GAINING GROUND

IT'S POSSIBLE TO DEFER CAPITAL GAINS TAXES WHEN BUYING, SELLING LAND

Few long-term investments can match land for added income potential and enjoyment. After all, you can't produce food in a bank vault or watch herds of whitetails on Wall Street.

But when land appreciates as quickly as it has in recent years, changing ownership can prompt a visit from the tax man.

Fortunately, Section 1031 of the Internal Revenue Code enables people who are selling business or investment property to reinvest in new property and defer capital gains tax. The tool helps farmers, ranchers and other rural landowners put the return on their investment to work when exchanging one property for another.

The savings from a 1031 tax-deferred exchange can be substantial. Without one, recent capital gains rules and a new net investment income tax mean that sellers with high income could pay as much as 23.8 percent in taxes on the gain.

"The case to do a 1031 is if you have a lot of gain," says Larry Kokel, a real estate appraiser and broker with Kokel-Oberrender-Wood Appraisal Ltd., in Georgetown, Texas. "Changes in the tax law make the 1031 even more important if the sale of the property throws you into a higher income tax bracket."

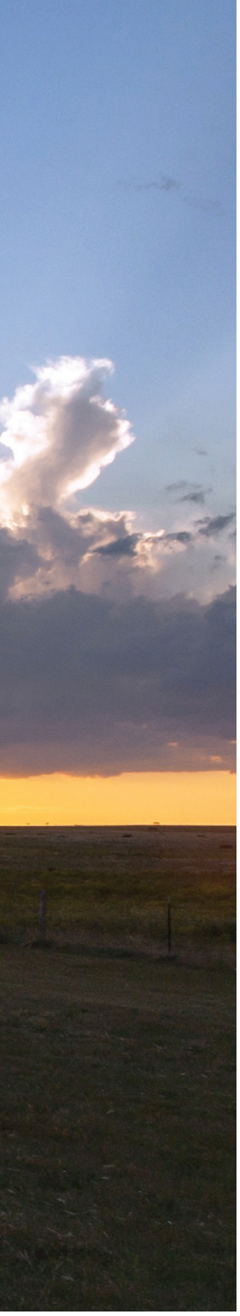
Often the people with the biggest gain have owned property for a long time.

"Let's say a rancher is selling a $2 million ranch that he's been running since his grandfather established it," says Rae Ann Carlisle of San Antonio, assistant vice president and exchange coordinator for IPX1031, the nation's largest 1031 exchange services company. "He's probably got a significant amount of gain. He can pay 15 to 23.8 percent in tax, or he can utilize the 1031 exchange, preserve his net worth, and reinvest that into a new business or investment property."

Many Kinds of Property Qualify

When rural landowners reinvest, they often use the gain to buy more property or property with more geographic diversity, convenience or access to water.

"In nearly all of the exchanges I see in the rural land market, people are trading up," says Wayne Young, a Capital Farm Credit senior appraiser in Huntsville, Texas. "Someone bought a ranch, the market appreciated, so they could potentially sell it, go a little farther out and buy a bigger place or a better place."



Land isn't the only type of business or investment property that can qualify for an exchange.

"There's a very broad definition of 'like kind,'" says Thomas C. Baird of Temple, Texas, a founding shareholder with the law firm Baird, Crews, Schiller & Whitaker, who has handled many 1031 exchanges. "If you meet all the requirements, it can cover raw land, ranchettes, apartment complexes, self-storage facilities — any number of income-producing properties."

What's above or below the land can also qualify, says Craig Dunagan, an Austin attorney and owner of Travis County Exchange Corp. Common exchangeable assets include mineral, water or timber rights and easements for conservation, electric transmission lines or oil and gas pipelines.

Property for personal use does not qualify, but it's still possible to partially defer taxes if land includes a home or hunting cabin.

"We recommend what we call the donut hole," Dunagan says. "Somebody sells property in an exchange, and wants to buy 200 acres with a nice house in the middle. They can usually pick the land around the house as the exchange property, and pay cash or borrow separately for the house and one acre as non-exchange property. They get the benefit of a good exchange for the land, and get the house for personal use."

Take a Team Approach

When doing an exchange, it's essential to work with group of professionals who understand IRS regulations and the rural real estate market, such as a lender, a broker, a lawyer or a CPA. That team must also include a qualified intermediary (QI), a facilitator who holds the proceeds of the sale until the taxpayer buys replacement property.

"In a tax-deferred exchange, the seller can't touch the money," Baird explains. "The money is held in an account in the qualified intermediary's name."

Giving someone access to your funds is not without risk, says real estate broker Jodie Rapp of Lakeway, Texas, president of Legacy Ag Group. That's why it's important to have experienced, trustworthy professionals on your side.

"Sometimes that's all the money a customer's got," says Rapp, whose company provides farm and ranch management and real estate services. "You want absolutely first-string people. A big part of what we do is put that team together. We're coordinators and facilitators."

The cost to do an exchange can be a fraction of the potential tax bill. QIs often charge about $650 to $1,000 for a transaction, plus other fees for additional properties. Legal work falls in a similar price range. The entire process can cost less than $1,000 for a basic exchange to about $3,000 for something more complex.

Play by the Rules

As with all tax laws, 1031 exchanges come with a lot of rules. For starters, the client must initiate an exchange with a QI before selling.

Another limitation is time, typically 45 days to identify replacement property and 180 days to complete the purchase (see "Types of Exchanges").

"Sometimes people get into trouble if they're under the gun to find replacement property," says Kelly Jennings, a senior appraiser for Lone Star Ag Credit, who sees exchanges used for farms, ranches and recreational property from Fort Worth to Sweetwater. "The market could be a little tight. There are not as many properties as in the past because they're selling so quickly. "

The rules also dictate that if you paid off a mortgage when selling, you'll be taxed unless you borrow the same amount when buying.

A lender who specializes in rural real estate can be a valuable partner.

"Some lenders don't want to deal with agricultural properties," says Jennings. "That's Farm Credit's primary function. We have specialized knowledge about rural properties and offer competitive rates."

Once the transaction is complete, you can enjoy your land for years to come without thinking about federal taxes — at least until it changes hands.

"If you sell property, you gift it to someone or change the manner of ownership, you can run into a taxable event," Carlisle says. "Once you break that investment chain or that chain of title, it can trigger taxation. But people can defer all the way into their estate, if they play it right. Proper planning and reasonable tax advice are crucial."

Even if the only certainties in this world are death and taxes, it's good to know that thanks to exchanges, at least one can be postponed.

Types of Exchanges

Deferred or delayed exchange: A property seller has 45 days after closing to identify replacement property and 180 days to purchase replacement property. The taxpayer may name up to three replacement properties of unlimited value, or more than three properties with certain restrictions.

Simultaneous exchange: The seller relinquishes title to the old property and takes possession of the replacement property in the same transaction.

Reverse exchanges: The taxpayer buys a replacement property before selling, and "parks" the title with a qualified intermediary until the original property sells. The taxpayer has 180 days to complete the exchange.

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