Straight Talk

THE GO-TO GUIDE WHEN SELLING YOUR FARM OR RANCH

Selling a Home Along with a Farm or Ranch: Using the Section 121 Exclusion

Selling a farm or ranch often involves disposing of business property – such as land, outbuildings, livestock and equipment – as well as non-business property like a home. You probably already know that using the 1031 exchange can enable you to defer tax on the sale of the farm or ranch real estate – but you cannot include your primary residence in the exchange. However, there is another section of the tax code that will enable you to take cash out of the sale of your home tax-free: Section 121.

Under Section 121 of the Internal Revenue Code, the gain on the sale of a primary residence can be excluded for income tax purposes, subject to the following conditions:

- You owned the home and used it as your primary residence during at least 2 of the last 5 years before the date of sale
- You did not acquire the home through a 1031 exchange during the past 5 years
- The exclusion has not been used in the past 2 years
- The exclusion is limited to $250,000 if single or married filing separately, or $500,000 on a joint tax return

If you don't meet these conditions, you may still qualify for partial exclusion if you moved because of a change in employment, for health reasons, or certain unforeseeable events.

Vacant Land

Vacant land adjacent to your home can be combined with the home under the Section 121 exclusion, subject to the following conditions:

- The land is adjacent to the land on which your home sits
- You owned and used the vacant land as part of your home – not for any business purpose

- The home sale occurs within 2 years – before or after – the land sale. Note: If the land sale occurs in a taxable year prior to the home sale, the land sale must first be reported as taxable on your tax return – but that can later be amended to claim the Section 121 exclusion once the home sale occurs.
- All other Section 121 requirements have been satisfied with respect to the vacant land

The sale of the residence and the vacant land are treated as one sale, and the applicable maximum – $250,000 if single or married filing separately, or $500,000 on a joint tax return – applies to the combined sale.

The big question is how much land can you include? This is a gray area with the IRS and each case is examined separately based on specific facts and circumstances. Relevant facts and circumstances may include:

- Has the land been used for personal use, such as growing crops or raising livestock for personal consumption?
- Is the land landscaped?
- Has the land been used for commercial farming or ranching purposes for the two years prior to sale?
- Has the land been used for any other income-producing activities, such as leasing pasture?
- Does the land contain outbuildings used in the agricultural business?

Previous tax court cases have allowed as much as 100 acres to be included with the home sale, but it's more common (and less risky) to include smaller acreage amounts, say from 1 to 10 acres, with your home sale.

Entity Ownership Issues

Generally, the 121 exclusion is available only to individuals – not corporations, partnerships and limited liability companies (LLCs) because these entities cannot use a house as a primary residence.

However, there are exceptions to this for certain single-owner disregarded entities. A disregarded entity is an entity that is separate from its owner for legal liability purposes, but is the same as the owner for tax purposes. For these entities, the owner will be treated as owning the residence for exclusion purposes. Certain trusts and single-member LLCs that own primary residences qualify for the exclusion. In certain circumstances, it may also be possible for husband and wife partnerships and LLCs to qualify for the exclusion.

For partnerships comprised of other family member partners, it may be possible to distribute the residence out of the partnership to the individual partners at least 2 years before the ranch sale, and this may allow for qualifying the residence sale for the exclusion. It's recommended to consult your tax advisor in these circumstances.

Substantiating Home Value

To successfully use the Section 121 exclusion, you must substantiate the value of the home separate from the ranch real estate. At a minimum, a market analysis should be prepared by a realtor, validating the value placed on the home. For added assurance, an appraisal by a professional appraiser might be prudent.

Contract and Closing

The sale price attributed to the home should be broken out separately from the price attributed to the ranch real estate. This can be addressed in the body of the ranch purchase and sale agreement (PSA), or in an addendum to the PSA. Some attorneys even recommend separate PSAs for the ranch and the home.

Regardless, two separate settlement statements should be prepared and issued by the closing agent, particularly if you are completing a 1031 exchange. Accordingly, at closing, the home sale proceeds will be given to you, while the ranch sale proceeds are wired directly to your 1031 exchange qualified intermediary. (This is necessary because 1031 rules forbid the taxpayer from receiving exchange proceeds directly.) The 1031 exchange documents should not reflect the primary residence sale.

Conclusion

Combining a Section 121 exclusion with a 1031 exchange can be a great strategy for agricultural families to take some cash from the sale of their farm or ranch tax free, while also deferring capital gain taxes on the working acreage.

For those selling a farm, ranch, or other appreciated real estate, Top Hand Realty Advisors may help you save taxes and create stable income through a 1031 exchange into high-quality commercial real estate. Our company combines real estate and tax expertise — a unique advantage in helping you meet your specific goals. Our analytical approach to evaluating properties and our efforts to educate you about the strengths and weaknesses of each property will clearly demonstrate our commitment to your best interests. From start to finish — from discussing your situation and goals to identifying commercial real estate opportunities, conducting due diligence and finally completing your purchase — we can guide you. We would like the opportunity to prove our value to you.

Top Hand Realty Advisors, Inc.
403 West Main St., Suite 1
Bozeman, MT 59715
406-586-0356
www.TopHandAdvisors.com

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