

# Farmland

## IN PERSPECTIVE

Volume 27, No. 2



### Food Processing Flourishes in China

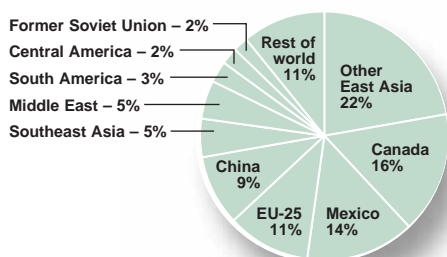
One of the world's largest consumers of food, China has a booming economy and a population of 1.3 billion that is growing by 10 million people a year. The country's annual food consumption is staggering, according to the Foreign Agricultural Service of the US Department of Agriculture:

- 51% of the world's production of pork
- 33% of world rice
- 19% of ice cream
- 19% of poultry
- 12% of beef

Though just 30 percent of food consumed is now processed, compared to 80 percent in Western nations, the market for processed foods is growing especially in urban areas.

Busy urban consumers want convenience, healthier choices, variety and quality — creating new demands for processed foods and new opportunities for US ingredients.

#### Major Destinations of US Ag Exports, 2004



### Shall I Sell or Exchange?

by Gary J. Hoff, E.A.

If a local Realtor approached you out of the blue with an offer for your 400-acre grain farm at \$10,000 per acre, what would you do? The farm will be used for a new housing development, and replacement land can be purchased further from town for \$4,000 per acre. You believe the offer is too good to refuse, but are not sure which of two options to pursue as a seller:

- Use of a like-kind exchange
- Pay capital gains tax and invest elsewhere.

The following example helps explain your options. Each has pros and cons. If the cost basis in the farm is \$600 per acre, the gain on the sale will be computed as follows:

|                                   |                    |
|-----------------------------------|--------------------|
| Sale price (\$10,000 X 400 acres) | \$4,000,000        |
| Minus basis (\$600 X 400 acres)   | 240,000            |
| <b>Gain realized</b>              | <b>\$3,760,000</b> |
| Gain recognized                   | \$3,760,000        |
| Federal income tax                | \$564,000          |
| State income tax (IL)             | \$112,800          |
| <b>Total taxes</b>                | <b>\$676,800</b>   |
| Sale price                        | \$4,000,000        |
| Total taxes                       | \$676,800          |
| <b>Remaining cash to invest</b>   | <b>\$3,323,200</b> |

#### Advantages to a Sale

1. Today's tax rate on long-term capital gains is at an all-time low. If plans for the property purchased through the like-kind exchange call for it to be resold, the tax rate in effect when it is finally sold may be higher than today's rate. Today's capital gains tax rate is 15%, if your ordinary income is taxed at a marginal rate higher than 15%.

The capital gains tax rate remains a "political football." Proposals range from not taxing capital gains to taxing capital gains at the ordinary income rate.

2. The net sale proceeds can be used to reduce debt. This would eliminate the interest expense on that debt. Let's assume \$3 million of debt exists at 6% interest. If this debt is repaid with your capital gains, \$180,000 per year will

Continued on page 2

# Verbal Lease Notification Dates

| State     | Traditional Verbal Lease Year*                               | Traditional Verbal Notification Date*   |
|-----------|--|---|
| ARKANSAS  | Jan. 1 – Dec. 31<br>But may vary. Consult your farm manager. | June 30   |
| FLORIDA   | Not well defined. Consult your farm manager.                 | Not well defined. Consult your farm manager.  |
| ILLINOIS  | Mar. 1 – Feb. 28   | Oct. 31   |
| INDIANA   | Mar. 1 – Feb. 28   | Nov. 30   |
| IOWA      | Mar. 1 – Feb. 28   | Prior to Sept. 1<br>Recommended that notices be provided in writing and sent by certified mail. |
| MINNESOTA | Not well defined. Consult your farm manager.                 | Not well defined. Consult your farm manager.  |
| MISSOURI  | Mar. 1 – Feb. 28<br>(Sometimes Jan. 1 – Dec. 31)             | 60 days prior to the day the oral agreement was given on.                                       |
| WISCONSIN | Mar. 1 – Feb. 28   | Dec. 1<br>90 days advance notice is required to terminate a verbal lease.                       |

\* Traditional lease year and notification date for verbal leases. In some states, the lease continues “as is” unless notified by a specified notification date. Lease years and notification dates may vary based on the terms of a written lease. Consult your farm manager or attorney for confirmation.

## Sell or Exchange? cont. from page 1

be saved in interest. This \$180,000 per year can be invested. It will earn interest and compound each year.

- Once the property is sold and the taxes paid, the cash can be invested in other investments: stocks, other securities, bonds, or even real estate. Because capital gains tax was paid, a new basis is created for the purchased assets. Their basis equals the cost of their purchase. This higher basis can reduce the taxable gains on their ultimate sale.

### Disadvantages to a Sale

Disadvantages to a sale exist too. The primary disadvantage is payment of the capital gains tax now rather than later. As a result, less money is available for investment, which in turn results in less annual income. This illustrates the time value of money concept.

For example, if \$1,000 is invested at 5% it will be worth \$1,628 in 10 years, assuming no annual tax liability. Likewise, if \$676,800 of income tax liability is deferred for 10 years and it earns 5% annually, for a total of \$1,118,725.

### Advantages of a Like-Kind Exchange

To remain invested in real estate, a like-kind exchange may be for you.

- The capital gains from the sale of the farm is deferred as long as the entire sale proceeds are reinvested. The amount of any cash or debt relief realized during the transaction, however, may be taxable.

## The Internet Finds a Home on the Range

The Internet appears well on its way to being a universal business tool for agricultural producers. According to data from USDA’s Agricultural Resource Management Survey:

- 56% of farms reported having computers with Internet access in 2004.
- 20% percent of those respondents used the Internet to purchase farm-related items.
- 29% percent used it to purchase household items.

- Internet use varied somewhat by the geographic location of the farm household. Use was lowest for farms in small towns.
- 49% of small farms (gross sales of \$10,000 to \$19,999) used the Internet.
- 84% of the largest farms (gross sales of \$500,000 or more) used the Internet.

Big picture, since the 1990s, access to and use of the Internet increased for

all regions of the United States, most types of workplaces, and all income groups, according to data from the October 2003 Current Population Survey. This survey found that:

- 42% of all U.S. employees had access to the Internet at their workplace.
- 60% of all US households had at least one adult who used the Internet someplace: work, school, home or library with the rate being 51% in rural households and 62% in urban households.

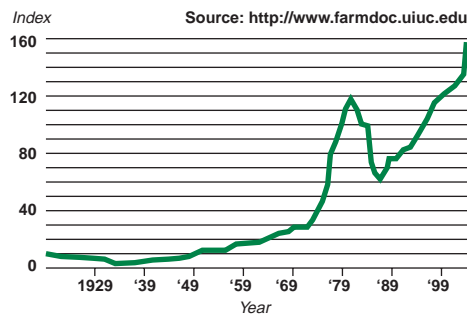
- The time value of money works to your advantage in the like-kind exchange.
- When land values increase or appreciate for the year, you benefit from increased value in addition to the income received on your investment. An investment in an asset such as a treasury bond eliminates the possibility of an increased value.
- The form of real estate can change. For example, farmland can be exchanged for residential or commercial rental property or vice versa.
- If the new property is held at the time of your death, it will receive a stepped-up basis. As a result, neither you nor your heirs will be taxed on the deferred capital gains from the exchange.

### Disadvantages of a Like-Kind Exchange

- You must reinvest in like-kind property. In the case of real estate, this can be either improved or unimproved land including rental and commercial property. You cannot, however, reinvest in stock, personal property or other unlike-kind assets and defer the gain.
- The newly acquired real estate will have the same basis as the relinquished property, unless cash is either paid or received during the exchange transaction. The gain in value will be realized when the newly acquired property is sold. As mentioned earlier, the tax rates may not be as favorable at that time.

- Real estate values may decrease. Therefore, the property you acquire may not be worth as much as it cost or its value increase may be less than that of other types of investments. This is a factor to consider when looking for the replacement property. You may not want to pay a premium just because you are deferring taxes on the relinquished property. The chart shows what happened to Illinois land prices in the late 70s and early 80s.

Illinois Farm Index Value, 1920–2005



- Exchanging properties involves the additional cost of employing the services of a qualified intermediary. The service fee will vary depending on the value and complexity of the deal.

### Making the Decision

Unfortunately, no formula exists that will answer clearly whether to pay the capital gains tax or use a tax-deferred exchange. Numerous factors should be considered, many of which require an assumption on your part. These factors include:

- The amount of capital gains on the relinquished property.

- What will likely happen to real estate values? Will they continue to increase or will they decline?
- Will tax rates for both ordinary income and capital gains remain the same? Will they increase or decrease?
- How does the return on real estate compare to the return on other investments?
- Will the acquired property be a part of your estate at your death?
- What will happen to estate tax rates? There not only has been discussion to eliminate the estate taxes, but also to eliminate or cap the stepped-up basis rules.

Ultimately the decision for landowners will be based on their personal goals and assumptions. Being informed, though, can help in the decision process.



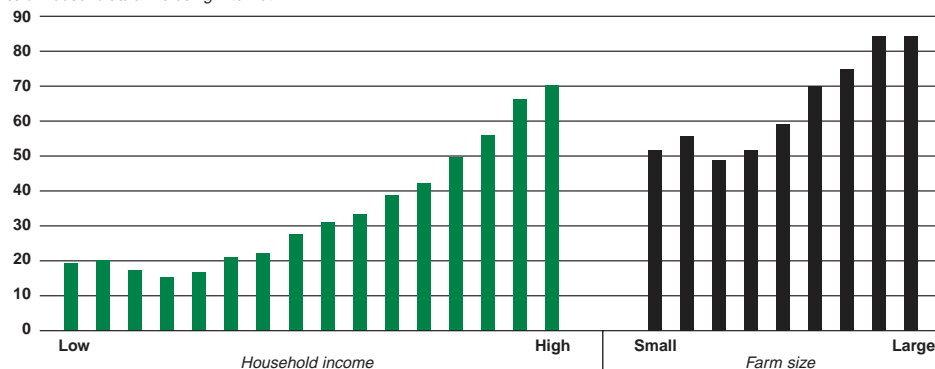
**Gary J. Hoff** is an Extension Specialist — Taxation with the Department of Agricultural Economics at the University of Illinois. He has been working with Midwest farm families for more than

30 years in accounting and tax preparation. He had his own practice in Ohio until 1987 when he became National Tax Manager for AgriSolutions, Inc. He joined the Illinois Farm Tax School in 2001 as an author and presenter in their program which trains more than 6,100 professionals annually.

Hoff, an enrolled agent with the Internal Revenue Service, received his B.S. from The Ohio State University. In addition to working for the University of Illinois, he maintains his own tax practice. Hoff has made tax presentations in more than 40 states and has written numerous tax-related articles.

### Rural household and farm Internet access

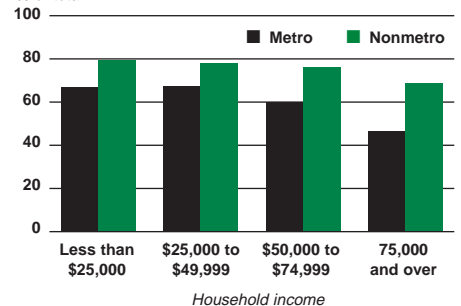
% of households/farms using Internet



Sources: Census Bureau, Current Population Survey; 2004 USDA Agricultural Resource Management Survey.

### Percent of Internet households with dial-up service by income and residence, 2003

% of total



Source: Calculations by USDA, Economic Research Service using data from US Census Bureau's Current Population Survey.

# Farmland IN PERSPECTIVE

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**Mac Boyd**  
ALC, GRI, ARA

## 2006 Illinois Society Vice President

Mac Boyd, ARA, ALC, GRI, president and owner of Boyd Real Estate, Inc., of Arcola and Tuscola, has been elected the vice president of the Illinois Society of Professional Farm Managers and Rural Appraisers (ISPFMRA). Boyd will serve one year as vice president in 2006 and will then become president-elect in 2007. The ISPFMRA, the oldest and largest state organization of its kind in the U.S., is one of 37 state chapters of the American Society of Farm Managers and Rural Appraisers (ASFMR). Members are professionals devoted to the management and appraisal of rural property and agricultural consulting.

Mac has long been actively involved in both the ISPFMRA and the ASFMR. He holds the Accredited Rural Appraiser (ARA) designation with the ASFMR. In 2004 he received the Hall of Fame award by the ISPFMRA, recognizing his accomplishments toward the furtherance of the farm management, rural appraisal, and/or agricultural consulting professions.

Mac is also a member of the Realtors Land Institute (RLI). In 2002 he served as its national president and in 1994 was named the Land Realtor® of America. He was also named the 1993 Illinois Farm and Land Broker of the year by the Illinois chapter of RLI.

Mac holds a B.S. degree in Agricultural Economics from the University of Illinois. He is an Illinois Certified General Appraiser and holds the designations of Accredited Land Consultant (ALC) and Graduate, Realtor® Institute (GRI). Please call Mac for your real estate needs or return the postage-paid card with any questions or comments. *Thank you.*



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