

INDIRECT FARMLAND OWNERSHIP/INVESTMENT STRATEGIES

Farmers who sell farmland (or other real estate) have the option to defer gain under IRC §1031. Most farmers reinvest the proceeds from farmland sales into other farmland or real estate. Recently, federal legislators and the Obama administration discussed limiting the scope and effect of tax-deferred exchanges and made at least one legislative proposal. Accordingly, many taxpayers with agricultural land expressed interest in alternative strategies to avoid gain on the transfer of farm or ranch real estate that is commonly characterized by a low income tax basis. Options available to the farmer include:

- The real estate investment trust (REIT),
- The umbrella partnership REIT (UPREIT), and
- The Delaware statutory trust (DST).

REAL ESTATE INVESTMENT TRUST

A REIT is a company that owns, and in most cases operates, income-producing real estate. A REIT offers an opportunity to invest in a diversified real estate portfolio without management and transaction costs. IRC §856 provides that a REIT is any corporation, trust, or association that essentially acts as an investment agent specializing in real estate and real estate mortgages. Consequently, REITs own many types of commercial real estate as well as agricultural land. In addition, some REITs engage in financing real estate. In early 2016, there were only a few funds that specialized in farmland ownership, typically leasing to farm operators with a targeted annual income return of 3–5%. The unique rules associated with REITs should be examined by taxpayers and tax preparers prior to investing in REIT interests.

Note. REITs were initially authorized by the REIT Act title of the Cigar Excise Tax Extension Act of 1960.⁶ The purpose of a REIT is to provide a real estate investment structure similar to what mutual funds provide for investment in stocks. A REIT offers investors the opportunity to invest in large-scale, diversified portfolios of income-producing real estate in the same way they typically can invest in other types of assets.

Basic Tax Rules

A REIT must annually distribute at least 90% of its taxable income to shareholders in the form of dividends.⁷ Thus, a REIT can be a strong income vehicle for its shareholders to the extent profits exist. A REIT is also entitled to deduct dividends paid to shareholders. As a result, a REIT often avoids incurring federal income tax liability on all or part of its income. To reduce or eliminate corporate income tax, a REIT must elect REIT tax treatment by filing Form 1120-REIT, *U.S. Income Tax Return for Real Estate Investment Trusts*, and satisfy certain other requirements.⁸

The key characteristics of a REIT can be summarized as follows.

- Structured as a corporation, trust, or association
- Managed by one or more directors or trustees
- Issues transferable shares or transferable certificates of interest
- Taxable as a domestic corporation
- Not a financial institution or a domestic corporation
- Shares or certificates owned by 100 persons or more (no attribution rules apply)⁹
- 95% of gross income derived from dividends, interest, and property income¹⁰

Note. Timber gain is included under IRC §631(a) as a category of statutorily recognized qualified real estate income of a REIT if the cutting is provided by a taxable REIT subsidiary and also includes gain recognized under IRC §631(b). The otherwise applicable 1-year holding period does not apply. For sales to a qualified organization for conservation purposes, the holding period is two years under IRC §857(b)(6)(D), which provides a safe harbor from prohibited-transaction treatment for certain timber property sales.

- Pays dividends of at least 90% of the REIT's taxable income (excluding net capital gain)¹¹
- No more than 50% of the shares held by five or fewer individuals (attribution rules apply) during the last half of each tax year¹²
- At least 75% of total assets invested in real estate, cash and cash items, and government securities¹³
- Derives at least 75% of its gross income from rents from real property, interest from loans secured by real property or interests in real property, gain from the sale of investment real property, REIT dividends, income from foreclosure property, qualified temporary investment income, and other specified sources¹⁴
- Maintains the statutorily required records¹⁵
- No more than 25% of its assets invested in taxable REIT subsidiaries (For tax years beginning after December 31, 2017, no more than 20% of a REIT's assets can be invested in taxable REIT subsidiaries.)¹⁶

REITs are potentially subject to tax at corporate rates on undistributed REIT taxable income, undistributed net capital gain, income from foreclosure property, the income "shortfall" if they fail to meet the 75% or 95% tests, income from prohibited transactions, and income from redetermined rents. Dividends paid and specified other items are deducted from taxable income.

Shareholders are taxed on REIT ordinary dividends they receive to the extent of the REIT's earnings and profits. In addition, shareholders are taxed on REIT capital gain dividends in the year received as long-term capital gains, regardless of the holding period.¹⁷

⁹ IRC §856(h). Under IRC §856(h)(2), this rule does not apply in the REIT's first tax year.

¹⁰ IRC §856(c)(2).

¹¹ IRC §857(a)(1)(A).

¹² This rule does not apply in the REIT's first year. IRC §856(h)(2).

¹³ IRC §856(c)(4)(A). For this purpose, "real estate assets" does not include mineral, oil, and gas interests. IRC §856(c)(5)(C).

¹⁴ IRC §856(c)(3).

¹⁵ IRC §856(k).

¹⁶ IRC §856(c)(4)(B)(ii).

¹⁷ IRC §857(b)(3)(B).

REITs provide the opportunity to own real estate assets and avoid the transaction and management costs of owning land directly. Purchases can be made in smaller lots, which allows more diversification of ownership.

UMBRELLA PARTNERSHIP REIT

In an UPREIT, instead of the REIT owning property directly, all of the REIT's assets are indirectly owned through an umbrella partnership (the "operating partnership") of the REIT. The REIT directly owns only interests in the operating partnership (the "unit").

Structure

Typically, the REIT contributes cash to the operating partnership in exchange for units. The real estate owners (farmers) contribute properties to the operating partnership in exchange for units that are convertible into REIT shares at the option of the unit-holder at a rate of one unit per REIT share.

Because the contributors transfer their property to a partnership, these contributions are generally tax-free under IRC §721 at the time of the contribution. However, the contributors must recognize any built-in gain in the future if they exercise their right to convert their units into REIT shares.

Note. If there is debt on the property contributed and the amount of debt allocated to the taxpayer decreases, the transaction may result in gain. Usually, the UPREIT allocates the same amount of debt back to the taxpayer as was transferred into the UPREIT. Debt in excess of basis also triggers gain to the contributing partner.

A "lockout" period is usually negotiated as part of the deal structure. This lockout period prevents the UPREIT from selling the contributed property for a certain term. Without this lockout period, the UPREIT could sell the property contributed, which would result in a recognized gain to the taxpayer under IRC §704(c). If the UPREIT sells the property during the lockout period, the UPREIT usually provides an indemnity payment to the taxpayer. The UPREIT is allowed to dispose of the property in a tax-free exchange.

Observation. The UPREIT provides diversification by allowing farmers to pool their farmland or other real estate investments. Several public and private REITS have been formed over the last several years. The use of an UPREIT has allowed taxpayers with large farm real estate holdings to diversify their holdings and provide more liquidity without incurring an immediate tax liability.

DELAWARE STATUTORY TRUSTS

In Rev. Rul. 2004-86,¹⁸ the IRS provided for the creation of a DST to hold real estate. Such a trust is structured as a "security," which allows the taxpayer to purchase an interest in the trust that holds title to the real estate. The investors in a DST share their investment in the real estate.

Note. The key difference between a DST and a tenants-in-common ownership (TIC) is that the DST investor does not directly own real estate. Instead, they hold beneficial interests in a particular form of trust (the DST). This eliminates the need for the investor to be on the deed and sign loan documents.¹⁹

The property sponsors, who are trustees of the DSTs, are national real estate developers who purchase the property and structure it as a securities DST. A written offering document provides very detailed information on tenants and leases, area demographics, financial projections, etc. The annualized income offered by the DST is usually in the 5-7% range, depending on investment opportunities.

Following are some of the **disadvantages** to the DST.

- The pre-packaged trust structure and property management arrangement for the real estate in a DST make this an extremely passive investment to the taxpayer.
- The holding period for these DSTs is normally in the 2–10 year range. Therefore, the taxpayer must “roll over” their investment at a later time.
- Investment returns are usually capped at the 5–7% range. An individual taxpayer who reinvests in other farmland or real estate may be able to generate a greater return on their own.

The **advantages** of a DST compared to a TIC are as follows.

- The investor in a DST generally has greater exit strategies than are available with a TIC arrangement. When the transfer of DST ownership occurs, banks are usually not involved.
- The DST investor has more diversification options during the 45-day identification period under IRC §1031.
- The limitation on 35 investors in a TIC arrangement set forth in Rev. Proc. 2002-22 does not apply. This allows offerings to 100 or more investors, with the minimum investment amounts in a more reasonable range of \$100,000 to \$250,000.
- The DST itself shields an investor from liability. Therefore, there is no need to set up single member limited liability companies.