Succession Planning and the Latest on Section 1031 Like Kind Exchanges of Farm Property

There are 4 things you should take from my talk

Number 1: If you intend to pass your land to your heirs, you don't have to think about Section 1031.

Number 2: If you have contracted to sell or you are thinking about selling subsidized farm land and using Section 1031, you should wait for final resolution of the Farm Bill before closing.

Number 3: If the final Farm Bill prohibits Section 1031 for subsidized farm land, you may wish to sell before 2011, when capital gains tax rates will go back up to 20%.

Number 4: If the final Farm Bill makes no change to Section 1031 and you are thinking about selling, seek professional advice to understand your options.

Point number 1 Background: Section 1031 of the Internal Revenue Code allows a property owner to defer the capital gains taxes due on the sale of the property by swapping what you own for another property.

If you own appreciated property when you die, you might pay an estate tax on its value, but you will not pay an income tax on any gain attributable to the property.

Your heirs will not pay an income tax either. For IRS purposes, they will be treated as having bought the property at the value your executor listed it at in your estate tax filing.

Since there is no income tax payable, there is no need to think about deferring an income tax with Section 1031 if you plan to pass your land to your heirs.

But recognize that if you die in 2011 or later, you will pay a 55% estate tax to the extent that your total assets exceed $1 million and they go to anyone other than your spouse.

You may be able to reduce that by proper planning so it could be worth a visit to good estate planning attorney or private wealth advisor

Point number two: The Senate version of the Farm Bill makes 2 big changes to Section 1031

First Change: Owners of non-ag property (apartments, office buildings, etc.) would not be able to swap into subsidized farm land

Second Change: Owners of subsidized farm land would not be able to swap for non-ag property (apartments, office buildings, etc.)

As written, Owners of subsidized ag properties would still be able to swap for other farm land (subsidized or not)

"Subsidized" farm land is essentially any farm land that receives Direct Payments or Counter-Cyclical Payments under the Farm Bill

You can pull your land out of the program permanently and avoid the new exchange rules, but that makes your land less valuable to a farm buyer. Only useful if selling to developer.

Problem: Some in Washington are reading the Senate Bill as prohibiting ANY swap out of subsidized farm land, even if it is into other subsidized farm land

If this section of the Senate version of the Farm Bill passes in its present form, the new rule will apply to any swap completed after the date the Farm Bill is enacted

Any guesses on when the Farm Bill will finally be passed?

House (mostly) and President Bush are opposed to this change in Section 1031 but it may pass as part of a compromise to get the rest of the Farm Bill passed

While we are waiting for the Farm Bill:

If you are trying to complete an exchange, you might beat enactment of the change.

But if you are not committed to an exchange, you are probably best off waiting to commit to one

Point 3: What should you do if the proposed restrictions to Section 1031 pass?

If it passes, and you want to sell, you have three choices:

First Choice: Sell, but remove your land from the subsidy program first.

That allows you to avoid the new exchange rules, but it makes your land less valuable to a farm buyer. Only useful if selling to developer.

Second choice: Sell, but swap into other qualified ag property.

But if you stay in ag properties, you have only transferred the problem to different acreage.

Choice 3: Sell and pay the tax

Until 2011, the federal rate is 15%.

Unless there is an extension of the Bush tax cuts (any bets on that one?) the federal rate will rise to 20%

Depending on who gets elected this Fall, we could see rates even higher than that.

Obvious conclusion: If you plan to sell and pay the tax in the next few years, you should do so before the rates change

Point 4: What should you do if Section 1031 is left unchanged?

Answer number 1: Again, if you are planning to hold your property and pass it to your heirs, ignore Section 1031 and make sure you have maximized your opportunities to minimize your estate tax

Answer number 2: If you are definitely planning to sell and definitely going to pay the tax within the next 5 years, then you are probably better off selling in the next 3 years while the rates are still at 15%

Answer number 3: If you are not sure when you will sell and it might be more than 5 years, you might be better off waiting, EVEN IF YOU PAY THE TAX AT 20% OR HIGHER

Answer number 4: No matter when you are going to sell, before you decide to "just pay the tax" sit down with a qualified advisor and sketch out where you will be financially if you pay the tax versus swap into other real estate.