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Death, Farmland, and Taxes

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Sometimes there are topics and situations that are ripe for confusion and chaos. If one combines uncertainty, never-ending attention, and significant financial implications, it's the recipe for considerable angst among decision-makers. In our minds, the rumblings of proposed changes to capital gains and estate taxes – especially as they apply to farmland - is a near-perfect storm of decision-making chaos.

Adding to the chaos surrounding the tax debate is great confusion given the numerous proposals[1], multiple moving pieces, and a decent measure of fearmongering. Considering all this, we thought it would be helpful to step back and write a bit about the situation.

Before diving in, we should state directly that we are not offering tax, investment, or estate planning advice. The following is simply an attempt to summarize the current situation and provide the reader with ideas for navigating any future legislative changes that might play out.

Three Levers

There are three primary levers that affect farmland taxes at the federal level[2]. As a starting point, let's review and define each:

Capital gains are incurred when a capital asset is sold above its tax basis. The tax basis is often the original purchase price but can also be affected by depreciation, such is the case with farm equipment.

For a farmland example, consider a purchase made in 1985 that could be sold today for considerably more. The relevant metric for calculating the capital gains tax liability would be the gains (current value less purchase price) and the capital gains taxation rate. A few details to consider:

- The most common change for capital gain is the taxation rate or the percentage of gains (income) upon which taxes are assessed.
- Generally speaking, capital gains are due when the asset is sold. This makes practical sense, given it is preferable to line up the tax liability with when the earnings are realized, and cash flows are generated.

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[1] We previously summarized the various proposals here: https://forecastnetwork.com/external/deeper_dive/179774

[2] Local and state property taxes weren't considered in this article, but can be a very significant annual cash outflow. There are also states that have estate taxes, which weren't considered in this article.

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- While capital gains on farmland are the center of this discussion, taxation on capital gains is also relevant to stock portfolios, farm equipment you sell above its depreciated value, etc.
- Like seemingly everything with taxes there are some exceptions. For instance, gains on the sale of a primary residence are treated differently than other capital assets. Likewise, the tax code also currently provides for capital gains on real estate to be deferred with a Section 1031 exchange, provided the funds are re-invested in a “like-kind” investment property.

Stepped-up basis comes into play when someone inherits a capital asset, such as farmland. As discussed earlier, the “basis” comes into play when calculating capital gain. If you inherited a farm, you would do so with stepped-up basis, meaning if you sold the farm in the future, the basis for calculating potential capital gain would be the market valuation at the time of inheritance. This provision allows farmland with a very low basis to be “stepped-up” to today’s value. Thus, when sold the capital gains are calculated using this updated basis.

Estate taxes fall under the broader category of transfer taxes, which includes estate and gift taxes. When someone dies, their estate is subject to potential taxes based on the gross market value of all assets – cash, properties, investments, life insurance proceeds, etc. If estate taxes are due, they are paid by the estate. There are two major elements to estate taxes, the taxation rate, and exemption rate; both have changed significantly in recent memory. In 2021, the exemption amount is $11.7 million per individual, with an estate tax rate of up to 40%. In 2000, the exemption amount was only $675,000 with a top estate tax rate of 55%.

- Conversations about estate taxes should also include gift taxes. The general rule is that any gifts under the current annual gift exemption threshold (in 2021, $15,000 per recipient) are exempt from a gift tax paid by the gift marker. Gifts above the threshold would trigger a gift tax or become intertwined into the estate tax exemption threshold. In other words, gifts above $15,000 and before death begin to use up the $11.7 million exemption.

A few examples

Sometimes it’s helpful to think about which levers come into play under different scenarios. Consider the following:

- Selling a farm, you purchased: if you decided to sell a farm, the tax liability on that farm would be based on the prices at which you purchased the farm. The amount of capital gains tax you owe would be subject to the gains and the taxation rates.
- Inheriting a farm: A relative passes away and you inherit a farm. The estate may incur estate taxes (based on the value of the entire estate). You would inherit the farm on stepped-up basis, meaning when you sell the farm, any potential capital gains tax will use market value at

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inheritance for the tax basis. If you sold the farm at the same value as the "stepped-up basis" value, you'd trigger no capital gains tax.

- Taxes at death: At your death, the value of your estate – gross, market value - would be calculated. If your estate exceeds the threshold value, an estate tax would be triggered.

Capital Gains and Stepped-up Basis in the Crosshairs

If you carefully listen to the various proposals, there has been a consistent argument being made - "Eliminate the stepped-up basis loophole." This even came up in Secretary of Agriculture Tom Vilsack's recent op-ed. While the argument sounds simple, there appear to be confounding issues.

In general, the argument for eliminating the provision goes like this: the gains on a capital asset - farmland, stock market investment, art, etc. – are never realized if the asset is never sold or sold immediately after inheritance. This isn't to say there are no taxes paid – annual income taxes on earnings generated and estate taxes are still in play - but the capital gains are never paid.

How does this occur? First, capital gains are – in general – realized when the asset is sold. Second, at death, those assets are transferred with stepped-up basis, effectively resetting the measuring point for calculating the capital gains the heirs would face. Consider the following two scenarios:

- If someone sold 1,000 acres of farmland but passed away the following week, there would be:
  - Capital gain based on the sale of 1,000 acres.
  - Estate taxes based on the cash from that sale of farmland.
  - Heirs would inherit the remaining cash.
- Alternatively, someone dies and passes along the 1,000 acres to their heirs. They are selling it the following week. There would be:
  - Estate taxes based on the value of farmland.
  - Heirs would inherit the farmland with stepped-up basis.
  - No capital gains as the heirs sold the farm at the valuation established by stepped-up basis.

We aren't trying to argue one way or another. However, we believe it's always valuable to highlight the alternatives. Both scenarios have roughly the same economic outcome: a death, a transfer of wealth, and 1,000 acres of land are sold. However, the timing and order of those events trigger very different taxation implications. Specifically, capital gains are triggered and due in the first, but not the second.

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While perhaps oversimplified, the above example highlights how policymakers are thinking about the problem. Stepped-up basis has been the scapegoat, but another contributing factor is how capital gains are recognized.

Stepped-Up Basis and Recognizing Capital Gains

There are essentially two leading arguments for how to tackle the problem. Congress could either eliminate stepped-up basis and/or change the treatment for how capital gains are recognized. While the goals are the same, there are very different implications with these proposals.

In the first scenario, eliminating stepped-up basis isn't very problematic or consequential, especially if your heirs plan to keep the farm or asset. If, however, they do ever sell the asset, they could face significant capital gains taxes as they have the initial purchase price (or basis) to calculate that tax. If farmland was bought for $300 per acre in 1980, that would be its tax basis for whenever it's sold in the future. In addition, if the estate tax is calculated on market values instead of the basis value, there could be significant estate taxes due.

In the second scenario, Congress could change how and when capital gains are realized and taxed. One informal proposal is calculating each year how much appreciation occurred and paying the tax annually, a pay-as-you-go method of sorts. This approach has obvious challenges and expenses that would be associated with respect to arriving at valuations for assets like farmland. A second proposal would be for the estate to be responsible for any capital gains of the inherited property. In other words, the estate would pay capital gains, estate taxes, and then heirs would inherit the farmland with stepped-up tax basis. The question would then become whether the capital gains taxes would be deducted from the gross value of the estate. Substantial changes to the recognition of capital gains are where all the doomsday scenarios come to life. As shown above, such changes would likely decouple the realization of gains with cash flow events. In other words, yes, there have been earnings, but there is no cash flow generated. This is where the fears of selling or mortgaging the farm to pay the tax bill would meet reality.

Unintended Consequences

Another concern worth keeping an eye on would be carve-outs or exemptions for agriculture. While having the potential of being politically attractive, these would have the subject of creating all types of unintended consequences. You can imagine all rules and tests that would go into effect if individuals had to prove they were actively farming or actively managing their business to avoid a different and less appealing set of tax rules.

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Along the same lines, we also have to realize capital gains, stepped-up basis, and estate taxes are not specific to agriculture, and other families and businesses will be subject to these as well. This is politically valuable as it affects a large cross-section of the economy and population. Cutting the other direction, it provides an idea about how many people might be using any perceived loophole.

Wrapping it Up

In general, the current taxation environment is perhaps the most favorable experience in your career. This is a scenario where the tax situation in the future probably could be less favorable. While all future scenarios are perhaps less favorable than the status quo, it's important to also realize some changes could be less consequential than others. In our mind, just eliminating stepped-up basis (no tax due until sale) would be less worrisome than decoupling the recognition of capital gain with the cash flows – for example, each year or at death.

One constant has been frequent changes to the estate tax rate, capital gains tax rate, and estate tax exemption levels. While these can have significant implications, they certainly wouldn't be as significant a change in, say, when capital gains are realized. Those carefully monitoring the debate and following the situation could consider the likelihood and implication of the following possible changes:

- Change to the capital gains taxation rates
- Change in the inheritance tax exemption level
- Change to the inheritance taxation rates
- Elimination of stepped-up basis
- Change in recognition of capital gains: at death
- Change in recognition of capital gains: annual

We all know the old saying that nothing in life is more certain than death and taxes. It's perhaps ironic that there is perhaps nothing as uncertain as to the timing of death or the rates and rules of future taxes.

One more thing: The Year with No Estate Taxes Wasn't Quite a Home Run

Here is a peculiar, real-life example of how capital gain and estate taxes can play out. In 2010, the owner of the New York Yankees – George Steinbrenner - died. The year is important and noteworthy because a sunsetting clause and lack of Congressional action resulted in there being no federal estate taxes that year. It's been estimated that his estate would have had to pay $500 million to $600 million in estate taxes. As one could imagine, this seems like a huge windfall for his family, but it wasn't quite a home run.

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Another quirk of 2010 was no stepped-up basis. This means his heirs have the same tax basis as when the franchise was purchased in 1973. In 2010, it was estimated the Steinbrenner share of the Yankees franchise was $880 million, compared to the original purchase price of $10 million. It goes without saying that capital gains are going to be an issue if they ever sell the team – or if there is a significant change to when capital gains are realized.

The takeaway from this? The interaction among estate taxes, stepped-up basis, and capital gains has several moving parts. While the Steinbrenner estate avoided the estate takes – to the tune of hundreds of millions of dollars – the heirs ended up with a huge potential capital gain tax liability if they ever sell.

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