of tax sheltering options from which to choose, including 1031 exchanges, Delaware Statutory Trusts (DSTs), depletion of tax ...

Jul. 17, 2020

Tax sheltering and land investing go hand-in-hand. That's because there are a myriad of tax sheltering options from which to choose, including 1031 exchanges, Delaware Statutory Trusts (DSTs), depletion of tax basis, step up in basis, retirement accounts, and conservation easements. Which ones are utilized all depends on the needs of the investor.

1. 1031 Exchange and DSTs

To begin, there is the famous "1031 tax deferred exchange". Under section 1031 of the U.S. Internal Revenue Code, taxpayers are allowed to defer recognition of capital gains on the exchange of certain types of real estate investments. Land is one of the types of investment real estate that is allowed to be exchanged. This can easily be done through conventional sales and acquisition models, but also through DSTs, which allow investors to own a fractional interest in a certain property with other investors. Investing in a DST allows you to be a passive investor and diversify your real estate portfolio through investments across many different types and number of properties.

2. Depletion of Tax Basis

Then there is the route offered by the depletion of tax basis. For example, if you purchase timberland conventionally through a mortgage or cash, and it has 4,000 MBF (thousand board feet) of merchantable timber worth $1 million on the day you purchase it, you can convert that 4,000 MBF of timber into $1 million of income over time through one or more timber sales without incurring any tax consequence or capital gain as it is only considered a recovery of capital vs a capital gain. Other timber management activities can add back to the depletable basis, or they can be

the date of the death of the investor. So, if the land is now worth $3,000 an acre, the heirs cost basis in the land becomes $3,000 an acre, meaning that they would incur no tax consequence of selling the property unless their net income from the sale exceeded $3,000 an acre, and only that amount over $3,000 an acre would be subject to any applicable gains tax, providing $1,000 an acre in tax shelter.

4. Retirement Accounts

Land can also be held in an IRA or 401K. In the case of an IRA it will have to be a self-directed one to allow for the investment. And as far as 401Ks are concerned, you cannot invest directly into the 401k account, but will have to rollover your 401k into an IRA and then use the proceeds towards the investment. The IRA shelter is strictly limited to land that is used for investment purposes. So this is not the right choice for people looking to offset improvement costs of a cabin or lodge.

5. Conservation Easement

The aforementioned tax sheltering instruments are applicable to different asset classes and don't exclusively relate to land investments. But conservation easements are typically used solely for land investments, yet many investors are still not sufficiently knowledgeable about how it works or why it is such a great tax shelter. This instrument resembles a deed restriction, but on a larger scale. Through this method, investors donate certain rights to the benefit of a charitable land trust. These rights are typically related to subdivision, development, mining, or surface uses that might adversely affect the subject property's wildlife or ecological benefit to the public (air quality, water quality, etc.). Typically, the more rights you donate, the bigger the tax shelter achieved. Through a conservation easement, anywhere from 50-100 percent of the donor's adjusted gross income can be sheltered for up to 16 years.

What makes easements particularly interesting is that next to the tax shelter, they

does not meet the charitable intent requirements of the IRS, the tax benefit involved could be revoked while the perpetual restrictions the owner applied through their donation of rights remain.

Bottom-Line

Land investors have many tax sheltering options available to them. While most are asset class-agnostic, conservation easements are exclusive to land and offer benefits that any keen investor must understand before employing them. Understanding all of the tax shelter opportunities available to you through the use of land investments is crucial to ensuring you don't leave any money on the table.

=======

Jason Walter is CEO/Founder of National Land Realty licensed in Alabama, Florida, Georgia, and South Carolina, and Clint Flowers is Partner/Accredited Land Consultant licensed in Alabama, Florida, and Mississippi. The company's proprietary video technology, Land Tour 360™, as well as its GIS land mapping system, LandBase™, is offered for free to the public. More information at nationalland.com.

Benefits • Technology