on August 15. Thus, the decedent lived 92 days of the growing season. In the fall, the estate harvested 2,000 bushels of corn which were sold to a local elevator for 3.10/bushel. As a result, the value of the crop for Iowa inheritance tax purposes would be \$3,728.10 ($92/153 \times 2,000 \times \3.10).¹⁸

The regulations also address the valuation issue if the decedent was a farm landlord with a tenant operating under a cash lease.¹⁹ In that situation, the Iowa inheritance tax value of the crop is determined in accordance with a formula in which the cash rent for the entire rental period is prorated over the entire year. The proration period is the number of days the decedent lived during the rental period, divided by 365 days. The resulting percentage is then applied to the total cash rent for the entire year. The regulation allows a deduction for rent payments made before death and specifies that if such a deduction results in a negative amount, no refund or credit is allowed.²⁰

Note: Apparently, crop harvesting costs can be deducted from the value of

the crop that results from the use of the formula.

Other states don't have specific procedures for valuing unharvested crops.²¹ In those states, value is arrived at by either discounting the crop by the amount of risk involved between the date of death and harvest with the amount of risk tied to the type of lease involved or by pegging the crop's value to the amount of a loan, secured by the crop that could have been negotiated as of the date of death. There may also be other acceptable methods of arriving at a reasonable value for unharvested crops.

Deceased Farm Landlords - Crop Rental Income Income Tax Issues

Crop rents that have accrued as of the date of the decedent's death, but which the decedent did not receive before death are included in the decedent's gross estate.²² They are not allocated between the estate and the decedent's final income tax return.²³ According to the IRS, a crop rent which is not payable until harvest is included, to the extent it has accrued, in the decedent's gross estate even though the decedent died before harvest. For estate tax valuation purposes, the crop is valued as of the date of death or six months after death if the executor makes an alternate valuation election.²⁴ If an alternate valuation election is made, any increase in value attributable to crop growth during the six-month alternate valuation period is not directly included in the gross estate.²⁵ Instead, the crop value (for both date-of-death and alternate valuation purposes) is allocated between the pre-death and post-death period in accordance with a formula. The formula multiplies the value by a fraction. The numerator of the fraction is the number of days in the part of the rental period which ends with the decedent's date of death, and the denominator is the total number of days in the rental period. When the crop is later sold (or fed to livestock) the sale proceeds (or the value of the crop on the date of disposition by feeding to livestock) are plugged into the formula to determine which portion of the crop rental is

income in respect of decedent (IRD) and which portion is income to the estate.

*Leonard Dolezal Professor in Agricultural Law, Iowa State University, Ames, Iowa, and Director of the ISU Center for Agricultural Law and Taxation. Member of the Iowa and Kansas Bar Associations and licensed to practice in Nebraska.

¹ The following possible ways to value an unharvested crop were suggested to the author as a first-year practicing attorney by Donald H. Kelley, then of Kelley, Scritsmier and Byrne in North Platte, NE.

² I.R.C. §2031.

³ I.R.C. §1014(a)(1).

⁴ I.R.C. §691.

⁵ The deduction occurs in the year the income from the IRD property is recognized. I.R.C. §691(c). The deduction is computed at the average estate tax rate and is determined by the ratio that the value of the items bear to the gross estate. This is because the amount subject to tax is lesser than the value of the gross estate. In addition, the deduction is allowed regardless of whether the IRD item is used to fund a marital deduction for the surviving spouse (in estate of the first spouse to die). Thus, in larger estates, it may be wise practice to fund the marital deduction with IRD items or with property items that are intended to be held by the recipient rather than resold or which have relatively low appreciation.

⁶ Rev. Rul. 58-436, 1958-2 C.B. 355.

⁷ Rev. Rul. 64-289, 1964-2 C.B. 173. While the Internal Revenue Code and the Treasury Regulations are unclear on the issue, it appears that the decedent could achieve material participation through an agent.

⁸ See, e.g., Estate of Tompkins v. Comr., 13 T.C. 1054 (1949). This is the rule for decedents on the cash method. For those on the accrual method, the items would be included in the decedent's closing inventory on the final return.

⁹ Treas. Reg. §20.2031-1(b).

¹⁰ 1964-2, C.B. 173 (1964). The formula is directed to decedents who were on the cash method and specifies that for decedent's dying during the rent period, only the crop (or livestock share) rents attributable to the rent period ending with the decedent's death are IRD.

¹¹ *Id.*

¹² I.R.C. §1223(11). But, this treatment does not apply to cattle (which must be held for 24 months) or other livestock (which must be held for 12 months) if the animals were used in the decedent's trade or business and were held for draft, breeding or sporting purposes. Rev. Rul. 75-361, 1975-2 C.B. 344. The ruling points out that there is no exception under

I.R.C. §1223(11) from the special holding period requirements of 24 months for cattle and 12 months for other livestock. See I.R.C. §1231(b)(3)(A)-(B). However, the holding period requirements don't apply to livestock held for sale, such as non-replacement calves. This type of livestock, if included in the estate of an active operator or a materially participating landlord are classified as property and are entitled to a basis equal to the date of death value, and any resulting gain upon sale is entitled to long-term capital gain treatment.

¹³ I.R.C. Secs. 268, 1231(b)(4).

¹⁴ See, e.g., *Bidart Brothers v. U.S.*, 262 F.2d 607 (9th Cir. 1959).

¹⁵ Rev. Rul. 75-11, 1975-1 C.B. 27.

¹⁶ IAC §701-86.11(7).

¹⁷ *Id.*

¹⁸ The resulting amount can be reduced by harvesting costs. Such reduction does not appear to be mandatory and, if taken, will increase the income tax payable by reason of the resulting increase of IRD.

¹⁹ IAC §701-86.11(8).

²⁰ *Id.* The regulation also states that the valuation formula is to be utilized whether the decedent is the landlord or tenant of the property.

²¹ Conversely, some states not having established procedures for valuing unharvested crops may have rules for valuing mineral interests at death. In Kansas, for example, interests associated with oil and gas leases are treated as tangible personal property. If the interest is large enough, an appraisal will be necessary. But, for smaller interests the state may prescribe the valuation approach to be used. For example, in Kansas, with respect to oil leases and royalties, the average annual income from production for the immediate three years before death is to be multiplied by 3.5. For a gas well, the average annual production for the five years immediately preceding death is to be multiplied by 10. If no production had occurred in the prior five years, valuation can be based on original cost if the gas well was purchased within a reasonable time before death and there has not been activity in the area to cause an increase in value.

²² I.R.C. §691(c).

²³ *Id.*

²⁴ See, e.g., I.R.C. §2032.

²⁵ Compare Priv. Ltr. Rul. 7743007 and Priv. Ltr. Rul. 7805008.