Tax Reform and Farmland Access:
Capital Gains Tax Changes to Support the Next Generation in Agriculture

Forty-one percent of farmland and ranchland in the U.S. is owned by individuals aged 65 and older.[1] The 371 million acres of land they own is likely to change hands in the next two decades.[2] How, and to whom, this land transfers will fundamentally impact American agriculture for generations to come.

Two changes to the federal tax code could incentivize the transfer of this land to next generation farmers and ranchers, helping them overcome a key barrier to success.

The Challenge: Competition for Limited Land on the Market

Young and beginning farmers have ranked access to affordable farmland as their top challenge in recent surveys conducted by both the American Farm Bureau Federation and the National Young Farmers Coalition.[3]

Three factors are contributing to this challenge:

- **Continued development of farmland and ranchland.** Nearly 31 million acres of agricultural land were converted to development between 1992 and 2012. Conversion has been greatest in and around metropolitan areas that offer some of the most profitable market opportunities for young, beginning, minority and veteran farmers.
- **The limited amount of farmland on the competitive market.** Less than 23 percent of the 91.5 million acres that USDA estimates will transfer between 2014 and 2019 was expected to be sold to non-relatives. Most will transfer to heirs (many of them non-farming) via trusts, wills and gifts.
- **More competition for what land that remains, driving up land values.** According to the National Agricultural Statistics Service, the average farm real estate value has increased from $1,340 to $3,140 per acre between 2001-2018 alone—an increase of over 130 percent.[1] Exacerbating the land access challenge is the fact that in many real estate markets these prices do not reflect the land's value for agricultural production, as land is increasingly valued for uses other than agriculture.[4] This often exceeds what farmers can afford to pay using that land for agricultural production.

> Of the 91.5 million acres that USDA estimated will transfer ownership between 2014 and 2019, just 34 million acres were likely to be sold, and only 21 million acres to non-relatives.

Federal Tax Policy Is Contributing to the Problem

Because the sale of farmland is subject to capital gains taxes, farmers and ranchers are reluctant to sell off land assets when they retire. The federal capital gains rate of 20 percent, based on a property's appreciation in value since purchase, can be significant for land that has been held for a long time or has appreciated significantly in value.

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[1] This includes land owned by both farmers and non-operator landowners. 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.

[3] Sophie Ackoff, Lindsey Lusher Shute, and Andrew Bahrenburg, "Building a Future with Farmers II," National Young Farmers Coalition, 2017.

[4] In 2016, the ratio of real estate value to production value was the lowest it has ever been with one dollar's worth of farm real estate generating just $0.16 in production. https://ageconomists.com/2017/09/11/farm-real-estate-pricey-compared-income/.

Land that transfers at death, however, is exempt from federal estate tax provided it is within current exclusion levels of $11.4 million for an individual or $22.8 million for a couple. The basis of the land is also "stepped up" to its present-day value for future tax purposes, meaning that no taxes are owed on the appreciation in value from the previous generation.

The federal tax code thus penalizes farmers and ranchers who want, or need, to sell land to finance retirement or to help a next generation farmer get started while incentivizing them to hold land assets until death. This limits the inventory of land on the market, causing increased competition for what land remains available.

Capital gains taxes are also imposed on the sale of an agricultural conservation easement—a property restriction that ensures that land cannot be developed and remains available for agricultural use in perpetuity. This not only discourages landowners who want to leave a legacy of protected land, but adversely impacts young, beginning and limited resource farmers, for whom protected farmland is often the only land they can afford to purchase.

Two Changes Could Improve Land Access for Next Generation Farmers and Ranchers

1. *A capital gains exclusion for the sale of land to a qualified farmer*

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. 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 part of the gain on the sale would not be taxed, it potentially gives sellers more flexibility on price.

Suggested guidelines for such an exclusion:

- Level of exclusion: Lifetime exclusion of $500,000 per individual or $1,000,000 per couple.
- Qualified farmer or rancher: Buyers who are beginners (in their first ten years of farm management), young (< age 45), socially disadvantaged, veteran, or limited resource, or any entity in which such a farmer/rancher has at least 50 percent ownership.
- Eligible land: Require that land subject to the exclusion be owned by the taxpayer in a family business for the three preceding tax years.
- Lookback provision: Include 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 (not including rotational fallowing). This is comparable to the recapture provision under IRC 2032A Special Use Valuation. Allow the buyer to lease or 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, but neither of their children is interested in taking it over. Like many farmers, their primary asset is their land and they have little saved for retirement, so they need to sell the farm. Mary inherited the farm in 1975, and it was valued at $200,000 at that time.

At current capital gains tax rates, based on a gain of $1.3 million compared to 1975, 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 buyers at a reduced price.

	Status Quo		With Changes
Current land value:	$1,500,000		$1,500,000
Original land value:	- $200,000		- $200,000
Capital Gain:	$1,300,000		$1,300,000
		Exemption:	- $1,000,000
Tax rate:	x .25		x .25
Taxes owed:	**$325,000**		**$75,000**

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

Farmland conservation is a key strategy to ensure that farmland remains available and affordable to farmers now and for generations to come. Excluding the proceeds from the sale of an agricultural conservation easement from capital gains tax would spur landowner participation in state and local Purchase of Agricultural Conservation Easement (PACE) programs and engagement with local land trusts. 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.[6]

Suggested guidelines for such an exclusion:

- *Level of exclusion:* Lifetime exclusion of $500,000 per individual or $1 million per couple.
- *Eligible transaction:* Proceeds from the sale of an agricultural 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. 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 $500,000 (the value of the conservation easement), they would owe $125,000 in taxes for permanently conserving their farm.

However, with an exclusion of $1 million, they would pay no capital gains taxes. This would give them an additional $125,000 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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