William C. Siegel, J.D.

2004 Tax Legislation A Plus For Woodland Owners

The Working Families Tax Relief Act of 2004 was signed into law by the president on October 4, 2004. After undergoing some compromises in conference, the bill sailed through the House of Representatives by a 339 to 65 vote margin, and was accepted by the Senate 92 to 3.

Then on October 22, 2004, the president signed the American Jobs Creation Act of 2004. Both pieces of legislation contain a number of provisions that will have a beneficial impact on the income tax aspects of growing timber. The Forest Landowners Tax Council, a partner of the National Woodland Owners Association, played the major role in gaining passage of the two timber-specific changes discussed in the following paragraphs.

Reforestation Costs

The general tax law rule is that direct costs incurred in connection with reforestation are required to be capitalized, and may only be recovered (deducted) when the trees are sold or otherwise disposed of. Section 194 of the Internal Revenue Code has provided a limited exception to this rule since 1980. All taxpayers except trusts could elect to amortize (deduct) over 84 months (actually eight tax years) up to $10,000 of qualifying capitalized reforestation expenses each year. In addition, reforestation expenses eligible for amortization were also eligible for a 10 percent investment tax credit.

The Jobs Act made significant changes to Section 194 which are effective for all reforestation costs incurred on or after October 23, 2004. The first of these permits up to $10,000 annually of eligible reforestation costs *per qualified property* to be immediately deducted (expensed) in the year incurred.

This means that if a woodland owner has more than one qualified property, the $10,000 yearly limit will be applied separately to each property. The term "each qualified property" is not defined in the new legislation, nor was it defined in the old Section 194. Thus the IRS will have to define it in the regulations it writes for purposes of administering the new law.

The second change permits all reforestation costs unable to be expensed, without limit as to amount, to be amortized over 84 months. The rules for amortization otherwise remain the same. This provision is also effective for expenditures made on or after October 23, 2004.

In return for the expanded benefits described above, the 10 percent reforestation tax credit was removed with respect to all reforestation expenses incurred on or after October 23, 2004. Unfortunately, the new provisions do not apply to trusts just as the old ones did not.

Taking the Deduction

Woodland owners who file as a business or as a pass-through entity (such as a Sub S corporation or partnership) will take the immediate deduction now permitted for the first $10,000 on their tax return as they would for any other business deduction. But what about those who file as an investor rather than a business? The good news is that such persons will not have to itemize deductions on their tax returns in order to claim the deduction. It will be an "above the line" deduction, taken in the same manner by investors as a reforestation amortization deduction.

Reforestation costs incurred early in 2004 will be subject to the old rules; those incurred on or after October 23 will be subject to the new rules. The following example illustrates the procedure.

Example

John Woodland Owner has an 800 acre tree farm. He clear cut some of his acres in 2003 and replanted in January and February of 2004 at a cost of $15,000. He clearcut additional acreage in the spring of 2004, and replanted in December of that year. The cost was $22,500.

The $15,000 of costs incurred early in the year are subject to the old rules. Therefore, $9,500 can be amortized over eight tax years beginning on the 2004 tax return and a $1,000 tax credit can also be taken on that return. The $10,000 basic limit for amortization was reduced by five percent ($500) because the credit was also taken. The $500 is permanently lost. The remaining $5,000 of costs stay in the reforestation depletion

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Keith A. Argow, Publisher
October 7, 2004

account as capitalized expenses until the trees are sold or otherwise disposed of. At that time they can be recovered (deducted).

The $22,500 in costs incurred in December are subject to the new rules. The first $10,000 can be deducted immediately on the 2004 return. The remaining $12,500 can then be amortized over 84 months beginning on the 2004 return. In actuality, the $12,500 will be combined with the earlier $9,500 for amortization purposes.

Timber Capital Gains

The Jobs Act also made a significant change in the way that woodland owners can qualify for capital gain eligibility for timber sale income. This change became effective on January 1, 2005.

The Old Law

Prior to 2005, only those timber owners who were classed as investors with respect to their timber operations could qualify for capital gain treatment for a lump-sum stumpage sale. Essentially, this category only included those woodland owners who made occasional sales at wide-spread intervals and who did not file business tax returns with respect to their timber harvesting. Taxpayers determined to be a business on audit by the IRS were denied capital gain treatment for lump-sum sales even if they called themselves investors and filed as such. The only way a woodland owner was able to be assured of capital gains without question with respect to a stumpage sale was to sell under Section 631(b) of the Internal Revenue Code with a retained economic interest—in other words, by using a pay-as-cut contract.

There are many disadvantages to a retained interest sale as opposed to a lump-sum sale. Suffice it to say, lump-sum sales are less complex, and much easier to structure and administer. Most prospective timber purchasers prefer lump-sum sales and landowners can usually receive more and higher bids when using them.

The New Law

The new law permits either a lump-sum sale or a retained interest sale, at the seller's option, to qualify under Section 631(b). This means that all woodland owners, regardless of their status as a business or investor, can now use lump-sum sales whenever they wish and still qualify for capital gains treatment. The change became effective on January 1, 2005.

Other Changes

Last year's two major tax bills contain several other provisions that will be of benefit to woodland owners.

Subchapter S Corporations

Many family forest ownerships are structured as Subchapter S corporations. The maximum number of shareholders for S corporations was raised from 75 to 100 and now all members of one family can elect to be treated as one shareholder. These changes became effective on January 1, 2005.

Section 179 Deductions

Section 179 of the tax code permits the costs of certain qualifying business property to be immediately expensed (deducted) in the year of purchase rather than being recovered over a period of years through depreciation. The maximum eligible dollar amount in 2004 was $102,000.

This was scheduled to revert to $25,000 in 2005. The new legislation extended the $102,000 ceiling, to be adjusted annually for inflation, through 2007. It is now scheduled to revert to $25,000, with no indexing for inflation, in 2008.

Another generation enjoys the family forest: Jan Anderson Sparks and daughters Victoria and Stephanie

Keeping It in the Family.

Just like their mother before them, Jim, Jan and Art Anderson grew up spending time in the family's woods—riding horses, camping out and fishing. Today, the property Jimps Hodges purchased in the '40s and left to his daughter Mary Ann continues to be valued by three generations of the South Georgia Anderson family.

For the past five years, a Georgia-Pacific Forest MAP forester has worked with the Andersons, developing a forest management plan for their family forest—a plan that will help them sustain their forest and its ability to create special memories for future generations of Andersons.

Mary Ann, sons Art and Jim, and Jimps Hodges in an earlier time.

FOREST MAP

Georgia-Pacific

www.gp.com/forestmap

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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 timber/timberland is of the highest consequence. We look forward to bringing you the latest quarterly federal timber tax information.

Issues: During the fall meeting of the Forest Landowners Tax Council's Board of Directors, Board members pondered the organization's next step, on the heels of our grand success in modifying IRC Section 631(b) to allow capital gains treatment on income from lump-sum timber sales. It was determined that the following priority issues would be focused upon in the 109th Congress: 1) Permanent and immediate elimination of the death tax; 2) Reform of passive loss rules; 3) Reinstate income averaging for tax purposes. Another item was also determined to be of high importance - finding funding for research on the tax structures of the European Union nations and others for non-industrial private forest landowners. Anecdotal evidence, and a two-decades-old study of similar intent, leads us to believe that there are advantaged tax systems for NIPF owners in other countries that should be at least considered for American NIPF landowners. The results of such an undertaking would provided an excellent point-of-beginning for the work that FLTC sees as necessary to improve taxes on investments in U.S. forestland; improvements needed to see that our forest landowners can afford to maintain their forests as forests and not succumb to the draw of better returns on development, for example.

Elections: As you read in our last edition, the South Dakota Senate seat was, to great extent, based of the issue on candidates' positions on the elimination of the death tax. Also as foreseen, the crown jewel of Democratic Senate seats was flipped, when former Rep. John Thune (R) defeated Senate Minority Leader Tom Daschle (D) by about 4,500 votes, 51 percent to 49 percent. No Senate party leader had lost a re-election bid in 52 years, until this. The Thune victory was also seen as a victory for death tax elimination, because the many, including the American Family Business Institute, had targeted Daschle for defeat after he had caused moves toward permanent/immediate elimination of the death tax to stumble. "Don't get Daschled" is a phrase that can now be heard in the hall of Congress, when Members talk about what is likely to be a vote on the death tax in the 109th Congress.

Congressional Agenda: The 109th Congress will work toward the extension of expiring tax cuts. While Congress may certainly consider extending certain tax breaks permanently beyond their anticipated expiration dates in 2010 and 2011, there are also discussions underway to consider extending only those with earlier expiration dates. This includes action to permanently eliminate the death tax. And the president has announced his interest in pursuing major reforms of the tax system.

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.net" or contact Stewart directly via email: Director@FLTC.net, tel: 703-549-0747, fax: 703-549-1579.

Alternative Minimum Tax

The alternative minimum tax exemption amount of $40,250 for single filers and $58,000 for joint filers, set to expire at the end of 2004, was extended through 2005. Under current law, the exemptions will revert to $33,750 and $45,000, respectively, in 2006.

Lower Capital Gain Rates Still Temporary

The current noncorporate long-term capital gain rates only apply through 2008. They were not extended by the new tax legislation. This means—unless Congress acts before 2009—that long-term capital gains for noncorporate woodland owners will once again be taxed a a maximum of 20 percent beginning in that year instead of the current 15 percent.

Conclusion

Woodland owners clearly were winners in 2004 from a federal income tax standpoint. Certain other items remain to be addressed, however. The onerous passive loss rules must be changed to reflect the unique aspects of timber growing and forest ownership. Low capital gain rates need to be made permanent. Income averaging, now available only to farmers, should he expanded to include timber sale income. The Forest Landowners Tax Council is committed to seeing that legislation addressing these concerns is passed.

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.

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On the Cover: *Timberlands in the foreground of this remarkable view of Mount Hood, Oregon's highest point, are well-managed private lands. Property close to this vantage point, the Belton Woodlands—the second Green Tag Forest certification in the state—will be featured in the next issue of National Woodlands.*

Image by Photodisc