



*The Voice of the 1031 Industry*

1255 SW Prairie Trail  
Ankeny, IA 50023  
Phone: (515) 244-6515  
Fax: (515) 334-1174  
www.1031.org

## **I.R.C. SECTION 1031 AGRICULTURE BASED TRANSACTIONS Commentary and Examples of Benefits**

### **Commentary**

#### **Higher Tax Rates Dramatically Increase the Benefit of Section 1031 for Farmers and Ranchers**

With the passage of the Tax Cuts and Jobs Act in 2017, the long-term federal capital gains tax rate can be as high as 20% plus a net investment income tax (NIIT) of 3.8%. State income taxes may range from 5% to in excess of 10%. Accordingly, total tax from sales of highly appreciated farm and ranch assets approaches 30% or higher. Furthermore, total recapture rates for depreciable assets can approach 40%. With significantly higher capital gains tax rates, Section 1031 has become an indispensable tool for all owners of capital assets, including farmers and ranchers.

#### **Statistics from Professionals Engaged in the Industry Demonstrate that Section 1031 Exchanges of Farmland are Routinely Undertaken by Farmers and Ranchers**

Internal statistics and observations from Federation of Exchange Accommodators ("FEA") members operating primarily in agricultural based markets show that with few exceptions, farmers and ranchers overwhelmingly exchange into similar farm or ranch assets. Conversely, non-farmland property owners predominantly choose to exchange into non-agricultural properties. In comparison to the full universe of exchange transactions, exchanges out of non-agricultural property into agricultural transitional development land are isolated.

Section 1031 is not an unfair tax break for the wealthy or large land owners. On the contrary, it is one of the few incentives available to and used by taxpayers of all sizes. A recent industry survey showed that 60% of exchanges involve properties worth less than \$1 million, and more than a third are worth less than \$500,000.

Academic and noted opinion leaders have stated in multiple instances that limits to §1031 will have a dramatic, negative impact on the agricultural community as a whole.

#### **Academic Studies Have Demonstrated that Section 1031 Decreases Land Values by Stimulating Sales and thus Increasing Supply of Land for Sale**

Prior to the recent economic crisis, there was a prevalent myth among stakeholders in rural communities that recent growth in farmland values may have, in part, been stimulated by Section 1031 exchanges of farmland. A 2010 Texas A&M Economics Department study focusing on economic supply and demand factors found that Section 1031 actually decreases market prices of agricultural land because owners are more willing to sell properties. Without the deferral benefit, agricultural owners would be less likely to sell for fear of lost capital through taxes. This finding was substantiated by an Iowa Realtor's Land

Institute survey where land professionals predicted a 30% reduction of land available for sale if Section 1031 were repealed.

## **Elimination of Section 1031 would have a Significant Negative Impact on Rural Communities and Economies**

Section 1031 provides significant benefits to owners of farm and ranch land providing them with flexibility and increased economic efficiencies. The “spillover” and economic stimulus effects on a myriad of agriculture related industries, including REALTORS®, contractors, title insurers, and lenders are substantial. The repeal or restriction of §1031 would have a dramatic, negative impact on the agricultural community as a whole. Given the extraordinary connection between the value of farmland and farmers’ economic well-being, any policy changes that may hurt farmers and those involved in the agricultural industry should be avoided.

## **Section 1031 Stimulates the Agricultural and General Economy as Demonstrated by Standing the Tests of Tax Reform Proposals since its Enactment in 1921**

Section 1031 budget scoring has demonstrated that elimination of Section 1031 would have a minimal impact on deficit reduction. Further, its elimination could actually have a negative impact as a result of diminished economic activity. Economic policy efforts today focus on encouraging investment in productive assets, encouraging additional borrowing by qualified investors, increasing the velocity of transactions, redeploying underutilized or idle assets, and discouraging fearful contraction and cash hoarding. Section 1031 encourages this type of growth by mandating reinvestment in like-kind assets, increasing ordinary income from additional investment in higher value assets and job growth, discouraging the hoarding of capital, and penalizing profit taking by taxing value taken out of the economy. Section 1031 not only encourages reinvestment over profit taking, it provides a strong incentive to keep that investment at home, in the United States. Eliminating or restricting §1031 would not make a meaningful impact upon tax reform or tax simplification, and would do substantially more harm than good.

## **Examples**

### **Example 1: Combining Acres and/or Exchanging into Higher Grade Farms**

**Facts:** A farmer owned two 80 acre tracts of farmland located 20 miles away from his home operation. Farmer’s neighbor listed for sale a 160 acre, higher quality tract adjoining the farmer’s “home farm.” Through a like-kind exchange, the farmer was able to divest the two distantly located 80 acre parcels, acquire the neighboring 160 acre tract, and combine his land holdings into a larger farm of 360 contiguous acres.

**Impact:** The like-kind exchange allowed the farmer to exchange into the new farm without reducing his purchasing power, and provided him with the ability to combine his acres, increase operational efficiencies and add to the original family farm.

**Conclusion:** Section 1031 promotes reallocations of capital to higher quality assets and results in greater operational efficiencies.

## **Example 2: Keeping the Farm/Ranch in the Family – The Beginning Farmer**

**Facts:** A 65 year old farmer owned an 80 acre farm that had been in the family for decades. When farmer acquired the farm, land prices were much lower. Farmer's son was a beginning farmer, starting his operation, and he desired to acquire the ancestral farm. Farmer sold the family farm to his son and was able to exchange into a larger, higher quality parcel located near another separate tract of farmland.

**Impact:** The like-kind exchange allowed farmer to help his son start his farming operation while passing the family farm on to the next generation. Farmer was able to sell the property to his son without being "tax locked" due to the fear of severe tax ramifications if gain had not been deferred under Section 1031.

**Conclusion:** Section 1031 promotes and incentivizes transitions of farmland assets to new and beginning farmers.

## **Example 3: Keeping the Farm/Ranch in the Family – Sibling Acquisitions**

**Facts:** Five siblings inherited an undivided one half interest in two 600 acre tracts of ranchland (Tract A and Tract B) when their mother passed away in the 1990s, subject to a life estate with father. Father passed away in 2013 leaving the remaining undivided half to the siblings. All of the siblings were left with equivalent tax consequences in the event of a sale. Two of the siblings continued to raise cattle on the tracts while three lived in other parts of the country. The siblings decided to sell Tract A at auction with the winning bidder agreeing to lease Tract A to the rancher siblings. The three non-ranching siblings agreed to sell their interests in Tract B, the "home ranch" to the rancher brothers to keep it in the family. One of the non-ranching siblings cashed out of her interest and the other two siblings exchanged into income producing properties in their cities of residence.

**Impact:** The like-kind exchange allowed the two rancher siblings to keep the "home ranch" in the family. At the same time Section 1031 incentivized the non-farming siblings to sell without fear of being "tax locked" and reinvest in assets where they live that more appropriately met their investment goals.

**Conclusion:** Section 1031 promotes and incentivizes transitions of farm and ranch assets to those who know and work the land for their livelihoods. Fifty-five percent of land in many states is owned by farmers and ranchers 65 year or older. This scenario occurs with significant regularity and will occur in increasing frequencies as nearly two-thirds of farm/ranch assets in many states pass to the next generation over the next 20 years.

## **Example 4: Retirement Planning**

**Facts:** A farming couple owned 1,000 acres of farmland and operated a 150 head dairy operation. The couple had three adult children all living and working in or near the capitol city in their state. None of the children desired to return to operate the dairy operation. The farming couple expected to retire from the farm in five years. Upon retiring, the couple desired to sell their dairy operation and reside near their children and grandchildren. Toward this end, the couple sold off 100 acres of their farm and exchanged into a rental condominium unit in the capitol city. Upon retiring five years later, the couple would be permitted under tax law to convert the previously income producing property into either their second home or their primary personal residence. The couple will retain the remaining 900

acres of farmland and receive an ongoing retirement income stream by renting the acres to a tenant farmer.

**Impact:** The like-kind exchange allowed the farming couple to plan for retirement and relocation near their family by exchanging into a different non-farm asset without reducing the value of their nest egg earned through their lifetimes of hard work.

**Conclusion:** Section 1031 serves as a flexible retirement planning tool for farmers and ranchers.

#### **Example 5: Diversification of Asset Type**

**Facts:** Farmer built a 2,000 acre farmland asset base over the last 15 years with average values appreciating from \$1,000 per acre to \$8,000 per acre. With farmland values approaching all-time highs, farmer determined it was wise to diversify his portfolio and exchange into depressed commercial assets nearby. Farmer sold a portion of his farmland and exchanged into a storage unit facility, an apartment complex and a retail strip center.

**Impact:** Section 1031 allows for exchanges into any real property held for investment or used in a trade or business. Accordingly, farmer was able to exchange into a depressed commercial investment and hedge predicted downside risk to farmland asset values by exchanging into a more diverse real estate portfolio.

**Conclusion:** Section 1031 serves as a diversification and risk-hedging tool for all real property investors, including farmers and ranchers.

#### **Example 6: Relocating Farm/Ranch Operations Keeping Investment Dollars in the U.S.**

**Facts:** An Amish couple owned 80 acres, a livestock operation and their homestead in a community in their home state and were relocating to an Amish community in another state. The couple exchanged out of the land and buildings on their current farm into a comparably priced farm/ranch operation in the new community.

**Impact:** Section 1031 allowed the Amish couple to pursue their life plans and continue their farm/ranch activities in their new community without diminishing their purchasing power or ability to earn a comparable living.

**Conclusion:** Property owners can relocate their investment assets, without fear of tax ramifications, to different locations suiting their needs. Section 1031 allows for exchanges of investment or business-use property in the United States for other investment or business-use property in the U.S. Domestic property cannot be exchanged for foreign property. Section 1031 incentivizes and promotes investment within the U.S.

#### **Example 7: Improvements to the Farm/Cattle Operation**

**Facts:** Farmer owned a 1,000 acre farm with a 500 head cattle feeding operation with buildings constructed in the 1970s. Farmer received an offer to sell the cattle feeding buildings and surrounding 160 acres for \$1,200,000. Farmer sold the buildings and

surrounding acreage and exchanged into a bare 160 acre tract worth \$800,000 that was closer to the balance of his land holdings. Farmer utilized an exchange accommodator to construct new cattle feeding buildings and grain storage with a completed value of \$600,000. Upon completion of the improvements, the exchange accommodator transferred the \$1,400,000 improved property and surrounding acres to farmer.

**Impact:** Section 1031 allowed the farmer to exchange into land and newly constructed improvements so that he could continue farming operations in a modern and more efficient facility without eroding his investment through recognition of more than \$400,000 of gain.

**Conclusion:** Section 1031 provides maximum flexibility to exchangers by allowing them to exchange into not only land, but improvements, without erosion of capital investment.

### **Example 8: Promotion of Conservation**

**Facts:** Farmer owned 80 acres of environmentally sensitive converted wetlands that had been row cropped. A watershed improvement district offered to buy a permanent conservation easement from farmer whereby the land would be restored to wetlands toward the end goal of improving downstream water quality. Farmer exchanged out of the permanent conservation easement into non-environmentally sensitive crop land.

**Impact:** Section 1031 facilitated and promoted the farmer's participation in the conservation program and allowed an exchange into less environmentally sensitive acres, all while preserving his asset and earning base.

**Conclusion:** Section 1031 incentivizes participation in conservation programs designed to improve water quality, reduce soil erosion and bolster wildlife habitat.