



Timber and Taxes

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Recent IRS Ruling Benefits Forest Landowners And Reader Questions Answered

In this article I'll first discuss a recent IRS revenue ruling that has considerable significance for certain nonindustrial woodland owners. I'll then share with you some of the questions I've received in recent months from readers and my answers to them.

Revenue Ruling 2001-50

Most corporations for tax purposes are subject to Subchapter C of Chapter 1 of Subtitle A of the Internal Revenue Code and thus are commonly called "C" corporations. A C corporation is subject to double taxation. Income taxes are paid at both the corporate level and again by the shareholders on the dividends received.

A C corporation can become a Subchapter S corporation, if the requirements can be met, by making a simple election with the Internal Revenue Service.

A Subchapter S corporation normally incurs no tax at the corporate level. All net income is passed through to the shareholders in the same manner as with a partnership; it is then taxed on their individual returns. Double taxation is eliminated.

Section 1374

Many family timber owning corporations have elected Subchapter S status in recent years. By so doing, however, they have become exposed to Section 1374 of the Internal Revenue Code which contains an exception to the "taxed only once" rule.

Section 1374 provides for a so-called "built-in gains (BIG)" tax for certain Subchapter S corporations that were once C corporations. The BIG tax is levied at 3.5 percent at the corporate level on built-in capital gains that are recognized by such corporations during the first ten years following the Subchapter S election. This ten-year period is known as the "recognition" period.

The onerous BIG tax thus applies to S corporations that, during the recognition period, dispose of assets such as timber that appreciated in value during the years that the corporation was a C cor-

poration. Capital gains net of the BIG tax are then passed through to the shareholders in the normal way for taxation at that level.

Section 1374 is designed to prevent corporations that had unrecognized gains on assets during their "C" years from avoiding the much higher corporate level tax on those gains by converting to S status.

Previous IRS Position

The IRS position is that timber-owning S corporations who sell timber during the recognition period by lump-sum sale using a timber deed are subject to the BIG tax.

In recent years, however, the Service issued a number of private letter rulings to S corporations which took the position that such corporations who disposed of timber during the recognition period under Section 631 (b) of the Internal Revenue Code—that is, by using a so-called pay-as-cut contract—were not subject to the BIG tax.

Other private letter rulings took the same position with respect to S corporations who cut their own timber using a Section 631 (a) election. Private letter rulings are applicable only to the recipient taxpayers; they may not be used as precedent by other taxpayers.

The underlying rationale for the private rulings was that Section 631 (a) and 631 (b) transactions are not really sales, but are just treated as sales by the Code as a mechanism for disposals of business property to qualify for capital gain status.

In 1998, however, the IRS put this issue on its "no rule" list which meant that it would no longer issue private letter rulings on the subject while the previous position was reexamined.

Indications were that the position set out in the private rulings would be reversed by issuance of a revenue ruling.

Thus for the last three years or so, affected timber owning S corporations who had not received a favorable private letter ruling were in limbo on this particular issue.

Current Position

Fortunately, the IRS recently favorably resolved this question by issuing Revenue Ruling 2001-50. A revenue ruling, unlike a private letter ruling, can be used as authority by any taxpayer whose factual situation is essentially the same as that set out in the ruling.

In Revenue Ruling 2001-50, the IRS listed three situations involving timber ownership and concluded that an S corporation's capital gain in each is not recognized built-in gain for purposes of Section 1374. In all three, an S corporation is described as holding standing timber with built-in gain when it converts from C to S status.

In the first situation, the S corporation cut the timber but did not do so under a Section 631(a) election. Although the BIG tax does not apply in this instance, the gain is nevertheless subject to tax as ordinary income rather than capital gain.

The second situation is the same as the first except that a Section 631(a) election is made. In this instance, as in the first, the BIG tax is inapplicable. The difference is that the gain is taxed as capital gain, not ordinary income.

In the third situation, standing timber is disposed of under a pay-as-cut contract as per Section 631 (b). Here, too, the gain is not subject to the BIG tax.

Revenue Ruling 2001-50 represents a resounding victory for nonindustrial woodland owners held in Subchapter S form. Both capital gains eligibility and avoidance of the BIG tax are now assured by using either Section 631 (a) or 631 (b) when harvesting timber.

Recent Questions By Readers

I recently replanted 80 acres in loblolly pine, partly in December and partly in January, after clearcutting the previous stand. I applied fertilizer when the seedlings were planted which substantially increased my per acre costs. I understand that I can amortize my planting costs (those for seedlings, site preparation and labor) and also take a 10 percent tax credit, subject to the \$10,000

per year limit. My question, however, is how do I handle the fertilizer costs on my tax return? I have heard that there are several ways to do that. Are they eligible for the tax credit?

The IRS addressed this question in General Counsel Memorandum 39791. Fertilizer costs incurred in connection with planting are eligible for the reforestation amortization and credit subject to the \$10,000 limitation. You should total your reforestation costs minus the fertilization expenses for each of the two years. If either of the totals are less than \$10,000, you should then add fertilizer costs until the \$10,000 ceiling is

reached. These amounts are then eligible for both the 84 month amortization and the 10 percent tax credit. If there are any remaining fertilizer costs, they may be recovered by amortizing them over the established life of the particular fertilizer in question—usually five to seven years. These remaining costs are not eligible for a tax credit, however.

I recently reforested some of my timberland after clearcutting the previous stand. My consulting forester arranged for the planting by hiring and supervising a planting crew who I paid directly. My forester billed me separately for his

services. I ordinarily deduct the amounts paid him on Schedule A of my tax return as a miscellaneous itemized deduction which means that a substantial portion of these costs cannot actually be deducted. Since the costs in question were related to reforestation, are they eligible for the reforestation amortization and credit?

Yes, the costs of your forester's services that are directly related to reforestation are eligible for the amortization and credit. In fact, the law requires that they must be capitalized as a reforestation cost. They are then eligible, together with the other expenditures associated with your planting, for the amortization and credit—subject to the \$10,000 annual limitation. Under no circumstances may these costs be deducted on Schedule A or anywhere else on the tax return as a current deduction.

I've always sold my timber by taking sealed bids and using a timber deed. We refer to this as a lump-sum sale. Last year I was audited by the IRS who said that my sale activity was frequent enough to classify me as a dealer, and that I should have been using a "pay-as-cut" contract. They taxed my last two sales as ordinary income and disallowed capital gains. The Appeals Officer reversed that ruling, but I don't want to take any chances in the future. I understand that there is a type of "pay-as-cut" contract that I can use that will allow me to still take sealed bids and be paid immediately but yet will qualify for capital gains. Can you explain this to me?

When a timberland owner, in the eyes of the IRS, crosses the threshold, with respect to selling timber, from being an investor to becoming a dealer, lump-sum sales no longer qualify for capital gain treatment. A disposal with a retained economic interest (pay-as-cut contract) under Section 631(b) of the Internal Revenue Code must be used if the proceeds are to be taxed as a capital gain. Revenue Ruling 78-104 describes a procedure acceptable to the IRS that will qualify under Section 631(b) and at the same time permit the seller to take sealed bids, accept the highest, and be paid the bid amount immediately as an advance payment.

The standing timber must be cruised before cutting by the seller. The dollar amount of the winning bid is divided by the cruise volume to determine the per unit payment to be received. If all of the contract timber is cut by the buyer, the total amount received by the seller will equal the total bid price. After cutting has been completed, any remaining contract timber must be recruised to

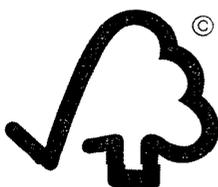
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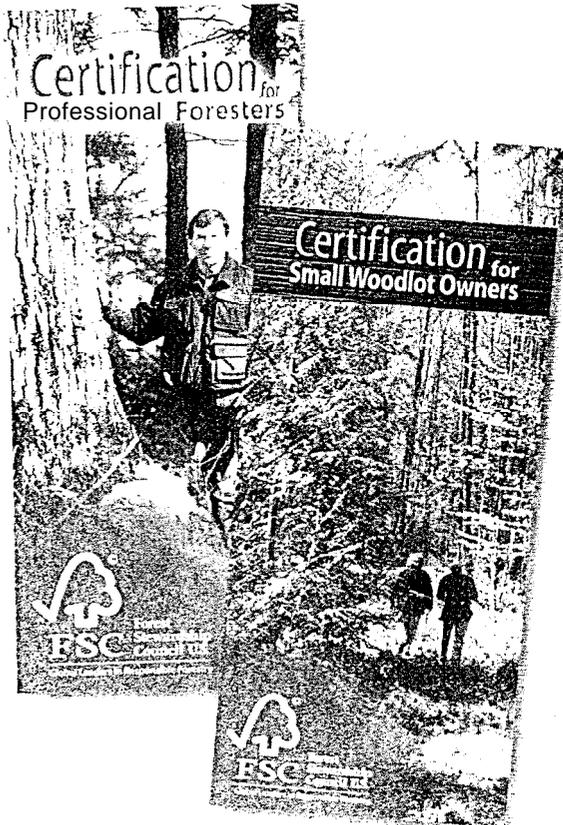
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determine its volume. The seller can then receive liquidated damages from the buyer for uncut contract timber equal to the actual economic loss suffered, and must refund the difference to the buyer. Liquidated damages are ordinary income. In the alternative, the seller has the option of legal action against the buyer for specific performance.

I own 160 acres of woodland in the Lake States. I recently surveyed my boundaries and fenced the entire property, and in addition put in some culverts and built several bridges over small streams that run through the land. I have only cut timber several times over the years and have never considered myself as being in the timber business. On several occasions I've added costs incurred with respect to my property to the miscellaneous itemized deduction category on Schedule A of my tax return. Someone told me that even though my woodland is not treated as business property that I can still depreciate my fences, culverts and bridges. Is this correct?

The answer is yes even though you are not filing tax returns as a business with respect to your woodland. You can, as an investor, depreciate any property associated with the investment that is eligible for depreciation. You should refer to IRS Publication 946, *How To Depreciate Property*. Your bridges, culverts and fences can be depreciated over 15 years beginning with the year that these items were placed in service.

Depreciation deductions not taken for a particular year are lost except to the extent that they can be reported on a timely filed amended tax return. As an investor, however, your depreciation deductions are part of your miscellaneous itemized deductions on Schedule A where they are subject to the limitation imposed on that category of deductions.

William C. Siegel is an attorney and consultant in private practice specializing in timber tax law and forestry estate planning. He is retired from the US Forest Service where he served as Project Leader for Forest Resource Law and Economics Research with the Southern Forest Experiment Station, where he still serves as a volunteer. He provides this column as a regular service to *National Woodlands* readers. Mr. Siegel welcomes comments and questions. They may be directed to him at: 9110 Hermitage Place, River Ridge, LA 70123; tel. (504) 737-0583. 



FLTC Tax Report by Frank Stewart, RF



Welcome to a new "21st Century Feature" from NWOA. This report will come to you quarterly, and we hope you believe, as we do, that the taxation of your timberland is of the highest consequence. We look forward to bringing you the latest quarterly federal timber tax information.

The following, from the Forest Landowners Tax Council, updates us on current federal tax legislation affecting non-industrial private forest landowners.

IRC Sec. 631 (b): The events of September 11 have forced modification of much of the previously anticipated agenda of the first session of the 107th Congress. However, even under circumstances of war, progress has been made on our modification of IRC Section 631 (b). S. 567 and H.R. 1341 allow more timber owners to be eligible for lower capital gains tax rates. These identical bills are both entitled the "Timber Tax Simplification Act of 2001." The congressional Joint Committee on Taxation has added the provisions of this legislation to its "Tax Simplification List." And, we are told, it is the only timber-related item to be on this roster of JCT requests to help refine and simplify the current tax code. Since our last report, Thomas Allen (D-ME), Jim Ramstad (R-MN, Ways & Means) and John Sununu (R-NH) have joined 15 of their colleagues in co-sponsoring H.R. 1341, which was sponsored by Rep. Mac Collins (R-GA). And Sen. Gordon Smith (R-OR) became the eleventh co-sponsor of the senate version, sponsored by Jeff Sessions (R-AL).

Death Taxes: Sen. Jon Kyl (R-AZ) tried to include a permanent repeal of death taxes in the "victims relief bill" because he understands the stress on the September 11 survivors. But, the Senate found little interest for this proposal. Congressional staffers and their bosses did not want to revisit the death tax issue just yet. So, the good senator filed an amendment to the House's Economic Stimulus Package, to make H.R. 1836 permanent. FLTC and allied organizations are asking family business owners to demand that the death tax repeal become a real repeal--to finish the job promised. According to recent polls, 70 percent of voters want this too; i.e., repeal the death tax immediately and permanently.

FLTC Board: At a meeting of the Forest Landowners Tax Council Board of Directors meeting on November 14, FLTC staff was directed to focus its 2002 advocacy efforts on (in order of priority): 1) Modification of IRC Section 631 (b); 2) Increase in the amount eligible for the reforestation tax credit and amortization, reduction of the amortization period, and expansion of the amortization and credit to include non-commodity planting; 3) Income averaging for timber harvesters.

Frank Stewart is the executive director of the Forest Landowners Tax Council (FLTC), which is an independent non-profit organization dedicated to providing an effective and unified voice for non-industrial, private forest landowners on federal tax issues. The Council seeks to provide technical research to identify opportunities for timber tax improvements. FLTC is also a source of education for those who wish to learn more about timber and timberland taxation, as well as the business aspects of forestry. Membership is open nationwide. Visit the official website at "http://www.FLTC.org" or contact Stewart directly via email: Director@FLTC.org, tel: 703-549-0747, fax: 703-549-1579.