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Issue Contents

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Is It Possible (or Wise) to Put Farmland in an IRA?

-by Neil E. Harl*

The question is raised from time-to-time – is it possible to invest IRA contributions in farmland? The answer to that is clearly "yes." But is it a wise move? That is a more difficult call but, in general, the answer tends to be "no" after a careful consideration of the pluses and minuses involved.[1] If the farmland is viewed strictly as an investment, with little or no involvement in the management of the property, the analysis points more clearly toward viewing farmland as an alternative investment for an individual retirement account.

State laws limiting trust ownership of farmland

The first step in deciding whether to invest IRA funds in farmland is to check the laws of the state where the land is located. Seven states impose some limitations on ownership of farmland in trust.[2] Although limitations on use of the corporation in organizing farm and ranch businesses have been in effect in some states for several decades, dating back to 1931,[3] restrictions on the use of trusts to own farmland are in effect in fewer states. The enactment of trust limitations was related directly to the announcement of investment intentions by "Ag Land I," a proposed investment vehicle for channeling pension and profit-sharing funds into farmland.[4]

Trust limitations were first enacted in Iowa in 1977,[5] and were applicable to trusts other than "family trusts," "authorized trusts" and testamentary trusts.[6] For those unable to meet the requirements to be a family trust, it is important to note that, to be an authorized trust, the trust income must not be exempt from state or federal tax.[7] That excludes, of course, IRA accounts.[8] Other state-level enactments were in Wisconsin (1977)[9] where a trust can own farmland if rented to an "eligible farm operator;" Oklahoma, where trusts were limited to no more than 10 beneficiaries and more than 65 percent of the trust's income must come from farming or ranching;[10] Kansas, with provisions similar to those enacted in Iowa;[11] Minnesota, which bars "pension or investment funds" from owning farmland;[12] Nebraska with provisions, again, similar to those enacted in Iowa;[13] and South Dakota which prohibits banks and trust companies from purchasing agricultural land "through a pooled investment fund formed from assets from retirement, pension, profit-sharing, stock, bonds or other trusts."[14]

ERISA limitations

The Employment Retirement Income Security Act of 1974 (ERISA),[15] does not provide detailed rules on investment of IRA funds but does state that a plan sponsor or plan administrator of a qualified plan is required, when investing plan funds, to exercise the

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judgment that a prudent investor would use in investing for his or her own retirement.[16] Self-directed funds allow the account owner to have greater control over investment decisions[17] but some transactions between a plan and a "disqualified person" are specifically prohibited.[18] Disqualified persons include the owner or holder of an IRA, the individual's immediate family, fiduciaries and individuals providing services to the plan, to name only some of those targeted.[19] Prohibited transactions include the transfer of plan income or assets to, or use of them by, a disqualified person; the sale, exchange *or lease* of property between the plan and a disqualified person; lending money or extending credit between a plan and a disqualified person and furnishing goods, services or facilities between a plan and a disqualified person.[20]

What this adds up to is that the owner of an IRA acquiring farmland can have essentially no financial involvement and minimal management involvement with the real estate. For many, that is unacceptable. Violations of the prohibited transaction rules can result in the account no longer considered an IRA with the account treated as if the assets were all distributed on the first day of the taxable year in which the prohibited transaction occurred.[21]

Other limitations

No expense method depreciation. As is widely known, estates and trusts (except perhaps for grantor trusts) are not eligible to claim expense method depreciation[22] which is a maximum of $250,000 in 2010.[23] Except for unimproved land, where no investment in eligible property is contemplated, this is a major consideration. As is stated in the Internal Revenue Code, an individual retirement account ". . . means a trust created or organized in the United States for the exclusive benefit of an individual or his beneficiaries."[24]

Distributions. Distributions from an IRA, including gains from the sale or taxable exchange of farmland, are included in gross income as ordinary income.[25] By contrast, the sale of farmland by a taxpayer taxed as an individual (or a pass-through entity such as an LLC or S corporation) can produce capital gains[26] or gain from property used in a trade or business,[27] either of which entitles the owner to the preferential treatment of long-term capital gains. So long as the preferential treatment remains in tax law, and if there is even a low probability of sale of the property, this factor is an important consideration.

It should be noted that farming losses would not pass through to the IRA beneficiary or beneficiaries for IRA-owned farmland.

New basis at death. Amounts in qualified plans at death, including IRAs, constitute income-in-respect-of-decedent[28] Thus, property held until death as IRD does not receive a new income tax basis at death.[29] On the other hand, farmland held until death by an individual has been accorded a new income tax basis at death through 2009.[30] Although a carryover basis regime became effective on January 1, 2010 for one year, it is likely that the concept of a new income tax basis at death will continue by Congressional action, retroactive to January 1, 2010.[31] This feature can be important on post-death sale or taxable exchange of the property or for post-death depreciation claimed.

Federal farm program eligibility. An IRA owning farmland, if the land is otherwise eligible to receive federal farm program benefits, is likely to be classified as an irrevocable trust for payment limitation purposes. The 2008 Farm Bill states that the Secretary is to administer the rules in a manner that will ". . . ensure the fair and equitable treatment of the beneficiaries of the trusts and estates. . . ."[32] It is not clear how the new rules would treat an IRA owning farmland.

Possible UBIT tax liability. Although rents from real property are excluded from the unrelated business income tax (UBIT),[33] for farmland held in a retirement account or other entity and enrolled in the Conservation Reserve Program, recent audits in some areas have assessed UBIT tax liability. Unrelated business income realized by a trust may be taxed at trust rates rather than corporate rates.[34] Trust rates are considerably higher than corporate rates.[35]

Practical considerations

In addition to the factors discussed above, there is the issue of improvements to farmland owned by an IRA. Contributions that are not "qualified retirement contributions" are not permitted so capital needed for repair or replacement of tile lines, fences or structures may pose a problem if the cost is expected to exceed the regular contributions which are allowed.[36] There is also the issue of the land being "tied up," essentially for the duration of the IRA. For some, that alone is sufficient to downplay land ownership by an IRA.

ENDNOTES

[1] See generally 4 Harl, *Agricultural Law* § 28.05[19] (2010); 1 Harl, *Farm Income Tax Manual* § 3.29[7] (2010 ed.).

[2] See 8 Harl, *Agricultural Law* § 62.02 (2010).

[3] Kan. Stat. Ann. § 17-5901. See 6 Harl, *Agricultural Law* § 51.04 (2010).

[4] See Harl, *Statement for Family Farms and Rural Development Subcommittee on Agriculture,* U.S. House of Representatives, February 18 and 24, 1977, in Hearings before the Subcommittee on Family Farms, Rural Development, and Special Studies of the Committee on Agriculture, House of Representatives, Serial 95-A, U.S. Gov't Printing Office, pp. 360-368.

[5] Iowa Code § 172C.4.

[6] *Id*. See 8 Harl, *supra* note 2, § 62.01[2][a].

[7] Iowa Code § 172C.1(12).

[8] See I.R.C. § 408(e).

[9] Wis. Stat. 182.001, effective May 27, 1978. See 8 Harl, *supra* note 2, § 62.01[2][g].

[10] Okla. Stat. tit. 18, § 955. See 8 Harl, *supra* note 2, § 62.01[2][e].

[11] Kan. Stat. Ann. §§ 17-5903(k), 17-5904. See 8 Harl, *supra* note 2, § 62.01[2][b].

[12] Minn. Stat. § 500.24(2)(f). See 8 Harl, note 2 *supra*, § 62.01[2][c].

[13] Neb. Rev. Stat. §§ 76-1515, 76-1507, 76-1517.

[14] S.D. Cod. Laws Ann. § 47-9A-4. See 8 Harl, *supra* note 2, § 62.01[2]f].

[15] Pub. L. No. 93-406, 88 Stat. 829 (1974).

[16] 29 U.S.C. § 1104.

[17] See I.R.C. § 4975(e)(1)(B).

[18] I.R.C. § 4975(e)(2).

[19] *Id*.

[20] I.R.C. § 4975(c).

[21] I.R.C. § 408(e)(2).

[22] I.R.C. § 179(d)(4).

[23] Pub. L. No. 111-147, 111th Cong., 2d Sess. (2010), amending I.R.C. § 179.

[24] I.R.C. § 408(a).

[25] I.R.C. § 408(d)(1).

[26] I.R.C. § 1221.

[27] I.R.C. § 1231.

[28] I.R.C. § 691(a)(2). See Rev. Rul. 69-297, 1969-1 C.B. 131 (profit sharing trust; estate as beneficiary); Ltr. Rul. 200316008, Dec. 31, 2002 (IRA proceeds distributed to estate and beneficiaries were income-in-respect-of- decedent).

[29] I.R.C. § 1014(c).

[30] I.R.C. § 1014(a).

[31] See Harl, "Income Tax Basis for Decedents Dying in 2010," 21 *Agric. L. Dig*. 81 (2010).

[32] The Food, Conservation, and Energy Act of 2008, Pub. L. No. 110-248, § 1603, amending 7 U.S.C. § 1308(a)(4).

[33] I.R.C. § 512(a)(1), (b)(3)(A)(i).

[34] See Sherwin-Williams Co. Employee Health Plan v. United States, 2002-2 U.S. Tax Cas. (CCH) ¶ 50,721 (N.D. Ohio 2002) (tax-exempt health plan).

[35] I.R.C. § 1(e).

[36] I.R.C. § 219(e).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

BANKRUPTCY

CHAPTER 12

DISCHARGE. The debtors obtained a loan from a bank secured by crops. The debtors used the proceeds for personal expenses as well as other farm expenses. The crop was sold but the proceeds were not used to pay the loan. The debtors filed for Chapter 12 and the bank moved to have the loan declared nondischargeable under Section 523(a)(6) for willful or malicious injury by the debtor to the creditor. The debtor testified that the debtor knew that the crop proceeds were supposed to be paid on the loan. The court held that the debtors' use of the loan and crop proceeds for their own use constituted a willful injury of the creditor and ruled that the debt was nondischargeable. ***In re* Marklin, 2010 Bankr. LEXIS 1706 (Bankr. W.D. Ky. 2010)**.

FEDERAL TAX

DISCHARGE. In 1996, the debtor filed for Chapter 13 and the IRS filed claims for taxes owed for 1988-1990 and 1992-1995. The debtor's plan provided for payment of the taxes and the debtor received a discharge in 2002. In 1998, the IRS assessed the debtor for 1996 and 1997 unpaid taxes and in 2002, the IRS assessed the debtor for unpaid taxes for 1999, 2000 and 2001. The debtor argued that the 2002 discharge included all taxes owed to that point. The court held that, because the 1996, 1997, 1999, 2000 and 2001 tax claims were not filed in the Chapter 13 case and were not paid under the plan, the taxes for those years were not discharged in that case. **Johnson v. Comm'r, T.C. Summary Op. 2010-69**.

FEDERAL FARM PROGRAMS

PACKERS AND STOCKYARDS ACT. The GIPSA has issued proposed regulations amending the regulations under the Packers and Stockyards Act, 1921, describing and clarifying conduct that violates the P&S Act, including (1) eight examples of conduct deemed unfair; (2) clarification of when certain conduct in the livestock and poultry industries represents the making or giving of an undue or unreasonable preference or advantage or subjects a person or locality to an undue or unreasonable prejudice or disadvantage; (3) whether a live poultry dealer has provided reasonable notice to poultry growers of a suspension of the delivery of birds under a poultry growing arrangement; (4) when a requirement of additional capital investments over the life of a poultry growing arrangement or swine production contract constitutes a violation of the P&S Act; and (5) whether a packer, swine contractor or live poultry dealer has provided a reasonable period of time for a grower or a swine producer to remedy a breach of contract that could lead to termination of the growing arrangement or production contract. **75 Fed. Reg. 35338 (June 22, 2010)**.

REIMBURSEMENT TRANSPORTATION COST PAYMENT PROGRAM. The FGSA has adopted as final regulations implementing the new Reimbursement Transportation Cost Payment (RTCP) Program for geographically disadvantaged farmers and ranchers authorized by the Food, Conservation, and Energy Act of 2008 (the 2008 Farm Bill). The purpose of the RTCP Program is to assist farmers and ranchers in Hawaii, Alaska and insular areas who paid to transport either an agricultural commodity or an input used to produce an agricultural commodity. The payments provided by the RTCP Program are intended to offset a