

1031 Exchanges: Benefits for Farmers and Ranchers

Smart farmers and ranchers can upgrade or replace land holdings with another property by using a tax deferral tool called 1031 tax deferred exchanges. Funds resulting from savings on capital gains taxes represent an indefinite, interest free loan for acquiring higher yielding investments. Knowing what property can be exchanged, in what time frame will help you and your advisors take advantage of the tax deferral strategy and avoid potential risks.

Reasons for Exchanges

Farmers and ranchers engage in 1031 exchanges for reasons of diversification, consolidation, relocation, appreciation and replacing existing real property with less labor-intensive cash flow properties. Once the often-difficult decision to sell has been made, the question is what to do next? What are the tax implications? How will this impact my children?

Given your goals, perhaps it may be best for estate planning purposes to diversify the ranch into properties that can be eventually gifted to the taxpayer's heirs. Alternatively, you may find it beneficial to consolidate multiple land tracts into one larger property. If the taxpayer is moving, relocating a property maybe the right choice. If the farm or ranch sales value has peaked, reinvesting into property in the path of progress for better appreciation may be the right alternative.

Finally, a less labor-intensive cash flowing property can provide the passive income sought to supplement retirement while maintaining an investment property for the taxpayer's beneficiaries.

IRS Code Section 1.1031

Enforced by the Internal Revenue Service (IRS) Code Section 1.1031, a 1031 exchange states "no gain will be recognized on property held for productive use in trade, business or investment when exchanged for like kind property held for productive use in trade, business or investment." Property denotes real property. The replacement property must be of equal or greater value than the property sold or a tax is triggered on the difference. A 1031 exchange has many rules and requirements, one of which is the use of a Qualified Intermediary to accommodate the exchange.

Example: What is Return on Investment?

As an illustration, let's say you are considering selling 500 acres for \$3,000 per acre or \$1,500,000

with selling expenses of 7%. The land was purchased 15 years ago for \$1,000 per acre and you earn above \$68,000 after deductions and exemptions, filing a joint tax return. The federal (15%) and state (3.4% state dependent) capital gains tax on the sale is \$164,680.

The choice is either to pay the capital gains rate or use those taxable dollars as an indefinite, interest free loan towards acquiring replacement property. The time value of money suggests that at the present time, money is worth more than the amount in the future. Inflation reduces the purchasing power of tomorrow's dollar. Given a conservative 3% appreciation per year for ten years, the \$164,680 will be worth \$221,316, or a 34.4% return on investment. The higher value is in addition to cash flow generated from the replacement property.

The risk is the replacement property does not appreciate at 3% per year and the eventual tax is higher than the return on the replacement property. When the replacement property is sold, the taxes due will include those of the \$1,000-acre farm and the replacement property at the then current capital gains rate the taxpayer can continue to exchange from one property to the next, leaving the property for their beneficiaries. It is suggested to seek the counsel of your accountant to review the tax implications.

Eligible Property

Real property in the United States may be exchanged for other real and property in the United States.

A partial list of real property includes:

- Oil and gas royalty
- Apartment
- Single family rental
- Golf course
- Mobile home park
- Vacation property
- Self-storage complex
- Commercial building
- Conservation Easement
- Convenience store
- Timberland
- Tenants in Common

Property ineligible for 1031 consideration includes:

- Primary residence
- Inventory
- Indebtedness
- Securities and notes

Mixed Use Exchanges

Often in the sale of a ranch or farm, there is a primary residence. That portion of the property designated as the primary residence is the area adjacent to the home including the area where grass is cut during the growing months. The Internal Revenue Code Section 121 provides for the exclusion of gain up to \$250,000 (\$500,000 for married persons filing jointly) on the sale if during the five-year period ending on the date of sale the property has been owned and used by the taxpayer as their principal residence totaling two years or more. This exclusion is given only once every two years.

If the taxpayer has owned the residence for less than two years, yet satisfied the ownership and use requirements, a prorated exclusion is granted given a change in place of employment, health or unforeseen circumstances.

Periods of unqualified use or when the home is not used as the taxpayer's residence do not apply towards the excluded gain. Surrounding land not used for residential purposes, but for an investment is eligible for 1031 tax deferral treatment. Consequently, the gain on the primary residence makes use of the Section 121 gain exclusion while the vacant land defers gain under Section 1031. It makes sense for the taxpayer to make use of as much of the Section 121 exclusion as possible given the tax benefits of paying no tax on the excluded gain of \$250,000 and \$500,000 depending on federal filing status. Gain above the exclusion can be deferred in a [Deferred Sales Trust](#).

Revenue Procedure 2005-14 has specific arrangements for when the primary residence is a separate unit from the non-residence like a farmhouse or living unit above the farm shop. The taxpayer can allocate the square footage of the dwelling unit and business portion as an acceptable method of determining the amount of gain attributable to the residential and nonresidential portions of the property.

Example: Mixed Use Property Exchanges

The taxpayer purchased a farm five years ago for \$270,000 that includes his primary residence, a separate dwelling unit for his business office and farmland. Based on the square footage of the two units the taxpayer allocates 1/2 of the property's original basis of \$270,000 to the residence (\$135,000) and 1/4 to the business office (\$67,500) and 1/4 to the vacant land (\$67,500). The taxpayer claimed depreciation deductions of \$17,500 resulting in an adjusted basis of \$50,000 for the business office. The taxpayer sells the entire property for \$450,000 exchanging for a primary residence, a separate building for his business office and a tract of land. The property's sale price is allocated \$225,000 to the residence, \$112,500 to the office and \$112,500 for the farmland. The replacement property is purchased for \$450,000 including a primary residence valued at \$225,000, a business office for \$112,500 and vacant farmland for \$112,500. The taxpayer realizes a gain of

\$197,500 in the exchange: \$90,000 on the primary residence, \$62,500 on the business office and \$45,000 on the farmland.

Under Section 121, the taxpayer excludes the \$90,000 gain on the sale of his primary residence, paying no tax because he meets the ownership and use requirements. The gain for the business office and farmland is not excluded under Section 121, but because the fair market value of the replacement business property and farmland is equal to the fair market value of the relinquished business and farmland, the taxpayer receives no cash and defers the remaining gain of \$107,500 under Section 1031.

Given the taxpayer income bracket is 25%, an estimated recognized federal and state capital gains tax of \$19,460: \$7,245 for the farmland and \$12,215 for the business office. A 3% appreciation for each of five years results in a future value of the tax deferral of \$22,560 or a 15.9% return on investment.

Unharvested Crops

Depending upon state law, unharvested crops may be considered real property. If so, then it may be wise to exchange the farmland before harvest. Harvested crops are not eligible for a 1031 exchange given they are considered inventory and taxable as ordinary income unless the presence of a 30-year lease for the farmland. In an exchange of a nursery, the unharvested trees and shrubs were considered real property and exchanged for other real property (*Asjes v. Commissioner of Internal Revenue*, 74 T.C. 1005, 1980 WL 4438 (1980)).

Water Rights

State law determines whether water rights are considered real property. For the purposes of section 1031, perpetual water rights are eligible for gain deferral as real property. Rights that are limited or restricted in duration or quantity are not like kind to a fee interest in real property.

In *Donald Wiechen, et al. v. U.S.*, 228 F. Supp. 2nd 1080 (D Ariz 2002), the Court ruled water rights limited in priority, quantity and duration for a 50-year term were not like kind to a fee interest in real property even though the water rights were real property under state law. The Court denied the 1031 exchange on the basis the water rights were restricted as opposed to unlimited use of real property.

In Private Letter Ruling 200404044, the Court ruled in favor of a decision where water rights were limited to a maximum diversion rate and quantity per calendar year but not duration to be like kind to a farm.

Ditch Rights

Congress approved the Food, Conservation and Energy Act of 2008 providing that stock held in a mutual ditch, reservoir or irrigation company, is eligible for 1031 exchanges. Shares can be exchanged, if the ditch, reservoir, or irrigation company is an organization described in Section 501(c)(12)(A) and the highest Court in the State in which the company organized or applicable State statute recognizes the shares as either real property interest in real property. A mutual ditch company is a non-profit organization created for the single purpose of managing a joint water distribution service on behalf of its members. Ranchers and farmers are the typical shareholders that have an exclusive right to use the ditch company's water in proportion to the number of shares owned.

Oil, Gas and Mineral Interests

Perpetual interest in minerals can be sold separate from the fee interest in the land. For instance, a mineral lease provides the lessee with the right to exhaust minerals for a period of time and inclusive of the costs associated with exploration and extraction. Per Private Letter Ruling 200805012, the lessee's interest in the mineral lease is considered a real estate interest for federal tax purposes.

To the lessor, the mineral royalty represents a royalty interest, bearing no cost of production and the right to receive a percentage of minerals extracted for the duration of the mineral interest. When the mineral lessee grants a sublease while retaining a royalty interest, the IRS adjudicated Revenue Ruling 72-117, 1972-1 C.B. 226, providing unimproved real estate is exchangeable for an overriding oil and gas royalty.

Landowners of farmland and ranches have real property that when sold can utilize the 1031 tax deferral strategy for higher yielding returns.

Forward 1031 Exchange

In a forward exchange the old or relinquished property is sold first followed by the purchase of the replacement property. The suggested steps to a forward 1031 exchange include:

- Determining capital gains and recaptured depreciation taxes triggered when the old property is sold.
- Working with a Realtor to list your property.
- Engaging a Qualified Intermediary (QI) to accommodate your exchange.
- Once in contract, scheduling a closing.
- At the closing 1031 exchange documents are prepared supporting your intent to affect a 1031

exchange.

- Net equity from the sale represents your exchange proceeds that are wired to an escrow account under your social security number.
- By the 45th calendar day, potential replacement properties are identified to the QI.
- A purchase contract is negotiated on the replacement property.
- Closing date is scheduled.
- At the second leg closing, exchange documents are prepared for signing.
- Exchange proceeds are wired to escrow or closing company.
- Exchange is completed by the 180th calendar day.
- A file is provided of signed exchange documents for you and your accountant.

Reverse 1031 Exchange

A reverse 1031 exchange is when the replacement property is purchased before the sale of the old property. It is a bit more complex given either the new or the old must be parked temporarily with the Exchange Accommodator Titleholder (EAT). The decision of which property to park depends on whether a new loan is required on the replacement property or does the state where the property is located assesses a conveyance or transfer fee. The goal is to minimize the purchase process and taxes. Often, it makes sense to park the old property to allow the franchisee or business owner to purchase the new property as normal.

The typical steps to a reverse 1031 exchange include:

- Determine the capital gains and recaptured depreciation when the old property is sold.
- List the old property with a Realtor and work with them to identify the replacement.
- Engage a qualified intermediary (QI) to accommodate the reverse 1031 exchange and determine which property should be parked with the EAT.
- Once in contract for the replacement property schedule a closing.
- Secure financing requirements.
- When improvements are to be made to the replacement property, the EAT will be the titleholder. If not, the EAT will be conveyed title to the old property prior to the closing on the new property.

- By the 45th calendar day, the old or relinquished property is identified to the QI.
- A sales contract is negotiated on the old property and closing scheduled. If EAT is the titleholder, the EAT signs the sales contract with the taxpayer signing under “Read and Approved.”
- At the closing the net equity received is wired to the taxpayer.
- Exchange is completed by the 180th calendar day post-closing on the replacement property.
- A file is provided of primary signed exchange documents for you and your accountant.

1031 Requirements and Rules

The primary 1031 exchange rules include:

- The purchase price of the replacement property is equal to or greater than the old or relinquished property net sales price. Otherwise, a tax is triggered on the difference.
- The taxpayer who sells is the taxpayer who buys.
- Replacement properties are identified by the 45th calendar day post-closing with an additional 135 calendar days to complete the exchange.
- If the old property is sold to a related party, the property must be held for two years before selling or the tax deferred by the 1031 exchange is due.
- You can purchase the replacement property from a related party, only if they are also initiating a 1031 exchange.
- The qualified intermediary cannot be considered an agent of the taxpayer for two years prior to the exchange or they are considered a disqualified person.
- Real property located in the United States can only be exchanged for real property located in the United States. International real property can only be exchanged for real property located internationally.
- Nonresident aliens or foreigners must comply with [FIRPTA](#) when selling real estate.

About the Author

Andy Gustafson, Certified Exchange Specialist®, serves as the managing member of Atlas 1031 Exchange, LLC, a worldwide accommodator of Internal Revenue Code Section 1031. To date, he has accommodated over 1,400 real and personal, simple and complex, domestic and international 1031 exchanges. You can reach him at 800.227.1031 and info@atlas1031.com.



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