Estate Planning: Stepped-Up Tax Basis

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A key consideration in estate planning is the transfer of assets to the next generation as 98% of farms are family owned and operated. Additionally, active operators or retired farmers own 75% of U.S. farmland (AgAmerica, 2023). As the average age of an operator increases, there is going to be a large transfer of farmland and other assets in the future whether by gifting, selling, or passing the farm to the next generation through inheritance.

Stepped-up basis is a tax provision that allows the value of an inherited asset to be adjusted to its fair market value at the time of the original owner’s death. This adjustment increases the asset’s basis, which is the value used to determine capital gains or losses when the asset is eventually sold by the heir. By stepping up the basis to the asset’s current market value, any appreciation that occurred during the original owner’s lifetime is not subject to capital gains tax, potentially reducing the tax liability significantly for the heir upon the sale of the asset. Although long-term capital gains are taxed at a lower rate relative to other types of income, the rapid appreciation of agricultural assets over someone’s lifetime make them a concern for people looking to sell assets in retirement or people inheriting farm or ranch assets.

This provision is particularly relevant for assets such as real estate and other capital asset investments such as stocks, mutual funds and bonds that may have appreciated in value over time.

The tax basis of land is determined by the amount originally paid for it — or its value at the time it was inherited — plus any improvements made to the property by the current owner, minus any depreciation on improvements.

Example

Say that father, Bob, bought land in the 1970s for $500/acre. Bob made no improvements on the land therefore no depreciation expense is available since land is a non-depreciable asset. Improvements made on bare land such as fences, terraces, and buildings can be depreciated. If Bob were to sell the unimproved land today at a sale price of $7,000/acre, then Bob would be subject to a capital gain of $6,500 per acre and taxed accordingly.

However, if Bob does not sell the land during his lifetime and his child inherits the farm, the beneficiary would inherit the land at fair market value ($7,000 per acre) on Bob’s date of death. The basis is then stepped-up from the $500 that Bob paid for it to $7,000 per acre.
If Bob's child or heirs chose to sell the land after inheriting it, they would be taxed on the portion of the sale amount above $7,000 per acre. If the inherited property is sold for less than the $7,000 per acre (their stepped-up basis), they could claim a capital loss on their tax return if the property is sold in an arm's length transaction. To receive the more favorable long-term capital gains tax rate, the heirs must own the asset for more than one year.

Death of First Spouse

When married couples own property as joint tenants, after the death of the first spouse, the surviving spouse would receive a stepped-up basis on 50% of the assets.

What assets qualify?

Current law not only supports the stepped-up basis for grain, livestock, machinery and land, but also for prepaid assets on hand. At someone's death, it may be important to begin collecting price data on these items. Sometimes, it is difficult to find this information months (or years) after the fact.

I inherited land (or other assets in the past), and now want to sell. Where do I find the basis?

On inherited property or assets, the fair market value of the property should be documented as of the date of inheritance. Having an appraisal done at the time real estate property is inherited establishes the new or stepped-up basis. For other investment assets, keeping documents, and published market data would assist in establishing a current market value. If a taxpayer cannot prove the basis, the IRS has the right to say it was zero.

For land, if there is no documentation of value at time of inheritance, a reasonable estimation using records such as USDA-NASS Census and Survey land values or other credible sources can be used, although not preferred.

Nebraska is one of the six states that has an inheritance tax. When Nebraskans inherit land or other property, they must pay inheritance taxes to the county where the property is located. The value of assets needs to be equal to what was put on the inheritance tax return.

Conclusion

A stepped-up basis can be seen as an ideal opportunity to sell long-held farmland or other assets that have appreciated in value, with minimal to no capital gains tax consequences if the next generation or heirs choose to sell all of part of the inherited property soon after the stepped-up basis is established. The impact of a stepped-up basis on each farmer or rancher depends on specific circumstances. Utilizing an estate planning team that includes professionals such as an attorney, accountant, and financial and/or insurance advisors can help when developing an estate strategy.

For additional articles regarding estate planning visit: https://cap.unl.edu/succession.
Source:


Publication 551, Basis of Assets, Internal Revenue Service. December 2022
www.irs.gov/publications/p551

Aiken, J.D. “Nebraska Inheritance Tax Update.” CAP Series 22-0304, Center for Agricultural Profitability, University of Nebraska-Lincoln, March 8, 2022.

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