

Agronomy Notes

Extra Edition

Financial Farming

A Fresh Look at Like-Kind Exchanges

The sharp increase in the value of farmland in our neck of Pennsylvania has created financial planning opportunities for farmers looking to sell farm real estate outright or their land development rights. By unlocking the equity in farm real estate, the farm's balance sheet can be firmed up or a retirement nest egg created for the baby boomer farmer.

However, material income taxes created by the gain on the sale of real estate or conservation easements can shortchange this plan. A proven real estate transfer technique to defer federal income tax on the sale of appreciated real estate/easements is the Section 1031 like-kind exchange.

Farmers have long used like-kind exchanges for real state transactions. The rules for a 1031 like-kind exchange are straight-forward: The seller must use a qualified intermediary to hold the proceeds from the sale until the replacement real estate is identified and purchased. You have up to 45 days to identify the replacement property and must close on the purchase of the identified property within 180 days. Finally, the replacement real estate must be real property used for "business" – not just farmland.

A common problem with traditional like-kind exchanges is finding suitable replacement property. In fact, many 1031 exchanges go uncompleted over the lack of available replacement property. To address this problem, and to capitalize on a new business opportunity, the professional real estate industry has increased the inventory of available replacement property by offering partial ownership in professional managed, institutional-quality real estate through tenants-in-common ("TIC") investment programs.

In 2002, the IRS announced a set of rules that, if followed, makes TIC-owned real estate eligible as 1031 exchange replacement property. One of the rules limits the number of co-owners each TIC property can have (maximum of 35) and the investor must meet certain financial tests to be eligible to invest. As the lead co-owner, the real estate firm purchases the property, arranges the individual TIC investments, collects rents from the tenants and manages the rental property on behalf of the other co-owners.

TIC investment real estate includes office, retail, warehouse, multi-family and other mix-use commercial properties. In addition to helping complete 1031 exchanges, current TIC investment programs pay investors between 6 – 8% in annual cash income generated from the rents, provide a stable value investment and the potential opportunity to share in the property appreciation when sold. Most TIC investments have a 5-10 year holding period, creating another 1031 exchange opportunity for the investor.

There are certainly risks associated with TIC investments. The property's income and target returns are not guaranteed and the possibility exists that the real estate firm will not manage the property effectively to achieve their target investor income and total return goals. Therefore, it is important to evaluate each TIC investment opportunity carefully.

A TIC investment could be an interesting option for the farmer looking to match tax-deferral with attractive passive income and professional real estate management. However, TIC investments would not be appropriate for some farm situations, so call me if you have an interest in learning more about them or if you have questions about like-kind exchanges in general.

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