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Robert P. Achenbach, Jr.
Contributing Editor
Dr. Neil E. Harl, Esq.

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Handling Prepaid Expenses at Death

-by Neil E. Harl*

Assets held until death, other than for assets producing income in respect of decedent,[1] generally receive a new income tax basis at death.[2] The basis of income in respect of decedent items, by contrast, is not adjusted at death, under the theory that the income is too close to being earned.[3] Income in respect of decedent assets carry over the decedent's basis into the hands of the heirs or other successor to the decedent.[4]

The question, often raised, is how are prepaid expenses handled? Are prepaid feed, seed, fuel, interest, rent and other prepaid expenses treated as intangible assets with a new basis at death? Or is the decedent's basis (usually zero because the expense has been deducted by the decedent or on the decedent's final return) carried over to the successor? Surprising as it may seem, there is relatively little direct authority on that point.

Rent as a prepaid expense

In a 1962 Tax Court case,[5] one of the few cases to deal with prepaid rent, the decedent left a will directing that a 50-year lease be entered into for business property included in the estate. The lessor then proceeded to argue that the value of the lease should be amortizable.[6] The Tax Court held that the lease had no value at death and the lease was not "acquired from the decedent" as is necessary for a new basis at death to be obtained under I.R.C. § 1014,[7] so the leasehold did not support an amortization deduction. Thus, partly because of the unique facts of the case, the court sidestepped the question of whether the prepaid rent was an asset that would be eligible for a new basis at death.[8]

Is prepaid expense an intangible asset or an accrued income item?

If a prepaid expense is deemed to be an accrued income item, arguably the item would be considered income in respect of decedent.[9] Under the income in respect of decedent statute, the scope of income in respect of decedent is ". . . all items of gross income in respect of a decedent which are not properly includible in respect of the taxable period in which falls the date of his death . . . "[10] If so, the amount is to be included in gross income of the estate or other person who, by reason of death, acquires the right to receive the item.[11] If a prepaid expense amount is refundable, or otherwise could yield income, it could conceivably be considered to be an income item and fall within the income in respect of decedent statutory framework. In that event, the item would not be eligible

* Charles F. Curtiss Distinguished Professor in Agriculture and Emeritus Professor of Economics, Iowa State University; member of the Iowa Bar.

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eligible for a new income tax basis at death. Presumably, most prepaid expense Items have a refund value or an exchange value that could be considered income within the meaning of the statute.

On the other hand, one could make a similar argument about many items that are eligible for a new basis at death including share rents under a material participation lease[12] or stored crops for a farm operator.[13]

The policy argument

One obvious obstacle to awarding prepaid expenses a new basis at death is that the decedent presumably deducted the expense once on the regular income tax return (or the decedent's final return) and to give the expense item a new basis at death and permit a second deduction to be claimed for the same expense by the estate of the decedent or the successor or successors to the decedent seems improper. However, the same argument could be made for depreciable property – that many assets are fully depreciated out by the decedent and yet the asset is typically eligible for a new basis at death, permitting the estate and the successors to depreciate the same asset a second time.

The policy argument may carry greater weight when applied to prepaid expense because of the ease with which a prospective decedent could maximize the tax benefit by loading up with prepaid expense right before death.

The tax benefit rule

An argument could be made that the tax benefit rule[14] could be invoked as it was in *Bliss Dairy*. In that case, purchased feed, which had been deducted for income tax purposes was allocated a basis after corporate liquidation, permitting a second deduction for the same feed. The tax benefit rule required the corporate taxpayer to recognize income with respect to the distribution of the purchased feed which had been expensed.[15] Again, arguably, the argument could be made that the tax benefit rule, if applied to prepaid expense, could also be applied to other items passing through the estate at death and receiving a new basis.

Related problems

Although it does not necessarily involve death of an individual, and eligibility for basis adjustment at that time, the courts have treated accounts receivable of partnerships as "a right to receive income in respect of a decedent"[16] so that I.R.C. § 1014(c) applies, meaning that no new basis is obtainable at death and a Section 754 election requires a reduction of the new basis at death for the accounts receivable.[17] By contrast, prepaid interest which was deducted by a partnership was allowed an adjustment in basis after the sale of a partnership interest and a Section 754 election on the grounds that the deduction for amortization of the prepaid interest over the remaining amortization period was justified in that a purchasing partner has an expectation of receiving the benefit of the remaining unamortized prepaid interest.[18] The expectations of successors after death are less easily dealt with than was the case with purchasers of an interest in the partnership in that case.

In conclusion

Resolution of the issue will require further litigation or the issuance of a definitive ruling by the Internal Revenue Service. Unfortunately, the typical situation where this question arises in a farm or ranch setting rarely has involved sufficient tax liability to justify either litigation or a request for a ruling.

Footnotes

[1] I.R.C. § 691. See generally 6 Harl, *Agricultural Law* § 47.03 (2006); Harl, *Agricultural Law Manual* § 6.02[1] (2006).

[2] I.R.C. § 1014(a).

[3] I.R.C. § 1014(c).

[4] Treas. Reg. § 1.691(a)-1.

[5] C.G. Sloan v. Comm'r, 38 T.C. 203 (1962).

[6] *Id.*

[7] I.R.C. § 1014(a), (b).

[8] See I.R.C. § 1014.

[9] I.R.C. § 691. See Treas. Reg. § 1.691(a)-1(b)(3).

[10] I.R.C. § 691(a)(1).

[11] *Id.*

[12] Rev. Rul. 64-289, 1964-2 C.B. 173.

[13] I.R.C. § 1014(a).

[14] E.g., United States v. Bliss Dairy, Inc., 460 U.S. 370 (1983).

[15] But see Rojas v. Comm'r, 90 T.C. 1090 (1988), *aff'd*, 901 F.2d 810 (9th Cir. 1990) (expenses used and consumed before liquidation not subject to tax benefit rule).

[16] I.R.C. § 691(a)(1), (3).

[17] George Edward Quick Trust v. Comm'r, 54 T.C. 1336 (1970), *aff'd*, 444 F.2d 90 (8th Cir. 1071).

[18] Bartolme v. Comm'r, 62 T.C. 821 (1974).