The Lost Art of Using a Land Contract for Buying & Selling Farmland

By Mike Downey, *Land, Lease & Farm Succession Consultant*

A common question we receive from young and beginning farmers is how can they position themselves for renting and purchasing land. Often times they are focused on the unthinkable task of bidding against their neighbors the next time a farm comes up for sale or rent at a public auction.

Alternatively, we encourage young producers to look for opportunity within their own family, extended family, and even outside the family with a long term landlord or neighboring landowner that may not have kids of their own interested in the farm. The biggest hurdle to overcome is some of the perceptions why we can’t sell land, one of those being the fear of paying capital gain taxes. This fear causes many to believe they only have 2 options:

1. Sell the farm, but use a tax deferred 1031 Exchange to defer the capital gain taxes.
2. Do Nothing. Hold onto the farm and pass it through their estate so their heirs can sell the farm with no capital gain taxes.

We offer another option in the form of a land contract, but let’s touch on these first:

1031 TAX DEFERRED EXCHANGE

IRC Section 1031 of the IRS Code allows a landowner to sell a property, reinvest the proceeds into a new like-kind property and defer all capital gain taxes.

We worked with a recent family with a 100-acre farm with a fair market value of $10,000 per acre, or $1,000,000. The same 100-acre acre farm had a 2,500 per acre cost basis, which is typically the price the property was purchased for or the fair market value when inherited. Much land today is owned with a lower cost basis due to appreciation in land values.

A landowner that sells a farm for $1,000,000 with a $250,000 basis, may pay state and federal capital gain taxes on this gain which in this example we estimated to be near $200,000.

The same landowner would pay zero capital gain tax if they sold the same farm using a 1031 tax free exchange to reinvest the proceeds into a like-kind property. This like-kind exchange would allow them to defer the capital gain and the current $2,500 per acre cost basis would carry-over to the new property.

DO NOTHING AND PASS THROUGH ESTATE

Our current tax laws encourage most landowners to hold onto their property to pass it through their estate because the property will receive an adjustment in its cost basis to the fair market value at the time of death. Many refer to this as a step up in basis.

For example, if the above farm would appraise for $10,000 per acre at the time of their estate, the farm would receive a step up in basis to $10,000 per acre which would allow the heirs to sell the farm subject to zero capital gains.

CONSIDER A LAND CONTRACT

A land contract can turn the fear of capital gains to a situation where they may actually be your friend. Most in the older generation are familiar with the concept and may have very well bought a farm on contract themselves. However, very few in the younger generation are as familiar with it.

We recently assisted the family above to set up a contract between an Aunt and Uncle and their nephew. They weren't as concerned about the purchase price but rather that the land payments would provide them a similar cash flow as if they were renting the farm for income.

MISCONCEPTIONS

Typically, we start this conversation by addressing some misconceptions:

1. A discounted purchase price may be considered a gift and subject to gift tax. Incorrect. You can sell your farm at any price you believe is fair.
2. Capital gain tax rates are high which makes it unfeasible to sell. Incorrect. Capital gain tax rates receive

preferential treatment versus ordinary income.

3. Capital gain taxes have to be recognized in the first year of sale. Incorrect. You can elect to stretch any capital gain tax over the term of the contract.

Think about how many times the same family farm goes into debt at each generation just to buy out other family members. Once upon a time the income from the farm could cash flow these buy-outs on its own. Most farm purchases today require subsidization from other areas of the farm operation or off farm income sources.

In the world of farm continuation, we believe cash flow is important to give those in the next generation every opportunity to make it work. Subsidization only stunts the future growth of the operation. This typically requires discounting the purchase price and it looks different for every family how they make up any discounts to their other heirs.

HOW IT WORKS

In the big picture, it really comes down to the fact that you can set any price you feel is fair for your farm as our lifetime federal estate tax exemption (currently $11,400,00 per person; $22,800,000 per married couple), is not only the amount you can die with without paying estate tax, but also the amount you can gift away while living without paying gift tax.

In this case, they set up the contract so the land payments were similar to as if they were renting the farm for $250 per acre. This yielded a purchase price of $4,500 per acre when set up over a 25-year contact at the government's long term AFR rate of near 3.0%.

As for capital gains, the selling price of $4,500 per acre also lowered their capital gain to the difference of this sale price and their cost basis of $2,500 per acre. We estimated the capital gain tax to now be near $50,000, or $2,000 per year ($20 per acre) when stretched over the 25 years of the contract. This contract actually netted them more than if they were renting the farm since the property taxes, insurance, property upkeep and maintenance are all now the responsibility of their nephew as the purchaser.

Farm transition specialist, Steve Bohr, writes about another example in this column he wrote in the Iowa Farmer Today in August 2013:

Don’t let capital gains hold you captive

ICING ON THE CAKE

Capital gains receive preferential tax treatment over ordinary income. For example, the federal capital gain tax rate at the 12% income tax bracket is actually <u>zero</u>. At the 22% income tax bracket the federal capital gain tax rate is 15%. Aunt and Uncle happened to filing at the 12% tax bracket which brought their federal capital gain taxes to zero. To boot, in Iowa there is a state of Iowa capital gain tax exclusion for selling a family farm if you meet certain active participation requirements. They qualified which brought their state capital gain tax also to zero.

They moved from a position of paying income taxes on land rent to paying zero capital gain tax on land payments. This is a situation where capital gains turned out to be their friend and they had the added comfort of knowing their family farm had transferred to their nephew who would continue to own and operate it for another generation.

For those of you searching for opportunity to purchase farmland, consider a good old fashioned land contract. In some circumstances, it offers a win-win for all parties and we have found it to be an excellent tool in farm continuation. Please reach out to us to learn more or if you have a potential opportunity where a land contract could be a fit.

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