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Recent Developments Affect Woodland Owner Tax Issues

This article will begin with discussion of several recent income and gift tax developments of interest to woodland owners. It will be followed by a question recently brought to my attention and the answer provided.

Job Creation and Worker Assistance Act

The Job Creation and Worker Assistance Act signed into law this past March contains two provisions that apply to woodland owners. Both are temporary and both apply retroactively to the 2001 tax year.

Additional First Year Depreciation

Taxpayers are now entitled to an additional first-year depreciation deduction equal to 30 percent of the adjusted basis of qualified property. Woodland owners who hold their forest land as either a business or as an investment can take advantage of this "bonus provision."

Property eligible for the special treatment includes that with a depreciation recovery period of 20 years or less. For example, computers and related equipment, automobiles, pickup trucks, tractors, planting machines, fences, bridge, culverts and the surface (such as gravel) of permanent roads all are included. The asset must have been acquired after September 10, 2001 and before September 11, 2004.

The taxpayer's original use of the property must commence on or after September 11, 2001 and it has to be placed in service before January 1, 2005. The basis of the property and the depreciation allowances in the year of purchase and in later years must be adjusted to

reflect the additional first-year depreciation deduction.

Since this new tax provision applies to items acquired on or after September 11, 2001, some woodland owners can qualify for the enhanced deduction on their 2001 tax returns. In most of these cases, amended returns will need to be filed.

Example

Mr. Jones purchased a pickup truck for \$22,000 in October 2001 which he is using entirely for his woodland operations. In addition, he paid \$3,000 in November 2001 to fence his timber acreage and bought a used tractor for \$20,000 in December 2001 for use on the property. The total cost was \$45,000.

Mr. Jones has established his timberland operations as a business. He is thus able to take advantage of Section 179 of the tax code which permits outright deduction of all or part of the cost of qualifying depreciable property instead of recovering it through annual depreciation deductions.

The limit on the Section 179 deduction for 2001 is \$24,000. Mr. Jones took this deduction on his 2001 federal income tax return which was filed in February 2002. This left a balance of \$21,000 to be depreciated. Using the IRS tables, the combined first year depreciation deduction for the three items equaled \$1,851.50. This deduction was also taken on Mr. Jones' 2001 return.

After reading about the new tax legislation passed in March 2002, and the retroactive provisions which apply to his purchases, Mr. Jones decided to file an amended return for 2001. The bonus 30 percent deduction to be reflected on the

amended return will equal \$6,300 (\$21,000 x 30%). This deduction is in addition to the \$1,851.50 already taken. The remaining basis of \$12,848.50 is recoverable starting in 2002 under the normal depreciation rules

Net Operating Losses

Taxpayers generally can carry back net operating losses (NOLs) two years. This would apply to woodland owners who operate their forest land as a business and not as an investment. For example, if deductible expenses exceed income from the property in a particular year (which is often the case if no timber was sold that year) and cannot be entirely offset against the taxpayer's other income, the difference is a net operating loss and can be applied against income during the two preceding tax years by filing amended returns.

The new law temporarily extends the general carryback period from two to five years. The losses must arise in tax years ending in 2001 and 2002. Taxpayers will be given an opportunity to elect out of this treatment if they so choose and the election is final. The new law also allows a taxpayer's NOL deduction to reduce taxable income subject to the alternative minimum tax up to 100 percent.

Tree Farm Costs are Nondeductible Start-up Expenses

The Tax Court has sustained the IRS's determination that an individual's "tree farm" costs were nondeductible start-up expenses.

Robert McKelvey bought property to start a tree farming business. The land included a barn and a cabin where

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McKelvey lived. After six years and various feasibility and planting tests, McKelvey hadn't decided which species of trees to plant and hadn't commercially harvested any trees. He had claimed deductions for his tree farming activities on his 1995 and 1996 tax returns.

The IRS determined that the expenses claimed were nondeductible start-up expenses under Section 195(a) of the tax code. Alternatively, the IRS argued that McKelvey's tree farming activity wasn't engaged in for profit.

The judge granted summary judgment to the IRS, agreeing that the expenses were nondeductible start-up expenses. The judge noted that McKelvey wasn't carrying on a trade or business in 1995-1996 and that he didn't commercially harvest any trees or even decide which species of trees to plant. The only purpose of a pilot planting of pine trees was to determine whether his property could sustain commercial pines.

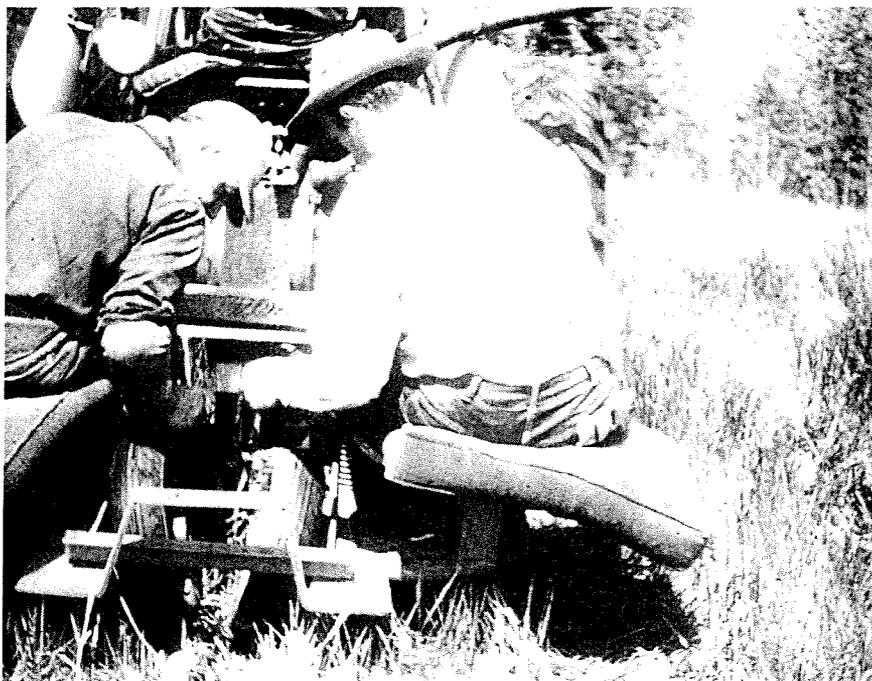
Thus, the court held that the so-called tree farming activities weren't part of a business during 1995-1996 and that any expenses McKelvey incurred were related to research into, and investigation of, the business potential of creating a tree farm. The court noted that it didn't need to address the not for profit argument.

Annual Gift Tax Exclusion for Timberland

In another recent decision (*Christine M. Hackl et vir. v. Commissioner*, 118 T.C. No. 14, March 27, 2002), the Tax Court held that individuals claiming an annual gift exclusion (previously \$10,000 per donee per year, now \$11,000) must show that the transfer of the gift conferred on the donee an unrestricted and noncontingent right to the immediate use, possession or enjoyment of property or income from property.

In 1995 and 1996, Albert and Christine Hackl gave their children and grandchildren membership units in Treeco, a limited liability company (LLC) formed by Albert to hold and operate tree farming properties. When the timberland was purchased, investment diversification was sought by Albert in the form of long-term growth and future income.

When put into the LLC, the land had little or no salable timber. Albert and Christine gave interests in the company outright to family members in 1995. The gifts were reported on gift tax returns and an election was made to designate them as one-half each by Albert and Christine under the special split-gift provision of the gift tax law. They also treated the gifts as donations of present



Tree farming expenses are a legitimate tax deduction, but some material commitment, such as planting trees, has to be demonstrated, according to a recent ruling.

interests and thus qualifying for the then \$10,000 annual exclusion.

The couple continued the gifting program in 1996 but this time transferred membership units in Treeco to their minor grandchildren's trust. The 1996 gifts were treated the same as those made in 1995. At the time of the gifts, Albert correctly anticipated that Treeco and several successor entities would generate losses and make no income distributions for many years. The IRS disallowed the exclusions for the 1996 gifts to the trust.

The judge, in deciding in the IRS's favor, noted that the dispute turned on whether the transfers amounted to gifts of a present or future interest. Because the gifts to the trust failed to confer substantial present economic benefits by reason of the use, possession or enjoyment of the property, or the income from it, the court concluded that they failed to qualify for the annual exclusion.

In reaching his decision, the judge rejected the Hackl's argument that when a gift to a trust takes the form of an outright transfer of an equity interest in property, no further analysis is needed or justified. He held that to follow this logic was to sanction exclusions for gifts based only on "conveyance form" without requiring into whether the donees received rights that differed from those associated with a traditional trust.

In examining the facts of the case, the court ruled that the economic benefit that the beneficiaries would ultimately obtain from their receipt of Treeco units was future, not present. It should be noted that the circumstances were dif-

ferent for the 1995 gifts which were outright and did not involve trusts. In that case, the present interest test was met since the donees could use and enjoy the property even though it produced no income.

Deferring Recognition of Salvage Harvest Gain

The following question was recently received from a consulting forester by a colleague of mine and referred to me. It essentially was as follows:

Question

My clients suffered damage to some of his timber in 1998 from an ice storm. We proceeded with a salvage sale which resulted in net income that exceeded the adjusted basis of the damaged timber. Part of the income was received in 1998 and part in 1999. My client also took a casualty loss deduction on his 1998 income tax return.

I understand that taxpayers can avoid paying tax on income from salvage sales by using either all or part of the money received to buy other timber and that they have three years to do this.

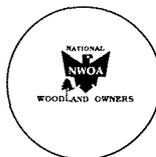
My client hasn't yet filed his 2001 tax return. Is he still eligible? What procedures does he have to follow and is the situation affected by the fact that a casualty loss deduction was taken on his 1998 tax return?

Answer

Timber losses from an involuntary conversion, such as from the ice storm in your case, will result in a taxable gain instead of a deductible loss if the owner



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 Death Tax and the IRC Section 631(b): To amend the Internal Revenue Code of 1986, the U.S. House of Representatives has passed the Tax Relief Guarantee Act of 2002 (H.R. 586) to make permanent the tax reductions enacted by the Economic Growth and Tax Relief Reconciliation Act of 2001 (H.R. 8) and to protect taxpayers and ensure accountability of the Internal Revenue Service. This bill's provisions for permanency included language to override the 2001 -passed, phase-out of the death tax in order to make it permanent -You may recall that last year's H.R. 8 is only a 10-year phase-out of the death tax, which will return in full force in the eleventh year. Interestingly, and subsequent to their H.R. 586-vote, the House also passed H.R. 2143, which does exactly the same thing-it makes the repeal of the death tax permanent. We think our Congressmen are serious about immediate and permanent elimination of this 55 percent penalty for dying! In addition, FLTC was pleased that, when H.R. 586 passed, it included the stipulations of the Timber Tax Simplification Act of 2001 (H.R. 1341), which modifies internal Revenue Code Section 631 (b) to allow capital gains treatment on income from lump-sum timber sales for most non-industrial, private forest landowners.

Your delegates to the U.S. House should be congratulated. However, our struggle continues on the Senate side. Recently, many readers helped recruit U.S. Sen. Kyl to vote to **pass** the Gramm / Kyl Amendment to make the death tax permanent. However, the measure failed to get the 60 votes need for passage (vote was: 54-for to 44-against) and Senate Majority Leader Tom Daschle (D-SD) now says that no other tax legislation will be considered on the Senate floor this year. But, FLTC would certainly like to see the matter readdressed after October 1 when it will only take 51 votes to pass, because of the Senate's rules on budgetary considerations.

Finally, FLTC asks readers to contact U.S. Senators who serve on the Finance Committee and ask them to co-sponsor S. 567, the Timber Tax Simplification Act of 2002. This is the same bill as H.R. 1341 mentioned above, which allows capital gains treatment on lump-sum sales. We are particularly interested in co-sponsorship by Senators Max Baucus (D-MT), John Breaux (D-LA), Bob Graham (D-FL), Blanche Lincoln (D-AR), Don Nickles (R-OK), Frank Murkowski (R-AK), Phil Gramm (R-TX), Fred Thompson (R-TN), and Olympia Snowe (R-ME). Senator Trent Lott (R-MS) is already a co-sponsor. To help out you can call the Senate switchboard (202-224-3121) or visit "<http://congress.org/>" for contact information for your Senators. To learn more about S. 567, call FLTC at 703-549-0747 or go to "www.fltc.org" and click the 'Hot Issue' button.

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.

receives salvage income or other reimbursement (such as insurance) that exceeds his or her adjusted basis in the timber plus selling expenses.

This situation precludes taking a casualty loss deduction which can only be done if the reimbursement received, or expected to be received, is less than the adjusted basis of the timber in question. In other words, if your client expected the net salvage proceeds to be more than his or her adjusted basis in the lost timber-which is the case-a casualty loss deduction should not have been taken.

Unless the 1998 return was filed late, it's now too late to file an amended return to correct the situation. At this point, it's unlikely that your client will be audited.

The three-year window for filing amended returns is still open with respect to 1999. Your client should therefore file an amended return for that year and with respect to the timber income reported on that return-use a zero basis. The loss deduction reduced the basis to zero. If this is done, the situation will at least be remedied in part.

The second part of your question refers to deferring the taxable gain from a salvage sale by reinvesting in qualified replacement property within the allowable period. For a casualty loss, this allowable replacement period is two years after the close of the first tax year in which the owner realizes any part of the gain.

A three-year window applies only in the case of condemnations. Since your client received part of the salvage sale payment in 1998, the allowable replacement period ended on the last day of 2000. It is therefore now too late.

You also asked whether an owner can elect to defer only part of a taxable gain realized from an involuntary conversion. The answer is yes. An election can be made to defer only part of the gain and pay income tax on the remaining amount.

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.