Chapter 12 *
BUYING AND SELLING A FARM

Introduction

The purchase and/or sale of a farm are major economic events for most producers and have significant tax consequences for both the buyer and seller. This chapter provides an introduction to the issues buyers and sellers face when they buy or sell a farm.

Allocation of Purchase Price

The buyer and the seller of a group of farm assets must each allocate the purchase price among the assets involved. The seller must know the sales price of the individual assets to separately calculate the gain or loss on each asset. The buyer must know the purchase price of each asset to determine its basis.

If the buyer and the seller are unrelated parties, they generally have divergent economic interests. The seller would like to allocate as much of the sales price as possible to assets from which gains are taxed as long-term capital gains, such as certain agricultural buildings that have been fully depreciated and land. In contrast, the purchaser would like to allocate as much of the purchase price as possible to assets for which cost-recovery deductions can be claimed as quickly as possible, such as machinery and equipment.

Generally, the buyer and seller can use any reasonable method of allocating the price. Ideally, they will agree on an allocation at the time of the sale and include that allocation in the sales agreement. If they agree in writing to an allocation, both parties must use that allocation for income tax purposes unless the IRS successfully challenges the allocation or one of the parties can show a mistake, undue influence, fraud, or duress.

However, the parties often do not discuss allocation of the overall price at the time of the sale. They then must allocate it when they report the sale or purchase on their income tax returns. The tax rules do not explicitly require the seller and the buyer to use the same allocation, but the IRS can compare the two parties' allocations and use a disparity to challenge either or both of the allocations.

Installment Sales

The seller may finance the buyer's purchase by entering into a contract that requires the buyer to make a down payment and periodic payments of principal and interest. When the buyer has made most,

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or all, of the payments, the seller gives the buyer a deed for the farm. Alternatively, seller financing can be documented with a deed from the seller to the buyer at the time of the sale and a promissory note from the buyer to the seller to pay the balance due with interest. The buyer also gives the seller a mortgage to secure the buyer's obligation to pay the promissory note.

The income tax treatment of a land contract and a deed with a promissory note and mortgage are identical. For income tax purposes, these sales are treated as *installment sales* if one or more payments are due in tax years following the year of the sale.

Cross-Reference

See Chapter 10 of IRS Publication 225, *Farmer's Tax Guide*, for an explanation of the installment sale rules. Chapter 5 of this book also discusses installment sales.

Tax Consequences for Seller

Generally, a seller reports gain as principal payments are received. However, the gain from the sale of assets that have been depreciated, that is treated as ordinary income under the depreciation recapture rules, must be reported in the year of the sale. Fences, grain bins, land improvements, and single purpose agricultural or horticultural structures are often sold in conjunction with farmland, requiring depreciation recapture in the year of sale, regardless of the amount of proceeds the seller received.

A seller can elect out of installment reporting by reporting all gain from the sale on the return for the year of the sale. Sellers who report all gain in the year of the sale have no gain to report as they receive each principal payment, but they must report interest as income when it is received.

Cross-Reference

See Chapter 9 of IRS Publication 225, *Farmer's Tax Guide*, for an explanation of the depreciation recapture rules.

Example 12.1: Installment Sale

Gabriella Muccio sold 180 acres of land to Liam Syed for $900,000 in 2022. Gabriella and Liam agreed to allocate $15,000 of the purchase price to fences that were included in the sale. Gabriella paid $30,000 for the fences and had fully depreciated that cost. Gabriella's income tax basis in the land was $200,000.

If Liam gets financing from a bank and pays Gabriella the full $900,000 purchase price, Gabriella must report $685,000 ($885,000 – $200,000) capital gain from sale of the land and $15,000 ordinary income (depreciation recapture) from sale of the fences on her income tax return for 2022. If Gabriella is single, and has $25,000 of other non-capital gain income, she would have a federal taxable income of $712,050 ($25,000 + $15,000 + $685,000 – $12,950 standard deduction).

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Example 12.1: Installment Sale (*continued*)

Of her taxable income, she would have $685,000 of capital gain and $27,050 of ordinary income. Once taxable income is known, capital gain is considered first when determining how much income is taxed ordinary or capital rates. If total capital gain is less than taxable income, the difference between total taxable income and capital gain is taxed at ordinary rates. If capital gain is greater than taxable income, all income is taxed at capital gain rates. In this example, capital gain is less than taxable income, so the difference of $27,050 ($712,050 – $685,000) is ordinary income. Gabriella would have a total federal income tax liability of $108,376 from the sale. Review Figure 12.1 for her federal income tax liability calculation.

Figure 12.1. Gabriella's Federal Income Tax Calculation from an Outright Sale of Land

Ordinary income from	To	Is taxed at	Ordinary Income in this bracket	Tax on ordinary income
0	10,275	10%	2,050	205
10,275	41,775	12%	-	-
41,775	89,075	22%	-	-
89,075	170,050	24%	-	-
170,050	215,950	32%	-	-
215,950	539,900	35%	-	-
539,900	+	37%	-	-
Total Ordinary			**2,050**	**205**
Capital gain income from	To	Is taxed at	Capital gain in this bracket	Tax on capital gain
0	41,675	0%	39,625	-
41,675	459,750	15%	418,075	62,711
459,750	+	20%	227,300	45,460
Total Capital Gain			**685,000**	**108,171**
Total			***687,050***	***108,376***

If Gabriella financed Liam's purchase of the farm, she could spread her gain from the sale of the land over the years she receives payments. (The gain from the sale of the fences must all be reported in the year of sale, even if Liam pays for them over several years.) That may allow her to take advantage of a lower tax rate on the capital gain.

For example, if she spread the capital gain over several years, she may be able to keep some of her capital gain in the zero percent bracket and limit the amount of capital gain taxed at the 15% rate. As mentioned earlier in this chapter, to determine the capital gains tax rate, you begin with all non-capital gain income. You then stack the capital gains on top of all other income on the tax return and apply the capital gains rates based upon where the capital gains fall in the brackets.

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Example 12.1: Installment Sale (*continued*)

Figure 12.2. 2022 Capital Gains Rates

Capital Gains Tax Rate	Taxable Income (Single)	Taxable Income (Married Filing Joint or Qualifying Widower)	Head of Household	Married Filing Single
0%	≤$41,675	≤$83,350	≤$55,800	≤$41,675
15%	≤$459,750	≤$517,200	≤$488,500	≤$258,600
20%	> $459,750	>$517,200	>$488,500	>$258,600

If Gabriella and Liam set up a ten-year installment sale for the purchase of the farm, Gabriella will recapture depreciation on the fence (ordinary income) in year one because the fence was depreciable property. In an installment sale, a gross profit percentage is calculated by dividing the gross profit by the total contract price. Gross profit is the contract price minus any remaining basis in the assets sold minus any depreciation recapture recognized in the year of sale. For Gabriella, gross profit is $685,000 ($900,000 - $200,000 land basis - $15,000 depreciation recapture) and her gross profit percentage is 76.11% ($685,000 divided by $900,000). Any principal payment received in an installment sale is multiplied by the gross profit percentage to determine the amount of capital gain in the payment. The remaining portion of the payment is not taxable.

Assume the same facts as earlier (Gabriella is a single taxpayer and has $25,000 of non-capital gain income), except Gabriella sells the land to Liam over 10 years, with a principal payment of $90,000 plus interest due to her each year. In the year of sale, her taxable income would be $92,549 ($25,000 + $15,000 + $68,499 ($90,000 X 76.11%)). Gabriella's federal income tax liability in 2022 would be $10,312. Review Figure 12.3 for her federal income tax liability calculation.

Figure 12.3. Gabriella's Federal Income Tax Calculation with an Installment Sale of Land

Ordinary income from	To	Is taxed at	Ordinary Income in this bracket	Tax on ordinary income
0	10,275	10%	10,275	1,028
10,275	41,775	12%	13,775	1,653
41,775	89,075	22%	-	-
89,075	170,050	24%	-	-
170,050	215,950	32%	-	-
215,950	539,900	35%	-	-
539,900	+	37%	-	-
Total Ordinary			**24,050**	**2,681**

Capital gain income from	To	Is taxed at	Capital gain in this bracket	Tax on capital gain
0	41,675	0%	17,625	-
41,675	459,750	15%	50,874	7,631
459,750	+	20%	-	-
Total Capital Gain			**68,499**	**7,631**
Total			***92,549***	***10,312***

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Caution

By financing the buyer's purchase, you run the risk of the buyer defaulting on the payments.

Tax Consequences for Buyer

For the buyer, an installment purchase is treated in the same way as a purchase that is financed by a third party. The buyer of business or investment property can begin depreciating assets in the year of the purchase and can deduct the interest paid to the seller as a business or investment expense.

Example 12.2: Installment Sale

Liam (from Example 12.1) can begin depreciating the $15,000 cost of the fence in 2022, whether the purchase is financed by Gabriella or by a third party such as a bank. He can deduct the interest he pays to Gabriella, if she finances the purchase, or to the bank, if it finances the purchase.

Sale of Farm with Principal Residence

A special provision in the Internal Revenue Code for the sale of principal residences allows taxpayers to exclude up to $250,000 ($500,000 joint returns) of gain on the sale or exchange of a principal residence. To qualify, the taxpayers must have owned the residence and used it as their main home for at least 2 of the 5 years before the sale. This exclusion from income increases the incentive for owners of farms to claim that land around the personal residence as a part of the residence, rather than being used in the farming operation. By claiming more of the land as part of the personal residence, more gain can be attributed to the personal residence and therefore excluded from income up to the $250,000 or $500,000 limit.

Cross-Reference

See IRS Publication 523, *Selling Your Home*, for an explanation of the exclusion of gain on the sale of a principal residence.

Growing Crops Sold with Land

If a growing crop is included in the sale of land, part of the purchase price must be allocated to the growing crop. That allocation must be reflected in the income tax reporting of both the buyer and the seller.

Tax Consequences for Seller

Taxpayers who sell a growing crop with the land on which it is growing can treat the gain on the growing crop as long-term capital gain if the land has been held for more than a year. The growing crop must be sold, exchanged, or involuntarily converted at the same time and to the same individual as the land.

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In calculating the gain from sale of the growing crop, the seller must allocate part of the purchase price to the growing crop and treat the costs of raising the crop as its income tax basis. The costs allocated to the basis of the growing crop cannot be deducted as a business expense.

Example 12.3: Sale of Growing Crop with Land

In 2022, Red Durham sold 240 acres of land with a growing winter wheat crop to his neighbor, Buck Wheat, for $4,575 per acre. Based on the value of the winter wheat crop, Red and Buck agreed in writing to allocate $325 of the per acre price (a total of $78,000) to the growing wheat crop.

Red incurred $30,000 ($125 per acre) of direct costs (seed, fertilizer, chemicals, etc.) and indirect costs (e.g., depreciation) of growing the winter wheat in 2021, and he deducted that $30,000 on his 2021 Schedule F (Form 1040). Now that Red has sold the growing crop in a transaction that qualifies for long- term capital gain treatment, he must remove the $30,000 from his deductions by amending his 2021 tax return. The $30,000 is included in his income tax basis in the growing crop.

Red also paid $18,000 ($75 per acre) for fertilizer and fungicide in 2022 for the growing wheat crop. Because Red sold the growing crop, he cannot deduct that $18,000. Instead, he adds it to the basis of his growing crop, which gives him a $48,000 ($30,000 + $18,000) income tax basis in the crop.

Red calculates his $30,000 gain on the sale of the growing crop by subtracting his $48,000 income tax basis from the $78,000 purchase price allocated to the growing crop. He nets that gain with the gains and losses from other sales of property used in the farming business (including the gain from the sale of the land). A net gain is treated as long-term capital gain to the extent it exceeds losses reported from sales of property used in the farming business in the previous five years. A net loss is treated as an ordinary loss.

Tax Consequences for Buyer

The buyer of land with a growing crop has a basis in the growing crop equal to the portion of the purchase price that is allocated to the growing crop. If the buyer of the land sells the crop, the basis reduces the income he or she must report from that sale. If the buyer of the land feeds the crop to livestock, he or she can deduct the allocable cost as an expense of raising the livestock.

Example 12.4: Purchase of Growing Crop with Land

Buck Wheat (the buyer in Example 12.3) has a $78,000 basis (the price he and Red agreed to allocate to the growing crop) in the wheat. When Buck harvested the winter wheat, he sold it for $100,000. He must report the $100,000 sale price on line 1, his $78,000 basis on line 2, and the resulting $22,000 gain on line 3 of Schedule F (Form 1040).

If Buck fed the wheat to his livestock in 2022 (the same year he purchased the land and growing crop), he can deduct the $78,000 income tax basis in the wheat on his 2022 income tax return.

If Buck fed part, or all, of the wheat to his livestock in 2023 (the year after he purchased the land and the growing crop), it is not clear when he can claim the deduction. Buck could take the position that he can deduct the entire basis in 2022 (the year he purchased the crop with the intent to feed it to livestock), but the IRS may allow him to deduct the basis only in 2023 (the year he uses the wheat as feed).

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Like-kind Exchange of Real Property

Taxpayers who do not need or want immediate cash from the sale of a farm can delay recognizing the gain by rolling the sales price into *like-kind* property. The deferred gain is rolled over by carrying the basis of the relinquished property into the basis of the replacement property. If the taxpayer never disposes of the replacement property, the taxpayer's heirs can avoid recognizing the deferred gain through the tax law provision for a basis adjustment to date-of-death fair market value.

The tax rules that allow the gain to be rolled to replacement property have a variety of labels, including tax-free exchange, like-kind exchange, and 1031 exchange (after §1031 of the Internal Revenue Code). More complex 1031 exchanges are called deferred like-kind exchanges, Starker exchanges, or reverse deferred exchanges.

Cross-Reference

See Nontaxable Exchanges in IRS Publication 544, *Sales and Other Dispositions of Assets* (for 2021), for an explanation of the like-kind exchange rules. Also see Chapter 7 of this book.

For real property, the term *like-kind* is interpreted very broadly. Any real estate can be exchanged for any other real estate as long as both the relinquished property and the replacement property are used in a trade or business or held for investment. Consequently, a farm can be exchanged for city real estate and improved real estate can be exchanged for unimproved real estate, although there may be some immediate tax impact when a property with certain depreciable improvements is exchanged for bare, or unimproved, land.

Example 12.5: Exchange of Real Property

Alva Babcock plans to sell bare farmland that has a $100,000 income tax basis and is worth $500,000. She wants to invest the proceeds in an apartment building. The farmland and apartment building are like-kind property. Therefore, if she exchanges the farmland for an apartment building that is worth $500,000, she does not have to recognize the $400,000 gain on her farmland. Her income tax basis in the apartment building is $100,000.

Requirements

A transaction does not qualify as a like-kind exchange to the extent the taxpayer receives cash or unlike property.

Example 12.6: Exchange of Real Property

Assume the same facts as example 12.5, except the apartment building is worth $450,000. After the exchange is complete, Alva receives $50,000 in cash. Her income tax basis in the apartment building is $100,000 (carryover basis from the land given up in the exchange). She will recognize gain of $50,000 (cash received) from the exchange.

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To qualify as a deferred like-kind exchange, the taxpayer must carefully comply with detailed rules that require the services of a knowledgeable professional. In general, those rules require the taxpayer to identify the replacement property within 45 days and to acquire ownership of the replacement property within 180 days of selling the relinquished property.

Caution

Taxpayer Cannot Possess Sale Proceeds

It is imperative that the taxpayer use a qualified intermediary and never have possession of the sale proceeds prior to completion of the exchange. If a taxpayer sells a farm and receives the sales proceeds, rather than the qualified intermediary, he or she cannot defer gain recognition by using the proceeds to purchase replacement property. Therefore, taxpayers should seek the counsel of a qualified professional before entering into any agreement to sell a farm if they plan to roll the gain into replacement property under the like-kind exchange rules.

Summary

Income tax planning is as important in buying and selling a farm as it is in operating a farm. Sellers can **defer** recognizing their gain by making an installment sale, **avoid** recognizing their gain on the sale of their principal residence, or **roll** their gain on business or investment property into replacement property through a like-kind exchange.

Buyers can reduce their taxable income after the purchase by depreciating the portion of their purchase price that is properly allocated to the depreciable property included in the purchase.

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