Tax Strategy Is an Easy Sell

A 1031 EXCHANGE CAN DEFER CAPITAL GAINS TAXES WHEN SELLING, REINVESTING IN RURAL PROPERTY

Few long-term investments can match land for added income potential and enjoyment. After all, you can't produce food, fuel and fiber 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 sell business or investment property to reinvest in new property and defer capital gains tax on their federal income taxes. 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 are the ones who 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

Exchanges often enable landowners to apply the appreciation on the old property toward new property with more acreage, improvements, geographic diversity 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 and buy a bigger place or a better place."

But land is just one type of business or investment property that can qualify for an exchange. For example, an aging couple can sell a farm and buy a shopping center that can provide income with less physical labor. Likewise, many exchangers sell commercial property and buy rural land because they see it as a safe investment with the potential for appreciation, recreation, and farm or rental income.

"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. "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, Texas, attorney and owner of Travis County Exchange Corp. Common exchangeable assets include mineral, water and timber rights; and easements for conservation, electric transmission lines, and oil and gas pipelines. Even livestock and agricultural equipment qualify, with additional restrictions.

What doesn't qualify? The rules exclude property owned by dealers who buy and sell quickly, as well as property for personal use. 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 farmland or ranchland around the house as the exchange property, and pay cash or borrow separately for the house and 1 acre as non-exchange property. They get the benefit of a good exchange for the investment land, and purchase the house for personal use."

Take a Team Approach

When doing an exchange, it's essential to work with professionals who understand IRS regulations and the rural real estate market. Your team might consist of a lender, a broker, a lawyer and an accountant, and must also include a qualified intermediary (QI) — a facilitator who holds the sale proceeds 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."

When choosing a qualified intermediary, ask how your funds will be protected from loss; how they will be invested, with or without interest; and whether they will be isolated from other clients' funds. Get the details in writing.

Giving someone temporary 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.

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>
> – Rae Ann Carlisle, assistant vice president and exchange coordinator for IPX1031

"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."

As beneficial as 1031 exchanges can be, they won't defer state income taxes or depreciation recapture on federal taxes. They also aren't right for everyone. Restrictions can rush the buying process and tie up funds in a long-term investment, making them unavailable for medical bills, college tuition or debts.

"Some people are so tax-averse that they make bad decisions," Baird says. "You may end up owning property you don't want or don't like. Are you better off paying the tax and having more liquidity?"

If an exchange is right for you, the cost can be a fraction of the potential tax bill. QIs often charge about $650 to $1,000 for a transaction, plus fees for additional properties. Legal work falls into 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 plenty of rules.

For starters, property owners must initiate an exchange with a QI before closing a sale, and include an exchange clause in the real estate contract. They then must identify replacement property and complete the purchase within strict time limits (see "Types of 1031 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 in Fort Worth, Texas. "The market could be tight because properties are selling so quickly."

The rules also dictate that if you pay off a mortgage when selling, you'll be taxed unless you borrow the same amount or use cash from personal savings when buying.

A lender with expertise in rural real estate can be a valuable partner. Farm Credit lenders can even help buyers identify replacement property.

"If you're planning to do an exchange, it's best to get involved with a lender early," says Gary Blair, vice president and branch manager for Southern AgCredit in Brookhaven, Miss. "We may be aware of the type of property you're looking for and can put you with a loan officer who knows what's for sale."

Once the transaction is complete, you can enjoy your property for years 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. ■ CF

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Types of 1031 Exchanges

Deferred or delayed exchange: The seller has 45 days after closing to identify replacement property and 180 days to make the purchase.

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

Reverse exchange: The exchanger buys replacement property before selling, and "parks" the title with a qualified intermediary until the original property sells. The exchange must be completed within 180 days.