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1031 Tax Exchanges and Nebraska's Farm Real Estate Market

Market Report	Yr Ago	4 Wks Ago	6/3/05
Livestock and Products, Weekly Average			
Nebraska Slaughter Steers, 35-65% Choice, Live Weight	$90.14	$90.14	$84.70
Nebraska Feeder Steers, Med. & Large Frame, 550-600 lb	133.26	143.48	*
Nebraska Feeder Steers, Med. & Large Frame 750-800 lb	116.97	116.15	*
Choice Boxed Beef, 600-750 lb. Carcass	150.43	162.00	146.13
Western Corn Belt Base Hog Price Carcass, Negotiated	74.29	79.07	66.05
Feeder Pigs, National Direct 45 lbs, FOB	45.60	64.22	50.70
Pork Carcass Cutout, 185 lb. Carcass, 51-52% Lean	79.63	74.35	66.36
Slaughter Lambs, Ch. & Pr., 90-160 lbs., Shorn, Midwest	97.50	107.25	111.00
National Carcass Lamb Cutout, FOB	232.12	254.74	254.98
Crops, Daily Spot Prices			
Wheat, No. 1, H.W. Omaha, bu	3.75	2.90	2.96
Corn, No. 2, Yellow Omaha, bu	2.93	1.82	1.92
Soybeans, No. 1, Yellow Omaha, bu	8.59	6.38	6.62
Grain Sorghum, No. 2, Yellow Columbus, cwt	4.70	2.82	2.96
Oats, No. 2, Heavy Minneapolis, MN , bu	1.68	1.62	1.64
Hay			
Alfalfa, Large Square Bales, Good to Premium, RFV 160-185 Northeast Nebraska, ton	115.00	115.00	115.00
Alfalfa, Large Rounds, Good Platte Valley, ton	62.50	62.50	62.50
Grass Hay, Large Rounds, Good Northeast Nebraska, ton	57.50	57.50	57.50

* No market.

"The 1031's are giving us a distorted value of farmland."

The above quote from a Southeastern Nebraska reporter to this department's 2005 Nebraska Farm Real Estate Survey, to be released July 1, reflects many of the comments made by reporters from across the state. The 1031 exchanges appear to be increasingly influential in local agricultural land markets from Chadron to Falls City. This year, for the first time in the series of monitoring factors influencing the value of agricultural land, the categories of *non-farm investors* and *1031 Tax Exchanges* were ranked by our survey respondents as the two most influential factors behind the recent rise of land values.

Given it's influence, it's important to understand fully just what this federal tax provision is and how it might be impacting real estate market dynamics. In this article we are presenting an overview of the 1031 exchange process; followed by a hypothetical example to illustrate how it can impact agricultural land values. Finally, we draw some implications regarding this tax provision.

The 1031 Tax Exchange in the federal tax code refers to provisions for tax deferral of capital gains taxes due on the sale of real estate property. If a real estate property has been owned for at least two years, the seller of that property has the opportunity to postpone to a later time any capital gains taxes owed upon sale of that property, so long as the individual reinvests in other real estate property within a specified time period. As currently structured, this provision allows for different types and combinations of income-producing real estate property to be used (for example, capital gains from sale of an apartment building deferred by purchase of farmland), so long as the "exchange" property is identified within 45 days of the sale of the original property and closing on the exchange property occurs within 180 days. For most individuals, the federal tax rate will be 15 percent of the total capital gains. At this rate, plus the state-level individual income tax assigned to the capital gains, the automatic deferral via the 1031 route can result in very sizable tax savings in the short-run.

To illustrate, consider the following hypothetical example. Assume a land owner sells 80 acres of Cass County Nebraska farmland to a land developer for $5,000 per acre (total sale price of $400,000), with the basis value of the property at $1,200 per acre ($96,000). The difference between the sale value and the basis value is the calculated capital gains which is $304,000. At the 15 percent capital gains federal tax rate plus the 7 percent Nebraska individual tax rate on the capital gains earnings, the total tax amount of the transaction would total $66,880 ($304,000 x 22 percent).

Now suppose the seller is able to find a 160-acre replaceable farmland property a few counties farther away from the original property for $2,500 per acre (reinvesting the full $400,000 sales proceeds from the first sale). He/she is now able to defer the full tax obligation of $66,880 ($45,600 of capital gains taxes plus the state individual income tax on those gains of $21,280).

Given the dollar magnitude of this tax deferral option it is easy to see why individuals may be quite willing to bid aggressively for an exchange property to execute this process. And that aggressive nature will only amplify by (1) limited numbers of properties on the market, and (2) time running out on the 45-day identification period. In fact, the reasoning might be that one would be willing to bid up the specific tract's value far beyond the $2,500 per acre level. In order to execute the tax exchange option to defer nearly $67,000 of taxes (essentially the same as an interest free loan from the government), this individual might well be willing, if necessary, to bid up the price of this exchange property by as much as $418 per acre. Or in other words, when all of the other normal market factors have been fully integrated into a bid price on this particular property, this potential capital gains tax deferment could engage further rounds of higher bid levels that could result in a further 17 percent price increase per acre for this exchange property.

Of course, the relative magnitude of the "bidding-up" effect is both a function of the dollar amount of the total taxes being deferred and the relative relationship of that dollar amount to the going market value of the exchange property. It is possible that buyer competition in the form of 1031 investors could rachet up real estate prices in a local market to an even greater magnitude than in the example above.

So what are the implications of 1031 Tax Exchanges in the agricultural land markets? There are several, but we will comment on two of them. First, from the individual taxpayer perspective, one cannot emphasize enough that the 1031 exchange mechanism is merely a capital gains tax deferral and NOT an automatic tax forgiveness mechanism. Ultimately, at some future point in time, liquidation of the real estate will occur and capital gains taxes will come due (under certain circumstances and sophisticated tax management, some may avoid payment, but these cases are more likely the exception than the rule). Moreover, it is entirely possible that when that time arrives, the taxpayer could face an even higher percentage rate of tax obligation than the current rate. Or, alternatively, the exchange property's price may have been bid upward beyond a sustainable value, and therefore economic losses are incurred. Consequently, those who exercise this option should use it with caution.

Second, from a market dynamic perspective, there is little doubt that this tax mechanism is currently creating some agricultural land market distortion. Tax-motivated investor buyers can be setting market bid levels that may not be economically sound. Competing potential buyers find themselves either needing to pay more than what they can economically justify, or simply being forced out of the market entirely. Given enough of this type of influence, a point could be reached where a major downward market value adjustment could occur which spills over on all property owners.

One of the basic principles of sound tax policy is *tax efficiency* – the aspect of how a particular tax may affect economic activity. Taxes "– that disturb market decisions the least are more efficient taxes."[1] On this basis, we would have to conclude the 1031 Tax Exchange mechanism needs a critical review.

[1] Shaffer, Ron, Steve Deller and Dave Marcouiller. *Community Economics: Linking Theory and Practice, 2nd Edition.* Blackwell Publishing, 2004.

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