Straight Talk

THE GO-TO GUIDE WHEN SELLING YOUR FARM OR RANCH

Using a Section 1031 Exchange When Selling a Farm or Ranch

Section 1031 of the Internal Revenue Code is a powerful tax-saving tool and wealth-building strategy for people selling highly appreciated real estate.

1031 Exchange Overview

What it is

Section 1031 of the Internal Revenue Code states: "No gain or loss shall be recognized on the exchange of real property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held for productive use in trade or business or for investment."

In other words, you can sell a property at a gain, reinvest the sale proceeds into like kind property and defer any capital gain taxes on the sale.

What it Means for You

Often, agricultural properties have been in the same family for generations and the properties have very little tax basis, so when they are sold the gain can be very significant – which means the tax can also be very significant. By using the 1031 exchange to trade out of the farm or ranch and into income-producing real estate, you can defer – or possibly eliminate – that tax. You also may increase your income significantly, as income-producing commercial real estate likely produces a higher return than a typical farm or ranch. And, under current law, the deferred tax liability may be eliminated entirely when your heirs inherit the property.

Therefore, a 1031 exchange may significantly enhance your income and increase the estate your heirs eventually inherit.

How it Works

We can sum up how the exchange process works in four basic steps:

1. You arrange for the sale of your farm or ranch, which in exchange terms is called "the relinquished property."
2. At closing, all sale proceeds are transferred by the closing agent directly to a Qualified Intermediary (QI) for a 1031 exchange.
3. You must identify, in writing, potential replacement properties within 45 days of closing on the relinquished property sale. (If no properties are identified within this time frame, no exchange can be performed. Instead, the QI will return the exchange funds to you and your sale becomes taxable.)
4. You must close on the purchase of your replacement property (or properties) and complete the exchange within 180 days of closing on the sale of the relinquished property. (Again, if this deadline is not met, the exchange cannot be completed. Instead the QI will return the exchange funds to you and the transaction becomes taxable.)

When a 1031 is Not Advantageous

An exchange may not be beneficial under the following circumstances:

- You have a small gain or even a loss on the sale of your property. If your gain and related tax is minimal, the cost and effort to complete an exchange may not be worth it. It may be best to pay the tax and have cash available to invest. Be very careful about using an exchange if you have a loss, as this will result in the deferral of the loss, rather than the immediate deduction of it on your tax return. If necessary, consult your tax advisor to determine the tax status of your property sale.
- You have current year tax losses or loss carryovers that may offset some or all of the gain on your property sale. Again, consult your tax advisor.

Before you decide to complete a 1031 exchange, make sure you have a comprehensive understanding of your tax situation.

Types of Exchanges

Simultaneous Exchange: This is the simplest type of exchange, and is a simultaneous swap of one property for another. They occasionally occur with farmers and ranchers who own adjoining properties. However, in reality it is difficult to find two parties who are both interested in each other's property, at the same time, and with comparable property values. Thus, a simultaneous exchange is rare.

Deferred Exchange (aka Delayed Exchange): This is the most common type of exchange. With the help of a QI, it allows you to sell a property and then acquire one or more replacement properties at a later date.

Reverse Exchange: This exchange allows the taxpayer, with the help of a QI, to first acquire a replacement property and later dispose of the relinquished property. Note that this is the opposite timeline of a delayed exchange.

Improvement Exchange: This exchange allows the taxpayer to use exchange proceeds in constructing improvements on a replacement property prior to closing on it.

If you are selling a farm or ranch, and intend to use the 1031 exchange to defer the tax on your sale and purchase income-producing investment real estate, you are most likely to use a deferred exchange. Thus, this is the type of exchange we will focus on in this article.

1031 Exchange Timeline

There are strict time frames pertaining to the identification and receipt of the replacement property for the completion of a delayed exchange.

45-Day Identification Rule

You must identify a potential replacement property or properties within 45 days from closing on the sale of your relinquished property. To do so, your QI will provide to you the proper property identification form, which you must fill out, sign, and return to the QI's physical possession before midnight of the 45th day. On the form, each potential property must be clearly described by a legal description, street address or distinguishable name.

There are no extensions of this deadline for any circumstance or hardship, except in the case of presidentially declared disasters. Additionally, after the 45-day period has lapsed, you cannot change or substitute any properties you had previously identified. You must exchange into one or more of your identified properties, or you may perform no exchange and instead pay the tax.

You may identify more than one potential replacement property, subject to the following rules:

- Three Property Rule: You may identify a maximum of three properties, regardless of value.
- 200% Rule: You may identify any number of properties as long as their aggregate fair market value does not exceed 200% of the value of your relinquished property.
- 95% Rule: You may identify any number of properties as long as the aggregate fair market value of the properties actually received by the end of the exchange period is at least 95% of the aggregate fair market value of all the identified properties.

180-Day Rule

You must close on the purchase of your replacement property, and complete your exchange, by the earlier of:

- 180 days after closing the sale of your relinquished property
- the due date (with extensions) of the income tax return for the year you sold your relinquished property

If an exchange takes place late in the tax year, the 180-day deadline can be later than the April 15 (March 15 for corporations) tax return filing deadline – in this situation, you simply have to file an extension for your tax return. If no tax extension is filed, your deadline to close on your replacement property will be the filing date of your tax return. In other words, do not file your income tax return until you complete your exchange.

As with the 45-day rule, there are no extensions of this time limit for any circumstance or hardship except in the case of presidentially declared disasters.

Managing the Exchange Process

When it comes to the 1031 time limits, the most critical of the two is the 45-day identification period. As many of our clients will attest, this goes by surprisingly fast once you close on your relinquished property sale. It is critical for the taxpayer to be diligent and proactive during this timeframe. At Top Hand, we don't wait for our clients' ranch sales to close before we begin searching for their commercial replacement properties. We begin the search roughly 30 days prior to the closing of their sale. This effectively extends the 45-day period to 75 days for practical purposes, and allows our clients to be far ahead of the curve when it comes to completing their exchange successfully.

Ideally, we like to have our clients in position to close on the purchase of their replacement properties within the initial 45-day ID period. This strategy reduces our client's risk:

- It ensures all deadlines are met
- It ensures that all due diligence is completed before you have to formally identify a property – so if any negative surprises are discovered in that property, you still have time to identify another property instead
- It maintains negotiating leverage – because if you're negotiating with a seller who knows you've already formally identified his property, he has you over a barrel if your only options are to either agree to his terms or pay a big tax bill

At a minimum, we want to have all due diligence completed before the 45-day ID window closes. In this scenario, we would also have backup properties secured and identified – which gives you options in case any of the above scenarios develop. Using this strategy we have never had an issue and have successfully managed the exchange process for numerous clients who have sold farms or ranches and exchanged into commercial real estate.

Before Conducting an Exchange

Document Your Intent

Although not a pre-requisite to completing a 1031 exchange, it is common practice to include in the purchase and sale agreement language announcing your intent to conduct an exchange. This language simply puts all parties on notice you intend to complete an exchange, and will assume all costs and responsibilities associated with it.

Conduct Any Cost Basis Planning

Farms and ranches that have been in a family for generations are often composed of multiple separately deeded parcels, which were purchased at varying prices as the family added to their acreage over the years. As a result, the individual parcels generally have significantly different cost basis figures.

This offers a simple, but effective, strategy if you wish to 1031 exchange part of a ranch, and also take some cash out of the sale. The portion to exchange should be the parcels with the lowest basis, and thus the highest gain and related tax. Those parcels with the highest basis, and thus the lowest gain and lowest tax, are the ones you should sell for cash.

To help avoid potential problems with the IRS, you should have one purchase and sale contract for the parcels that will be exchanged, and a separate purchase and sale contract for the parcels being sold for cash. Accordingly, make sure your ranch broker understands up-front what you are trying to accomplish. You don't want to spring this on a potential buyer after a contract is in place, as they may not be agreeable to restructuring the contract.

Address Any Issues Related to Ownership Entities

Farm and ranch real estate may be owned in a variety of ways, including by individuals, C corporations, S corporations, partnerships (general and limited), limited liability companies and trusts. All of these entities can perform 1031 exchanges. However, issues can arise with certain ownership structures including LLCs, partnerships and corporations – particularly when members, partners or stockholders want to perform exchanges and go their separate ways. Advance planning is critical in these scenarios – sometimes years in advance. These issues are too complex and detailed to address in this article, so please refer to our *Straight Talk* guides *"Entity Planning When Selling a Farm or Ranch: Partnerships, LLCs and the 1031 Exchange"* and *"Entity Planning When Selling a Farm or Ranch: Corporations and the 1031 Exchange."*

1031 Exchange Requirements

There are strict, complex rules governing Section 1031 exchanges – and, if not followed properly, the consequences can be harsh. Below are some of the most notable requirements that you should know.

Qualifying and Non-Qualifying Property

Under current tax law (2018), only real estate held for productive use in a trade or business, or held for investment purposes, qualifies for 1031 treatment.

Personal use property, such as a personal residence, does not qualify. However, there are attractive planning opportunities available that may provide the taxpayer with tax-free cash when a home is sold with a ranch or farm. For further information, please see our *Straight Talk* guide *"Selling a Home Along with a Farm or Ranch: Using the Section 121 Exclusion."*

Personal property exchanges are no longer allowed. Although previously it was possible to perform a 1031 exchange with depreciable tangible personal property — such as farm machinery, irrigation equipment or livestock — that section of the code was repealed in the Tax Cuts and Jobs Act that took effect January 1, 2018. Under current law, Section 1031 now refers exclusively to real estate assets.

Like Kind Requirement

The exchange must be for "like kind" property. Like kind properties are properties of the same nature or character. While the term "like kind" can be confusing, the Code allows for ample flexibility when it comes to exchanging different types of real estate. Basically, most real estate will be like kind to other real estate.

For example, when our clients are selling their ranch or farmland, they are trading into commercial real estate such as retail, office or multi-family properties. These qualify as like kind properties. Other real estate interests that qualify for 1031 treatment include leasehold interests (of 30 years or more), certain easements (conservation, right of way), water rights, ditch rights, mineral rights, oil and gas interests, fractional interests and more.

Foreign Real Property Exchanges

Real estate located in the U.S. and real estate located outside the U.S. is not considered to be like kind. So exchanging farm ground in northern Montana for farm ground in southern Saskatchewan would not qualify for 1031 treatment. Trading foreign owned real property for other foreign owned real property, however, would qualify.

Qualified Intermediary

When performing a 1031 exchange, you cannot have actual or constructive receipt of the proceeds from your relinquished property sale. If the buyer gives you their money, your exchange is blown and you owe tax. Instead, you must have an independent party facilitate the exchange for you. That party is called a Qualified Intermediary or QI.

The QI's role is as follows: The QI acquires the relinquished property from you and transfers it to the buyer, holds your sales proceeds in escrow, and then uses those proceeds to acquire your selected replacement property, finally transferring the replacement property to you to complete the exchange. The QI will prepare all applicable documents to facilitate the exchange process.

The QI cannot be the taxpayer (i.e., you) or a "disqualified" person. A disqualified person is anyone who has acted as your "agent" (such as your CPA or attorney) within two years prior to the property sale and exchange.

Take Title in Same Name

You must take title to your replacement property in the same name in which the relinquished property was held. Thus, if your ranch real estate is in a corporation or partnership, it is the corporation or partnership that must take title to the replacement property.

An exception to this rule applies to disregarded entities, such as a single-member limited liability company (LLC). A disregarded entity is separate from its owner for legal liability purposes, but is the same as the owner for tax purposes. In this case, the owner-member could sell a property and the LLC could take title to the new property, or vice versa. Certain trusts may also qualify.

Cash, Debt and Boot

If you receive any "boot" in your Section 1031 exchange, it will be taxed to the extent of your gain on your relinquished property sale. Boot is the money (cash boot), debt relief (mortgage boot) or fair market value of any non-like kind property you receive in an exchange.

Boot can result from a variety of factors, but commonly occurs from "trading down" in a 1031 exchange – i.e., when your relinquished property is worth more than your replacement property. This is called a partial exchange, and common reasons for completing one include:

- To establish cash reserves for liquidity needs or for emergency purposes.
- To diversify into other, non-real estate investments like stocks or bonds.
- To use existing capital loss carryovers to offset capital gains from a partial exchange.
- To reduce your overall indebtedness.
- To structure an installment sale with part of the sale proceeds to (1) provide the buyer of the relinquished property with a means of purchasing the property if they have difficulty in obtaining financing and/or (2) to create future income for the taxpayer. Installment sale payments are taxable in the year received.

Bottom line: In order to defer 100% of the gain in an exchange, you must maintain or increase your equity <u>and</u> maintain or increase your debt. If either are reduced, the difference is boot and will be taxed to the extent of your gain on the sale.

Any debt you have on the ranch will be paid off at sale closing by the closing agent, and you will be taxed on this debt reduction — unless you take out the same amount of debt (or more) on your replacement property.

Debt is a common component of operating a farm or ranch, and many of our clients have small operating loans secured by the ranch real estate. Many of these folks look forward to paying off the debt at closing and becoming debt-free — until we explain the mortgage boot rules to them. That said, there are some possible solutions:

- You may offset any mortgage boot by contributing additional cash to the transaction. For example, if you are selling a $4 million ranch with a $500,000 mortgage on it, you could contribute $500,000 in cash, exchange $4 million into commercial real estate, and pay off $500,000 in debt. The additional cash balances out the debt reduction, so there is no boot.
- You can deduct certain exchange expenses (QI fees, closing costs, real estate commissions, legal fees, title insurance premiums, etc.) against taxable boot to lower your income tax liability.
- If you are also selling equipment and livestock, those sales may generate significant after-tax cash. Thus, you could replace the debt on your relinquished property with a new loan on the new property – thereby maintaining a 100% tax-free exchange – and sometime after closing on the replacement property, use the cash from the equipment and livestock sales to pay off the new loan. This can work well if the cash from equipment and livestock sales is more than enough to pay off the new loan and meet your liquidity needs.
- If you are exchanging into commercial real estate that will provide significant future cash flow, you may choose to replace the debt from the ranch with a new loan on the commercial property – again

maintaining a 100% tax-free exchange. You can then use the cash flow generated by your new commercial replacement property to rapidly pay off the new loan.

Earnest Money Treatment

Relinquished Property: Any earnest money you receive from a buyer must be transferred to the closing agent on or before closing, who will then transfer the money to the QI at closing. Otherwise, if you receive the earnest money and keep it, it will be taxed as boot. To avoid this risk, we recommend that your buyer make any earnest money deposit directly to the closing agent.

Replacement Property: Earnest money deposited on the replacement property can be handled in a couple different ways:

- If the relinquished property sale has already closed and your QI is holding the sale proceeds, the QI can directly transfer the earnest money deposit to the closing agent for the replacement property transaction.
- If the relinquished property sale has not yet closed, the taxpayer can transfer money from their own funds to the closing agent. It is then possible for the taxpayer to be reimbursed for their earnest money deposit at closing without adversely affecting the exchange.

After a 1031 Exchange

Refinancing

Refinancing a real estate loan and tapping into the property's equity to take cash out is a common practice. However, with an exchange property, the timing and purpose of doing this is important.

Under the "step transaction" doctrine, the IRS may determine that the refinance was part of a series of separate steps included in the exchange transaction, as opposed to being independent of the transaction, and therefore, the cash received from the refinance should be taxable as boot.

Whether you are refinancing the relinquished property prior to its sale or the replacement property after its purchase, the most critical factor in validating the refinance and avoiding taxable boot is to substantiate an independent business purpose for the refinance. If the IRS determines that the only reason to refinance the property was to take cash out, and thus avoid tax, classification as boot may occur.

Generally, it's advised to treat the refinance transaction as separate and distinct from the exchange transaction. If the independent business purpose designation is questionable, it's best to avoid refinancing the relinquished or replacement property immediately before or after the exchange, respectively.

Holding Period

One of the most common questions regarding 1031 exchanges is, "How long do I have to hold my replacement property before I can resell it?" There is no magic answer, because the Code states no specific time period.

Qualifying for tax-deferral treatment under Section 1031 hangs on the taxpayer's intent. You must intend to hold the replacement property for "productive use in a trade or business, or for investment." Property deemed to be held for resale could be considered inventory not held for investment intent, which is non-qualifying property under 1031 rules. This determination by the IRS could result in a taxable transaction instead of a tax-deferred transaction.

Generally, to be safe, it is wise to hold the replacement property for a minimum of two years before the property is sold or converted to personal use. However, if you can substantiate investment intent, it is certainly possible to hold property for shorter time periods and still qualify for 1031 treatment. At a minimum, a holding period that straddles two income tax reporting periods is recommended.

Please note: A special rule applies to exchanges between related parties. Generally speaking, property is required to be held for a minimum of two years in related party transactions. Consult your tax advisor for further clarification.

Tax Basis

In an exchange, your tax basis in the relinquished property carries over to the replacement property. Consequently, there is no "step up" in basis for depreciation purposes, and future depreciation deductions will be based on the carryover basis.

Accordingly, the deferred gain will also carry over and be recognized in future years if the replacement property is ever sold in a non-exchange transaction. At that time, both the deferred gain plus any additional gain realized since the purchase of the replacement property would be subject to tax.

Conversely, if you "trade up" and exchange into a more expensive replacement property by contributing additional cash or taking on additional debt, the property's tax basis will be increased.

Benefits of the 1031 Exchange

So given all the strict rules governing a 1031 exchange, why should you perform one? Because it may provide you, as the seller of appreciated property, with several compelling benefits, including those listed below.

Defer/Eliminate Taxes

By deferring taxes now, you can put 100% of your equity to work for you. This enables you to invest more in income-producing real estate, which in turn should generate more income than if you had invested after-tax dollars.

Additionally, you may not only defer the tax but can, in fact, eliminate it altogether. Under current (2018) tax law, if you hold your replacement property until death, your heirs will receive a "step-up" in basis to the property's fair market value. This step-up in basis is tax-free. Conceivably, your heirs could then sell the property for fair market value and pay little or no tax. Thus, by employing the 1031 exchange until death, it may be possible to not only defer taxes on the sale of property, but permanently eliminate them.

Thus, the 1031 exchange may enable you to generate more income through your lifetime, and also leave a larger estate for your heirs.

Build Wealth

Another significant benefit, but not recognized by many taxpayers, is the accumulation of future wealth by completing an exchange. The additional income you can generate from investing 100% of your equity builds over time.

For example, if we assume a rancher sells land with a tax basis of $500,000 for a price of $4 million, the gain will be $3,500,000. Using a combined federal and state capital gain tax rate of roughly 30% (which includes the 3.8% Medicare surtax), the tax bill will be $1,050,000 – and once paid, that money is lost forever. But completing a 1031 exchange allows that $1,050,000 to instead be reinvested into additional real estate to provide future income and potential appreciation. Assuming an annually compounded growth rate of 7%, including both income and appreciation, that $1,050,000 of saved and reinvested tax would grow to $2,065,509 (pre-tax) in 10 years. In 20 years, it would be $4,063,169.

Create Passive Income

The 1031 exchange provides an opportunity to transition to owning commercial real estate that may provide you with passive income. This can be a great solution for retirement, after the physical demands of working a farm or ranch operation become too taxing. Many of our clients have invested in triple-net leased properties, which require the tenant to assume all costs and management responsibilities of the commercial property; our clients simply receive a monthly rent check.

Generate Higher Income

When it comes time for folks to sell the ranch and transition into partial or full retirement, exchanging into commercial real estate can provide them with a significant increase in their income. Comparatively, operating income from ranch real estate is generally significantly lower than that of good commercial real estate. Thus, our clients generally see their cash flow increase dramatically by investing in high quality income-producing property.

Diversify

Many of our clients are selling high-value farms and ranches that represent much of their net worth. They then use the 1031 exchange to reinvest the sales proceeds into commercial real estate that will provide them with stable, long-term income. Rather than investing in a single property, we encourage our clients to diversify into two or more properties as a risk-reduction strategy. This also presents an opportunity to diversify by geographic location and type of commercial property (retail, office, multi-family, etc.), offering further diversification of risk.

Bottom Line: The 1031 exchange provides exceptional opportunities to indefinitely defer or eliminate capital gain taxes on the sale of appreciated farm or ranch land. Those interested in saving tax on their real estate sale should strongly consider this powerful tool.

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.

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