The Tax Benefits of Using the 1031 Exchange to Sell Farmland and Secure Retirement Income

Image: Flickr CC user United Soybean Board

In many ways, the term *farmer's retirement* is an oxymoron. An old joke says that farmers don't retire, they just go to seed. Indeed, many consider farming more a way of life than they consider it a job. Often, farmers are continuing a family tradition that goes back several generations and can't imagine themselves doing anything else, even in retirement.

For others, however, the ups and downs of farming and agricultural markets, or the lack of someone willing and able to take over the farm, might cause them to look for something they have never considered: an exit plan.

While some farmers may have built up savings or used self-employed IRAs (also known as a simplified employee pension, or SEP) in anticipation of retirement, given how capital-intensive farming can be, a farmer's biggest retirement asset is likely the farmland itself. While leasing out farmland may be a viable solution, it may come with issues that the farmer does not want to take on in retirement.

Threats to a Retirement Portfolio: Taxes and Market Fluctuations

Selling the farm is another option. Proceeds from a sale can be used to fund retirement through a mix of stocks, bonds, and mutual funds that can provide income and growth of asset values. Unfortunately, taxes on the gains may pose a major problem. Many family farms (and farmland) that have been held for decades come with a significant capital gains liability. Recognizing such gains in a single year may very well bump the farmer up to a 20% long-term capital gains tax as well as subject them to the 3.8% net investment income tax (part of Affordable Care Act funding).

Once the taxes have been paid, the farmer still must endure the potential ups and downs of stock and bond markets. Consider that twice in the last 20 years even blue chip stocks have seen a decline of nearly 50%, while yields on 10-year treasuries are currently less than 3%.

1031 Exchanges, Risk Management, and Estate Planning

Farmers who don't want to pay capital gains taxes may consider using a 1031 exchange. The 1031 exchange allows a real estate holder to defer capital gains (and recapture) taxes on the sale of a property when those proceeds are subsequently invested in a like-kind property. Under the tax code, "like-kind" has a pretty ambiguous definition, so farmland could be sold and exchanged for other types of income-producing property, such as commercial real estate.

A key aspect of a 1031 exchange is that more than one property may be purchased, which might give the investor an opportunity to diversify their investment streams. From a farmer's perspective, this may mean managing the risk associated with the ups and downs of agricultural prices and farmland lease rates.

A recent *Wall Street Journal* article notes how many farmers have been adversely affected by "a multi-year slump in prices for corn, wheat, and other farm commodities" that is driving many further into debt and raises the prospect that "the next few years could bring the biggest wave of farm closures since the 1980s."

While commercial real estate certainly has its own economic cycles, it also affords the opportunity to use professional management to assess risk and identify various markets and projects that may deliver a stable income stream. The tax benefits of real estate investing also allow for some of the income to be sheltered or deferred.

In addition to providing a farmer the opportunity to transition to commercial real estate investment, the 1031 exchange comes with a significant estate planning benefit (link to Estate Planning with 1031 Exchange article). The exchange can be used repeatedly to defer capital gains taxes throughout the lifetime of the investor. Upon the investor's death, heirs will receive not only the property but a stepped-up cost basis, meaning that all capital gains and recapture taxes have not simply been deferred, they have been eliminated.

Plotting a Course of Action

Given a love of the farming life and a fierce independent streak that many farmers possess, 1031s and commercial real estate investing are a non-starter for many. But for those who would like (or need) to exit farming and are one of the surprisingly many who have not identified a successor to run the farm, a 1031 exchange may provide the route to a secure and stable retirement.

While the 1031 is a valuable tool, the rules and regulations (link to Calculating Basis post) surrounding their use are complex. You should consult your tax and investment professional before making any decisions.