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INCOME IN RESPECT OF DECEDENT

by Neil E. Harl*

In general, property held until death receives a new income tax basis equal to fair market value at death,¹ the value of property as of the alternate valuation date² or special use value in the case of land where that election is made.³ This is particularly advantageous in farm estates because raised animals and grain with a zero income tax basis receive a higher basis and consequent elimination of gain and the basis of machinery and equipment and farmland often is adjusted upward at death. However, for some assets the basis adjustment rule has a negative effect as a potential loss prior to death is eliminated as basis is adjusted downward as a result of death.

One class of assets, property defined as "income in respect of decedent," is not subject to basis adjustment at or after death.⁴ These are basically income items that are uncollected at death and are later subjected to income taxation to someone other than the decedent, e.g., the estate, heirs or beneficiaries.⁵

MAJOR ITEMS OF INCOME IN RESPECT OF DECEDENT

Share rents. For farm property held until death, the major item of concern as income in respect of decedent has been share rents. Share rents held by the decedent at death or share rents which the decedent had a right to receive at the time of death for economic activities occurring

before death may be income in respect of decedent taxable on subsequent sale by the estate or other successor to the decedent.⁶ Share rents are income in respect of decedent only if the landlord is *not materially participating* in production under the lease.⁷ A landlord's share of rental items is *not* treated as income in respect of decedent if the landlord was a "materially participating" landlord.⁸

If a non-materially participating landlord dies during a rent period, with crops and livestock sold after death, the portion of the proceeds allocable to the period before death is income in respect of decedent. That portion is also includible in the gross estate for federal estate tax purposes as accrued rent. The remaining amount represents ordinary income earned by the estate after the landlord's death. The proceeds of sale are apportioned according to the number of days in the rental period before and after death. For rents received in kind and held by the landlord at the time of death which are later sold, the proceeds of sale are similarly allocated between income in respect of decedent (representing the portion of value at the time of death) and ordinary income representing the portion of value accruing after the date of death.

What if crop share rents are fed to livestock before death? Presumably, the animals (if owned on shares) would be treated as income in respect of decedent.⁹

The status of the landlord as materially participating or non-materially participating is critical to the determination of whether an asset produces income in respect of decedent. If this issue is raised, as a matter of pre-death or post-death planning, it should be noted that material participation by a landlord creates possible liability for self-employment tax¹⁰ even after the landlord is retired and receiving benefits. Therefore, raising the issue might subject the estate to claims for self-employment tax for prior years.

If material participation is achieved by agent, can the landowner — (1) avoid self-employment tax, (2) avoid loss of social security benefits and (3) assure a new income tax basis for growing crops and livestock and stored crops at the time of death? Clearly, for purposes of self-employment tax liability and loss of social security benefits, the activities of an agent are not imputed to the principal, in this case the landowner.¹¹ An amendment added in 1974 assures that result.¹² Yet the general rule (and the applicable rule wherever the 1974 amendment does not apply) is that the activities of an agent *are* imputed to the principal.¹³ Therefore, it would seem that the presence of a materially participating agent acting for a landlord would eliminate income in respect of decedent status for landlords while at the same time not jeopardizing social security benefits or incurring self-employment tax. Thus, if the services of an agent can be obtained at a reasonably low cost (such as with a family member as agent), establishing an agency relationship could be part of a prudent planning effort.

In some estates, a question may be raised as to whether assets on hand at death are properly treated as rents.

Example: a farmer retires, rents the tillable farmland to a neighbor under a non-material participation crop share lease, and keeps a small cow-calf herd on the permanent pasture. The cow-calf herd is a separate enterprise of the decedent, not part of the crop share lease, and, therefore, would not be treated as an item of income in respect of decedent. But what about the hay produced under the crop-share lease which will be used for the cow-calf herd? At what point does the hay cease being income in respect of decedent and become part of a material participation enterprise with assets receiving a new basis at death? While authority is lacking on that point, it would seem

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that hay that had been segregated and set aside for the cow-calf herd should receive a new basis at death. Arguably, the amount of hay reasonably needed for the cow-calf herd for the next year should be so treated even if not segregated and set aside.

Government savings bonds. Interest accrued on Series E or EE bonds is also income in respect of decedent.¹⁴ The executor may elect to report the interest increment on the bonds in the final return of the decedent even though the decedent held the bonds uncashed at death.¹⁵ H bonds issued for E bonds may be similarly treated.

If Series E bonds are redeemed by the estate, the interest amount is includible in the gross income of the estate as income in respect of decedent.¹⁶

The bonds could be held uncashed with the ultimate beneficiary reporting the interest income.¹⁷ In that event, all interest including interest accrued before the decedent's death is taxed to the beneficiary (which could be the co-owner with the decedent) on redemption.¹⁸

Sale of farm products. Sales contracts for farm products entered into before death normally produce income in respect of decedent even though the decedent is an operator or a materially participating landowner. However, the

result may not be income in respect of decedent if a significant economic contribution is made by the estate after death.¹⁹

Example: several days before death, a farm operator sold calves under a contract calling for the calves to be delivered at a specified weight. The farm operator died before the calves were delivered. Indeed, the calves at the time of death were too light for the contract and were kept for several weeks to add weight. When ultimately delivered, the calves are no longer income in respect of decedent because of the additional effort and expense on the part of the estate.²⁰

Other items. Installment land contracts or contracts for deed also create income in respect of decedent.²¹ Payments received after death are treated as income in respect of decedent and the recipient, whether estate representative, or other successor, reports the income in the same manner as the decedent would have done if living.²²

Interest on certificates of deposit attributable to the period ending with the date of the decedent's death, but not received as of the date of death, is income in respect of decedent.²³

Income tax deduction. A taxpayer reporting income in respect of

decedent is entitled to an income tax deduction for the federal estate tax on rights to receive income in respect of decedent that are included in the decedent's gross estate.²⁴ The deduction is apparently available if the decedent held only a limited interest (such as a life estate) and at death the property passed to holders of the remainder interest.²⁵ The deduction is claimed as a deduction from gross income.²⁶

The deduction is based on the highest marginal federal estate tax rate.²⁷ The net value of income in respect of decedent items is figured by subtracting the deductions and credits in respect of the decedent for expenses, interest, taxes and depletion and the foreign tax credit.²⁸

If long-term capital gains are involved, during periods when long-term capital gains are entitled to preferential income tax treatment, the deduction for death taxes paid attributable to income in respect of decedent is applied first before the capital gains exclusion is subtracted.²⁹ Thus, for purposes of computing the long-term capital gains exclusion (when available), the amount of the gain is reduced (but not below zero) by the amount of any applicable deduction for estate tax attributable to income in respect of decedent.³⁰

FOOTNOTES

¹ I.R.C. § 1014(a)(1).

² I.R.C. § 1014(a)(2).

³ I.R.C. § 1014(a)(3).

⁴ I.R.C. § 691(a). See 6 Harl, **Agricultural Law** § 47.03 (1990).

⁵ I.R.C. § 691(a)(1).

⁶ Rev. Rul. 64-289, 1964-2 C.B. 173. See Davison v. U.S., 292 F.2d 937 (Ct. Cl.), cert. denied, 368 U.S. 939 (1961).

⁷ *Id.*

⁸ Rev. Rul. 64-289, 1964-2 C.B. 173.

⁹ See O'Byrne & Davenport, **Farm Income Tax**

Manual § 303(b) (9th ed. 1987).

¹⁰ I.R.C. § 1402(a)(1).

¹¹ Pub.L. 93-368, amending I.R.C. § 1402(a)(1).

¹² *Id.*

¹³ See Harl, "Developments in Planning Estates with Farm and Ranch Property," 23d **Inst. on Est. Plan.** ch. 17 (1989).

¹⁴ See Rev. Rul. 68-145, 1968-1 C.B. 203.

¹⁵ *Id.*

¹⁶ Ltr. Rul. 8407083, Nov. 17, 1983.

¹⁷ See Apkin v. Comm'r, 86 T.C. 692 (1986) (no election had been made by decedent to report accrued interest as income).

¹⁸ *Id.*

¹⁹ *Est. of Peterson v. Comm'r*, 74 T.C. 630 (1980), aff'd, 667 F.2d 675 (8th Cir. 1981).

²⁰ *Id.*

²¹ I.R.C. §§ 691(a)(4), 453B(c).

²² Treas. Reg. § 1.691(a)-5. See 6 Harl, **Agricultural Law** § 48.03[8][f] (1990).

²³ Rev. Rul. 79-340, 1979-2 C.B. 320.

²⁴ I.R.C. §§ 691(c)(2)(A), 691(c)(2)(C).

²⁵ *Sun First Nat'l Bank of Orlando v. U.S.*, 607 F.2d 1347 (Ct. Cl. 1979).

²⁶ Rev. Rul. 78-203, 1978-1 C.B. 199.

²⁷ I.R.C. § 691(c)(2)(C).

²⁸ I.R.C. § 691(c)(2)(B).

²⁹ I.R.C. § 691(c)(4).

³⁰ See Ltr. Rul. 8702004, Sept. 24, 1986 (deduction for estate tax attributable to amounts received as long-term capital gain on installment obligation is claimed as reduction in amount of long-term capital gain reported by decedent's estate).