Selling a Farm With Unharvested Crops

Selling a farm with unharvested crops presents some unique tax issues. The tax rules today may provide the farmer with far greater advantages than the rules that existed back in 1953 when the Supreme Court first ruled on the tax treatment of the sale of farmland with standing crops, but care must be taken to assess the impact of the tax rules and structure the sale transaction to minimize the tax costs of the sale.

Early Supreme Court Ruling

A Supreme Court case involved Mrs. Gladys Watson, who had sold her interest in a 110-acre orange grove located in California. At the time of the sale, the tax rules seemed rather clear to Mrs. Watson who treated her profit on the sale of the orange grove as a capital gain. The IRS, however, took exception to Mrs. Watson's capital gain treatment of the sale because when the property was sold, there were unharvested oranges growing on the property. If Mrs. Watson had waited until the orange harvest and sold the oranges, the proceeds from the sales of that crop would have been taxed as ordinary income, not as a capital gain. The IRS argued to the Court that part of the property's purchase price paid to Mrs. Watson was for the land and part of that price was for the orange crop. The land sale, the IRS contended, was rightfully treated as a capital gain by Mrs. Watson but that part of the purchase price attributable to the unharvested oranges should be taxed as ordinary income. The Supreme Court agreed with the IRS, noting that under the relevant section of the tax code in effect at that time, capital gain treatment was to be given to property "used in the trade or business..." and not given to property "held by the taxpayer primarily for sale to customers in the ordinary course of [the] trade or business."

Today's farmer selling land with unharvested crops will find the tax rules far more favorable and flexible than those that applied to Mrs. Watson's orange grove sale.

The “Double Advantage” of Today’s Tax Code §1231 for Farm Sales

First, IRC §1231 of our current tax code provides the farmer with some distinct advantages upon the sale or exchange of "property used in a trade or business" that the farmer holds for more than 1 year. Generally, the farmer’s gain from the sale of “section 1231 property” will be treated as a long term capital gain (which means a favorable tax rate for the farmer on that gain). In addition, the farmer’s loss on the sale of this type of property is treated as an ordinary loss (meaning that the farmer can apply the loss amount against other sources of income for the year). If the loss were characterized as a capital loss instead, the farmer would be limited to applying that loss only against capital gains plus an annual limit of $3,000 that could be claimed against other income. Section 1231 has some limitations and other tax code sections can cause the farmer to pay additional taxes, particularly if the farmer claimed depreciation on the property sold or exchanged. However, §1231 generally provides the farmer with a “double advantage”: favorable capital gains tax treatment on gains and favorable ordinary loss treatment on losses.

Second, this §1231 double advantage specifically applies to unharvested crops that are growing on farmland that is sold or exchanged if certain conditions are met. Unlike Mrs. Watson, today’s farmer might benefit from §1231 advantaged tax treatment on the unharvested crops if:
The unharvested crops are on farmland held for more than 1 year and used in the farmer’s trade or business of farming, and
The farmland and the unharvested crops are both sold at the same time and to the same person.

However, this advantageous tax treatment will not apply if the farmer retains any right or option to reacquire the farmland in the sale or exchange transaction. However, if the farmer retains the customary rights associated with providing the buyer with a mortgage upon selling the property, retaining these rights will not “taint” the favorable tax treatment given to the unharvested crops on the farmland sold.

If the farmer is transferring an interest in farmland that falls short of an ownership interest, such as the transfer of a lease on the farmland, crops growing on that farmland do not qualify for favorable capital gains tax treatment.

Depending on the farmer’s tax circumstances, however, the farmer may find that the application of §1231 to unharvested crops may not be advantageous.

Costs of Production for Qualifying Unharvested Crops

Production costs associated with unharvested crops that benefit from the favorable capital gains tax treatment rule are not deductible. These production costs are instead added to the basis of the unharvested crop that is part of the farmland sale. This serves to reduce the amount of taxable long term capital gain from the sale of the property instead of reducing ordinary income for the farmer in the tax year in which the property is sold. Production costs attributable to the unharvested crops include items such as:

- Seed
- Fertilizer
- Pesticides and herbicides
- Fuel
- Equipment depreciation

The production costs associated with an unharvested crop can be estimated using crop budgets for the farmer’s region of production.

Crop budgets for Illinois farmers are available from the farmdoc website at: [www.farmdoc.illinois.edu/manage/2012_crop_budgets.pdf](http://www.farmdoc.illinois.edu/manage/2012_crop_budgets.pdf)

Selling the Farmland in the Year After Crops are Planted

If the farmland with unharvested crops is sold during the tax year and the production expenses have already been claimed in the prior tax year, an amended return is necessary for that prior year to remove the expense deductions attributable to the unharvested crop production costs. Those expenses are then used in the year of sale to increase the basis of the unharvested crops sold.

Example. In October, 2012, Ken and Betty plant winter wheat on their 100 acre farm. They have owned this farmland since 1986 and have actively farmed the farmland each year. They decide to sell their farm in May, 2013. Ken and Betty file their joint tax return for the 2012 tax year in February, 2013 and claim the production expenses incurred in 2012 attributable to the planting of the winter wheat. The following information applies to the farm sale.
Ken and Betty determine that the amount received in respect of the winter wheat crop in the farm sale will qualify for capital gain tax treatment because they have held the farm for more than 1 year, have used the farmland in their farming business and the land and wheat crop are both to be sold to the same person. Prior to the farm sale closing date, Ken and Betty, along with the buyer of the farm, agree to allocate $36,000 (60 bushels per acre × $6 per bushel × 100 acres) of the purchase price toward the standing wheat crop. Ken and Betty use crop budgets to estimate the production costs associated with the planting of the winter wheat. These estimated production costs, including the allocable depreciation on the relevant farm equipment used for planting, amount to $16,000 ($160 per acre × 100 acres). Because capital gains tax treatment will be given to the sale of the standing crops, Ken and Betty are not permitted to claim expense deductions for those production costs. They must do the following:

- Amend their 2012 Schedule F to reduce their deducted expenses by the $16,000 of production costs for the standing wheat crop, and
- Increase their tax basis in the sale by the same $16,000. This will reduce the amount of capital gain recognized on the sale by $16,000 in 2013.

Ken and Betty will have a total basis in the sale of $616,000.

The amendment to the 2012 Schedule F is accomplished by entering “-$16,000” on the line for “Other Expenses” (line 32) with an indication that the adjustment is a “production expense reduction”. Upon the sale of the farmland in 2013, the $36,000 that Ken and Betty receive in connection with the winter wheat will appear on their Form 4797.

**Is There Tax Savings?**

Whether this §1231 treatment of unharvested crops will save Ken and Betty tax depends upon a number of factors. It should be noted that the capital gains tax treatment for unhar vested crops and denial of any deduction for the production costs is the mandatory tax treatment of the unharvested crops for a farmland sale transaction falling within the qualifications mentioned earlier. Ken and Betty should consult their tax advisor to determine the tax impact of this rule before they sell the farm. Some of the questions the tax advisor should consider to determine the amount of added tax savings or cost from the application of the §1231 rule are:

- What capital gains tax rate will Ken and Betty pay on the gain attributable to the crops under §1231?
- How much additional income tax will they pay in 2012 if $16,000 of expenses are no longer deducted for that year?
- How much income tax will they pay if they harvested and sell the crops and reported the income in 2013?
- How much additional self-employment tax will be payable?
- Are Ken and Betty subject to the Medicare tax changes that will become effective January 1, 2013?

In addition, income tax brackets and rates, as well as capital gains rates, may see dramatic changes as we move into 2013, so assessing the tax impact of this rule will be most challenging until more is known about what tax rates will prevail for 2013 and subsequent years.
If application of §1231 is not desired, the farmer may wish to enter into the farm sale with standing crops by selling the land using one contract and making the standing crops subject to a second contract with the buyer where the farmer reserves the right to harvest and sell the standing crop. This may provide the ability to “bypass” an undesired impact of §1231 capital gains tax treatment of the standing crops and allow the farmer to report the value of the crops as ordinary income while preserving the ability to deduct the production expenses.

Retaining some right in the farmland, such as an option to repurchase at a future date, will also prevent §1231 from applying to standing crops. Obtaining proper tax advice in connection with the sale of farmland with standing crops is essential in order to minimize the tax on the sale.

Conclusion

Today’s farmer selling farmland or other assets used in the farming business has the “double advantage” of §1231. When selling farmland with standing crops, however, the farmer must assess whether §1231 will be beneficial or not. Several factors in the farmer’s tax analysis make it necessary to assess the impact of this tax rule on the sale transaction. Present uncertainty with changes in capital gains rates, income tax rates and tax brackets provide an additional variable to consider in such an assessment.

References

2 The farmer may be required to treat gain as ordinary income if §1231 losses were recognized in the five years prior to the sale or exchange of property. In addition, §1245 and/or §1250 may cause “recapture” of depreciation claimed on the property sold or exchanged. Recapture generally serves to recharacterize long term capital gain as ordinary income.
3 Treas. Reg. §1.1231-1(c)(5).
4 Treas. Reg. § 1.1231-1(f).
5 IRC § 268.
6 IRC §1016(a)(11); Treas. Reg.§ 1.1016-5(g).
7 Treas. Reg. §1.268-1.
8 IRC §1231(d)(4).

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