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Income Tax Implications of the Sale of a Farm

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Selling the family farm is a unique event in the life of a farm family. The sale may take place because a family retires, a death occurs, or financial adversity hits. There are unique features of a farm sale that need to be reviewed from time to time.

The seller of an entire farm business is particularly vulnerable to income tax because there is a surge in taxable income when a farm is sold. Even with good financial management, the tax bill related to the sale of the farm can be significant. For these reasons, farmers need to begin the process of tax management very early when they are considering the sale of a farm.

Every farm sale will have unique features and characteristics and so each case is a little different. While it is very difficult to provide general guidelines that apply across-the-board for every sale, there are some general guidelines which can be applied to every farm situation.

If you want to minimize federal income tax on a farm sale, the time to begin planning is at the time of purchase.

One of the most important things to do at the time of purchase is to allocate the purchase price of the farm to the various components of the farm. A farm consists of land, buildings, fences, perhaps timber, and in some case gravel, and other natural deposits. The tax manager should allocate the total purchase price among those various assets based on the fair market value of those assets.

Basis is defined as the amount that we have the right to recover at the time of disposal of an asset. It is the amount that was paid for the asset plus any improvements made to the asset. By allocating the total purchase price of an item plus improvements, you establish basis. If the sale of the farm occurs by heirs after the owner's death, the heirs will receive a so-called "stepped-up basis" which is the fair market value of the farm within six months after the date of death.

The property acquired as part of a farm unit may be depreciable or non-depreciable. Land cannot be depreciated for tax purposes. Other items such as buildings and fences are depreciable for tax purposes.

The basis allocated to non-depreciable assets (land, personal residence) will be carried throughout the lifetime of the owner and will eventually be transferred to someone else, perhaps a child. Amounts allocated to non-depreciable assets will not be recovered and will produce no real tax benefit until they are sold or transferred through an estate.

The amount allocated to depreciable property will be recovered relatively quickly through depreciation deductions. If most of the items are depreciable, there will be an immediate tax benefit. It is important to remember that the deduction is lost if you do not use it in the year it is available. Depreciation cannot be saved.

When a farm is sold, regardless of whether the sale is because the farm manager is retiring or because financial adversity, illness, or disability are forcing the liquidation, the sale involves disposal of both business and non-business property. Land, livestock, machinery/equipment, and other assets that are used on the farm are considered business property. A set of tax rules applies to business property and another set of tax rules applies to non-business property (personal residence and associated property).

The tax code requires sellers to defer paying tax on the gain from the sale of their personal residences if the residences are replaced with another residence of equal or greater value within two years of the original sale. The sale of the personal residence must be separated from the remaining value of the farm unit in order to take advantage of this provision.

Farm business property (land, structures, certain cattle, horses, and other livestock, and machinery/equipment) is reported differently. Depreciation taken on this property may cause a gain on the disposition of that property which needs to be treated as ordinary income or capital gains depending on the length of time the property is held (one year for land, structures, livestock other than cattle and horses used for draft, breeding, dairy, or sporting purposes and machinery/equipment; two years for cattle and horses used for draft, breeding, dairy, or sporting purposes).

Certain sales, made under an arrangement that provides for part or all of the selling price to be paid in a later year, could provide some tax savings. These "Installment Sales" are sales of property where one or more payments are received after the close of the tax year of the sales. The gain on the sale is reported when payment is actually received. This method of reporting relieves paying tax on income not collected and spreads the tax burden over a number of years allowing income from the farm sale to be taxed at lower rates.

At the time of this writing, Congress is writing changes into the tax code which may affect capital gains and estate taxation. Farmers who are contemplating the sale of a farm should keep a close watch on the latest developments from "Capitol Hill."

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