USING FEDERAL TAX POLICY TO HELP THE NEXT GENERATION OF FARMERS AND RANCHERS GAIN ACCESS TO LAND

Forty-one percent of farmland and ranchland in the U.S. is owned by farmers and non-operator landowners aged 65 and older, according to the U.S. Department of Agriculture.[1] As a result, more than 370 million acres of agricultural land are likely to change hands in the next two decades.[2] *How and to whom this land transfers will impact American agriculture for generations to come.*

Federal tax policy can help facilitate the transfer of this land to the family farmers who are most challenged in finding and affording it: young, beginning, veteran and minority farmers. Young and beginning farmers have ranked access to farmland as their top challenge in recent surveys conducted by both the American Farm Bureau Federation and the National Young Farmers Coalition.

A significant factor is the limited amount of farmland on the competitive market—caused in large part by current tax policy, which penalizes landowners for selling land during their lifetimes and incentivizes transfers of land through estates. Of the 91.5 million acres that USDA expects will transfer ownership between 2014 and 2019, just 34 million acres are likely to be sold, and only 21 million acres will be sold to non-relatives. Most land will transfer to heirs—a majority of them non-farming—via trusts, wills and gifts. And while non-farming heirs may, in turn, sell the land, they are more likely to be motivated by price than by the characteristics of the farm buyer. Young and beginning farmers are unlikely to outbid large established farms and ranches or farmland investors.

Farmland availability and affordability are also impacted by the continued conversion of land to development. Since 1982, the U.S. has converted 2.5 million acres of farmland to development--an area the size of Indiana and Rhode Island combined. Farmland loss has been greatest in and around metropolitan areas that offer some of the most profitable market opportunities for young, beginning, minority and veteran farmers. In places with active farmland protection programs, next generation farmers are often able to purchase more-affordable protected farmland. Yet the federal tax code discourages conservation-minded landowners from permanently protecting their land by taxing the proceeds of the sale of a farm or ranch's "development rights."

Two specific changes to the Internal Revenue Code could offer new opportunities for next generation farmers and ranchers—helping to revitalize rural America and grow successful new farm enterprises.

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[1] Farmland Information Center, *2014 Tenure, Ownership, and Transition of Agricultural Land Survey Talking Points*, January 2016, p. 3. http://www.farmlandinfo.org/sites/default/files/2014_Tenure_Ownership_and_Transition_of_Agricultural_Land_Survey_AFT_FIC_06-2016.pdf.

[2] *Id.*

1. *Create a capital gains exclusion for the sale of farmland/ranchland to a qualified farmer.*

Rationale: Sales of farmland are currently taxed as capital gains, at an approximate rate of 25 percent nationally (a combined federal rate of 20 percent and an average state rate of five percent). In contrast, land that is transferred at death has no capital gain, as the basis is "stepped up" to the value at the date of death.[5] Given that land is typically a farm or ranch's primary asset, and that land owned over many years or even generations often has a very low basis, the combination of capital gains tax plus "stepped up" basis discourages farmers and ranchers from selling their land during their lifetimes.

Considerations: Establishing a capital gains exclusion on the sale of farmland or ranchland to a "qualified farmer" for agricultural use frees up farmers, ranchers and landowners to decide the future of their land during their lifetimes. By reducing or eliminating the tax on land sales, farmers and ranchers will be more likely to pursue gradual transfers and other transfer strategies to next-generation farmers as they retire or step back from full-time farming. And because any gain on the sale would not be taxed, it gives sellers more flexibility on price to increase affordability for young, beginning, socially disadvantaged, veteran or limited resource farmers.

- ❖ *Level of exclusion:* We suggest a lifetime exclusion of $500,000 per individual or $1,000,000 per couple.
- ❖ *Qualified farmer/rancher:* We suggest limiting the exemption to farmer/rancher buyers who are beginning; young (< age 45); socially disadvantaged; veteran; limited resource; or any entity in which a beginning, young, socially disadvantaged, veteran or limited resource farmer/rancher has at least 50 percent ownership.
- ❖ *Eligible land:* We suggest requiring that land subject to the exclusion be owned by the taxpayer in a family business for the three preceding tax years.
- ❖ *Lookback provision*: We suggest a 10-year recapture provision, requiring the buyer to pay the full amount of capital gains tax excluded should the buyer take the land out of active agricultural use (except for fallowing as part of an agricultural rotation). This is comparable to the recapture provision under IRC 2032A Special Use Valuation. The buyer should be allowed to sell the land to another qualified farmer without being subject to the recapture provision.

Example: John and Mary Smith own a 250-acre dairy farm worth $1.5 million. They have two grown children, neither of whom is interested in coming back to work the farm. Like many farmers, their primary asset is their land, and they have little saved for retirement. They need to sell the farm and would like to find a young couple interested in taking it over. Mary inherited the farm in 1975, and it was valued at $200,000 at that time.

At current capital gains tax rates (estimated at 20 percent federal and five percent state), based on a "gain" of $1.3 million (sales price less basis/value at the time of inheritance), they would owe $325,000 in taxes when they sell the farm.

With an exclusion of $1 million ($500,000 for each of them), they would pay tax on only $300,000 ($1.3 million gain minus $1 million exclusion)—or $75,000—if they found a qualified farmer buyer. With $250,000 in potential tax savings, the Smiths would be in a better financial position and potentially able to offer the farm to the farmer buyer/s at a somewhat reduced price.

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[4] Farmland Information Center, *The 2012 NRI: Changes in Land Cover/Use,* October 2016. http://www.farmlandinfo.org/2012-nri-changes-land-coveruse

[5] While land transferred at death is subject to the federal estate tax, USDA's Economic Research Service (ERS) estimates that 99 percent of farm estates in the U.S. would not have owed federal estate tax in 2014 at the exemption level of $5.34 million. *See* U.S. Department of Agriculture Economic Research Service, *Federal Estate Taxes,* May 6, 2015.

2. Create a capital gains exclusion for the sale of an agricultural conservation easement.

Rationale: Agricultural conservation easements protect farmland and ranchland from development in perpetuity. Importantly, they also can reduce the purchase price of land once protected, enabling farmers and ranchers to buy land that would otherwise be unaffordable.

Twenty-eight states have active state programs that purchase agricultural conservation easements (PACE) from willing sellers, and at least 95 independently funded local PACE programs operate in 20 states. Land trusts also purchase or help other entities acquire easements on farmland and ranchland. All of these entities leverage federal dollars from the Agricultural Land Easement component of USDA's Agricultural Conservation Easement Program. State and local PACE programs have permanently protected more than 3.3 million acres of productive farmland since the 1970s.[6] Farmers and farmland owners who sell an agricultural conservation easement—and, in doing so, forego in perpetuity the right to develop their land for non-farming purposes—are typically compensated based on the appraised value of the land and easement. This sale is considered capital gain and taxed.

By taxing landowners on the proceeds of the sale of an agricultural conservation easement, the federal tax code discourages farmers and ranchers who want to protect their land in perpetuity. It also impacts state and local investments in farmland protection. Since PACE programs are largely funded by state and local governments, taxing the proceeds from these programs' investments serves as a tax windfall for the federal government at the expense of state and local governments.

Considerations: Excluding the proceeds from the sale of an agricultural conservation easement from capital gains tax would spur landowner participation in state and local PACE programs. Importantly, it would also free up proceeds from easement sales for reinvestment in or expansion of farm businesses, proving additional economic opportunities for the current and next generation of farmers on the land. Studies by American Farmland Trust have found that most farmers who sell an agricultural conservation easement use the proceeds to expand or improve their business or to facilitate the transfer of the farm to the next generation.

- ❖ *Level of exclusion:* We suggest a lifetime exclusion of $500,000 per individual or $1 million per couple.
- ❖ *Eligible land:* We suggest limiting the exclusion to proceeds from the sale of a conservation easement on a farm or a ranch.

Example: Robert and Shirley Jones own a 50-acre vegetable farm. They are considering the sale of an agricultural conservation easement to help fund their retirement and make the farm more affordable for their daughter and her husband who are currently farming in partnership with them in the farm LLC. Robert and Shirley purchased the farmland in 1975 for $50,000. The land is presently worth $1 million. The conservation easement (which would permanently restrict the land to agricultural use) has been appraised at $500,000.

At current capital gains tax rates (estimated at 20 percent federal and five percent state), based on a "gain" of $450,000 (difference between original purchase price and current value of the farm, less the value of the conservation easement), they would owe $112,500 in taxes for permanently conserving their farm.

[6] Farmland Information Center, *2017 Status of State Purchase of Agricultural Conservation Easement Programs*, http://www.farmlandinfo.org/2016-status-state-purchase-agricultural-conservation-easement-programshttp://www.farmlandinfo.org/2017-status-state-purchase-agricultural-conservation-easement-programs; *2016 Status of Local Purchase of Conservation Easement Programs,* http://www.farmlandinfo.org/2016-status-local-purchase- agricultural-conservation-easement-programs (accessed 9/22/17)

However, with an exclusion of $1 million, they would pay no capital gains taxes. This would give them an additional $112,500 that could be used for retirement, to reinvest in the farm business, or to provide a nest egg for their daughter and son-in-law. The general public gets a conserved farm, the daughter and son-in-law can purchase the farm at a more affordable price, and state, local and/or private funder(s) of the conservation easement see 100 percent of their investment go towards conservation.

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