



UNIVERSITY OF MINNESOTA
EXTENSION

Ag Business Management

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Transferring the Farm Series #5 10/2007

Should You Sell Your Real Estate?

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Introduction:

A major portion of the asset base 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 or landlord 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 to include 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 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 capital gain rate. The gain on the sale of the house can usually be tax free, providing certain tax law rules are followed.
- Gifting: Buildings can be gifted to farm heirs as well. This is assuming the grantor of the gift can afford to do so and it does not violate their transfer 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, filing 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.

Ways 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 income 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. 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.

Example: In 2005, Mom decides to sell a designated 10 acres to her son Bill. In 2006, she sells another 5 acres to Bill. In 2007, Bill has a good year and is able to purchase 15 acres. Bill has acquired 30 acres in 3 years, has them paid for, and has no debt or further obligation to Mom. Bill may wish to enter into an "option to buy" with Mom for various parcels over a number of years. This would guarantee his right to purchase an entire 80 or 160 acres even though Mom may die.

- Consider a tax-free 1031 exchange. Exchanging like-kind property with your child can postpone the taxation of gain.

Example: Assume you own a 160 acre farm with a tax basis of \$40,000. You exchange it even up for similar property worth the same amount. You now own the new property with a basis of \$40,000. No income taxes are paid on tax-free exchanges if no money or unlike kind property is involved.

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.

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).

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