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Should You Sell Your Real Estate?

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Introduction:

A major portion of assets for retiring farm families is usually real estate. Real estate assets may consist of land, buildings and a house. Disposition of real estate assets is usually a major decision.

Of all the real estate assets mentioned, land is usually the most valuable. Many farmers choose to retain ownership of most of their land into retirement. They do so for several reasons:

- Ownership can provide a fairly secure annual income throughout one's retirement years if it is rented to another operator. Most farmers prefer a simply cash rental contract rather than share renting their land. Share renting is more risky, income is unknown, and shared expenses must be paid. The landowner has to also assume responsibility for storage and marketing of their share of the crop produced. Cash rent provides a known income with less risk.
- Land ownership can be viewed as an inflation hedge and can nearly always be liquidated to willing buyers.
- Holding low basis land until death, with heirs receiving a stepped-up basis, can save many thousands of dollars of capital gains tax, especially if it is later sold by the heirs.
- Land is sometimes viewed as security and can be a valuable part of a diversified array of retirement assets which may also include stocks, bonds, savings, and retirement plans.

Some farmers choose to sell their land at retirement. Some of the reasons they give are:

- They want it to go to the farming children. They guarantee it will go to them by selling it to them.

- They don't want to be faced with the inconvenience of dealing with rental contracts including establishing and collecting rents, repair and maintenance, and the liability exposure.
- Some are fearful that land values (rents) will fall and real estate taxes will increase, leaving them with less and less income. Others fear land values will rise and increase their estate taxes.
- They feel they can get a better rate of return on their money if they invest it elsewhere.

Disposing of buildings and personal residence?

Maintaining farm buildings is expensive. There is a never-ending list of repairs, insurance, utilities, real estate taxes, and other costs. Also, tenants may request additions and improvements on a regular basis. Sometimes keeping good tenants is a problem. Consequently, many farmers dispose of their buildings. Disposal usually takes place in two ways:

- Sale: Selling low basis assets may create a large tax bill. Selling a quarter section of farmland with a farm building site and home, that has a low adjusted basis, will result in a taxable gain. The farm sold represents several different types of property that is taxed at different rates. The sale price is allocated among the various properties. Each property has its own basis. The gain on the land portion would be taxed at the maximum federal capital gain rate of 15% (through 2010). The portion of un-recaptured depreciation on depreciable buildings will be taxed at 25%, with the additional gain (if any) on the buildings taxed at the federal capital gain rate. There can be state capital gain taxes as well. In MN, capital gains are taxed as ordinary income with rates from 5.35% to 7.85%. The gain on the sale of the house can usually be tax free, providing certain tax law rules are followed.

- Giftng: Buildings can be gifted to farm heirs as well. This is assuming the donor of the gift can afford to do so and it does not violate their business transfer and personal estate planning goals.

Selling your personal residence:

If you have a personal residence you want to sell, the sale can generally be accomplished tax-free under a change made in the tax code. For sales of your personal residence after May 6, 1997, up to \$250,000 of gain can be excluded from income and capital gains tax if you file a single tax return or \$500,000 of gain if married, filling a joint return.

To qualify, you must have used the home as your personal residence for two of the past five years. This exclusion can be taken many times during your lifetime (but not more than once every two years), providing you meet the "personal residence" qualification.

Methods of selling land:

If you decide to sell the land and/or buildings, you have several ways to accomplish this.

- Sell it for cash in a lump sum and pay the accompanying taxes.
- Sell it on a contract-for-deed. A contract puts you in the position of a lender. As the contract payments are made, you include them in your taxable income over a number of years. By signing a contract for deed with installment sale reporting, you do obligate yourself or your heirs to paying the income tax on the gain. However, the capital gain tax, if any, is paid over the course of the contract rather than in the year of the sale. Selling on a contract can provide the buyer with a source of credit and terms he or she can afford. This method, however, obligates the buyer to pay you a lot of interest over the life of the contract. Interest you receive from the buyer is fully taxable to you. If you become a contract for deed holder, you assume the risk of default by the buyer. You may get your land back through forfeiture or you may be forced to foreclose on the party in default. The contract-for-deed does not protect the assets from lawsuits or other adverse actions.
- Sell your land piecemeal as the buyer can afford to purchase it. Using this method, the buyer can apply all purchase money to principal and none to interest. This method does not protect the asset from lawsuits and other adverse actions.
- Consider a tax-free 1031 exchange. Exchanging like-kind property with your child can postpone the taxation of gain.

A tax-free, 1031 like-kind exchange can be used if a farming son or daughter has land they wish to exchange for the parents' home farm, which usually is the base of the operation. The parents end up with a piece of land with a low basis and the son or daughter end up with the home farm.

Certain types of property do not qualify for 1031 exchanges. They include:

- inventory or stock in trade
- stocks, bonds, or notes
- other securities or debt
- partnership interests
- certificates of trust

There are also two time limits that must be met in order to qualify for a 1031 exchange. The first limit is that you have 45 days from the date you relinquish the property and you identify a new property. The identification must be in writing, signed by you and delivered to a person involved in the exchange like the seller of the replacement property or the qualified intermediary. However, notice to your attorney, real estate agent, accountant, or similar persons acting as your agent is not sufficient. The second limit is that the replacement property must be received and the exchange completed no later than 180 days after the sale of the exchanged property or the due date (with extensions) of the income tax return for the tax year in which the relinquished property was sold, whichever is earlier. The replacement property received must be substantially the same as property identified within the 45-day limit described above.

Caution: if property is disposed of within 2 years of the exchange, the property no longer qualifies for the like-kind exchange (see your accountant).

As always, any of these strategies can be complicated and any mistake can result in tax consequences. Therefore, make sure you check with your attorney and accountant as you proceed.

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