William C. Siegel, J.D.

Tax Implications Of Forest Property Exchanges

For various reasons, it may be advantageous for woodland owners to voluntarily exchange some or all of their timber and/or timberland for other property. For example, exchanges can be used to consolidate or diversify forest holdings and other investments; to obtain greater cash flow; and eliminate or reduce management problems. In many cases, voluntary exchanges—rather than sales and purchases—are used for these and other purposes in order to postpone the payment of income tax on the difference between the value of the property given up and the property's basis.

This article deals with voluntary exchanges. These should not be confused with postponing the recognition of gain or loss when property is involuntarily converted, such as with a casualty or condemnation, and qualified replacement property acquired with the proceeds.

Introduction

Section 1031 of the Internal Revenue Code provides that gain or loss is not recognized when property held for productive use in a trade or business, or for investment (except stock, securities and similar property) is exchanged solely for like-kind property which is also to be held for productive use in a trade or business, or for investment. Property acquired solely for exchange purposes is not considered held for productive use in a trade or business or for investment. Partnership interests also do not qualify.

The like-kind exchange provisions do not apply to property held for sale to customers in the ordinary course of a trade or business—i.e., dealer property. Thus some timber properties may not qualify, as discussed later in this article.

Basic Provisions

Exchanges under Section 1031 are sometimes referred to as *tax-deferred* or *nontaxable* exchanges. Postponement of gain or loss is achieved by carrying over to the property received in the exchange, the basis of the property transferred. The holding period for capital gains purposes of the property given up is likewise transferred to the property received. The realized gain is deferred until the property acquired in the exchange is disposed of in a subsequent taxable transaction.

Thus the gain is only potentially taxable. The tax may be avoided altogether if the replacement property is still held by the taxpayer at his (her) death when its basis is stepped-up to its date-of-death value.

If, however, money or nonqualifying property is received in the exchange, gain is recognized to the extent of the sum of money and/or the fair market value of the other property received, and is taxable. Cash and nonqualifying property received in an exchange is often referred to as "boot."

***Example**—In 1999, in order to more closely consolidate his timber holdings, Mr. Brown exchanged a 40-acre tract (both land and timber) with a fair market value of $50,000 for 30 acres of timber property with a fair market value of $40,000 plus $10,000 in cash. The adjusted basis in the 40 acre tract was $25,000. Although the realized gain is $25,000 (the difference between the total consideration of $50,000 received and the $25,000 adjusted basis), the gain is recognized only to the extent of the cash received. Therefore Mr. Brown only pays tax on $10,000 of gain. The entire transaction, however, is reported on his 1999 income tax return.*

Nonrecognition Mandatory For Qualified Exchanges

Satisfaction of the like-kind exchange provisions, results in mandatory application of nonrecognition treatment. Nonrecognition in such cases is not elective. Thus, there will be no benefit from an exchange which results in a loss. This is because any available deduction for the loss would be postponed until the property received in the exchange is disposed of by sale or other taxable transaction.

Properties Eligible For Like-Kind Exchange Treatment

It is not necessary that investment property be exchanged for other investment property, or that property used in a business be exchanged for other property used in a business, in order to qualify for nonrecognition of gain. Therefore, property used in a trade or business may be exchanged for investment property, and vice versa. The property received in exchange must only be of a like-kind to that given. Like-kind refers to the nature or character of property, not its grade or quality.

Thus, an exchange of an item of property within one of the three classes used in defining like-kind property for another item within the same class will qualify as like-kind. The three classes are:

1.) depreciable tangible personal property such as equipment;
2.) other personal property including intangible personal property, nondepreciable personal property, and personal property held for investment; and
3.) real property.

Investment Versus Trade or Business

As noted earlier, at the time of the exchange the property given up and the property received must both be held either for productive use in a trade or business, or for investment.

As discussed in previous issues of *National Woodlands*, there is no precise definition in the tax law of what constitutes a trade or business, or an investment. If timber production is not a woodland owner's principal or a major source of income, but the property is otherwise being managed for the eventual realization of a profit, it perhaps is being held as an investment.

Property is considered as held for

use in a business if it is part of an activity entered into and carried out for profit on a more regular basis than in the case of an investment. The key factor in both cases, however, is an intention to make a profit.

Exchange of Real Property For Real Property

The exchange of virtually any parcel of real property for another parcel of real property should qualify as like-kind, as long as the interests in the property given up and those of the property received are of a similar character or nature. The most common form of ownership interest is "fee simple." A fee simple interest is not limited to a certain period of time.

A leasehold interest is not of the same character or nature as a fee simple interest, because a leasehold interest is limited to a designated time period. However, a lease with 30 years or more remaining is an exception to this rule. It is considered of like-kind to a fee simple interest and nonrecognition treatment is available to the person holding the lease (the lessee).

Nonrecognition may not be available to the person granting the lease (the lessor) because receipt of the fee simple interest may be treated as advance rental payment that must be reported as ordinary income.

Change in Use

The property given up may have been originally acquired for another purpose. Likewise, the use of the property received may be changed to a nonqualifying use at some point after the exchange. However, such a change in use of the property received may indicate an intent not to hold it for a qualified use at the time of the transaction.

The burden is on the taxpayer to prove that both the property given and received were held for productive use in a trade or business or as an investment.

Other Requirements: Time Considerations

If an exchange of like-kind properties is not simultaneous, the exchange must be completed (i.e., the second transfer must take place) by the earliest of: (a) the 180th day after the first transfer of exchanged property, or (b) the due date (including extensions) for the transferor's federal income tax return for the tax year in which the exchange took place.

Furthermore, in a nonsimultaneous exchange, the property to be received by the first transferor must be formally identified as such on or before the day that is 45 days after the date on which the first transfer occurred.

Multi-Party Exchanges

A woodland owner may wish to exchange part of his or her property for another particular tract, but the person willing to take the property doesn't own the other tract. It is still possible to enter into a nontaxable exchange if the other person acquires the acreage that the woodland owner wants to receive, and then exchanges it for the woodland owner's property.

Example—*Mr. Smith owns 100 acres of farmland with a low basis which he purchased some time ago as an investment. He doesn't want to sell the land because the sale would result in a large capital gains tax that would have to be paid. However, Mr. Smith is willing to exchange it for a 200-acre tract of timberland that is on the market. Mr. Smith's neighbor wants the farm acreage, but doesn't own the timberland. Although the owner of the timber acreage wants to sell, he doesn't want the farm property. To arrange a transaction acceptable to all parties concerned,*

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Mr. Smith's neighbor purchases the timber property for cash from its owner. Mr. Smith then transfers his farm land to his neighbor in exchange for the timber acreage. The exchange is nontaxable to Mr. Smith if the time limits described earlier are met.

Assumption of Liabilities

Liabilities, such as mortgages, assumed in an exchange are treated as cash equivalents (boot). The taxpayer who assumes the liability, or gets property subject to a liability, is the one who owns the boot. If each party assumes a liability of the other (or acquires property subject to a liability), only the net liability constitutes boot given or received.

Related Party Examples

If like-kind property is exchanged with a related taxpayer, and within two years of the date of the last transfer that was part of the exchange, either party disposes of the property received in the exchange, then any gain or loss not recognized in the exchange is recognized on the date of the later transaction.

Related taxpayers include brothers and sisters (whole and half-blood), spouses, parents and grandparents, and lineal descendants. Inlaws are not related taxpayers. Disqualifying dispositions include indirect transfers, such as to a corporation controlled by a related person. Exceptions are made for transfers at death and as a result of certain involuntary conversions, and for non-tax avoidance transactions.

Application to Timber Properties

As noted above, property given and received in an exchange, in order to qualify for nonrecognition of gain, must only be of like-kind (of the same nature or character)—not necessarily of like grade or quality. Timberland and unharvested timber—also called standing timber or stumpage—are real property. The right to cut and remove standing timber under the provisions of a timber deed or cutting contract is classified as "other personal property" in most states.

There is, however, some variation among states regarding the classification of timber contracts. Since state, not federal, law determines the legal classification of items of property, it is necessary to consult legal counsel for such determinations.

An exchange of forestland containing primarily premerchantable and young growth timber may be exchanged for timber property containing mostly mer-

AND THEN SOME.....

Profiles of woodland owners throughout the U.S. who have made significant personal commitments to private forest stewardship "and then some...."*

Nels Hanson is no stranger to woodland owners in the Pacific Northwest. Starting 41 years ago, he put together 600 acres of forestland in western Washington State, parcel by parcel. His management practices earned the award of "Washington Outstanding Tree Farmer of the Year" in 1985. He was among the first in the state to open his stewardship to review for Green-Tag certification.

Hanson's main career, which overlapped with tree farming, was education. He started out in 1940, teaching high school chemistry, physics and vocational agriculture (during which time he bought his first parcel of forestland). By mid-career, he had become a supervisor of science and mathematics in Olympia, the state capital. He capped his career in education serving 15 years as president of Centralia Community College before retiring in 1981.

From 1985 to 1989 he served as president of the Washington Farm Forestry Association (a National Woodland Owners Association state affiliate), and has served as executive director ever since. He is the editor of *Landowner News*, a WFFA monthly newsletter and a frequent contributor to *Northwest Woodlands*, the joint magazine of the Washington, Oregon and Idaho landowner associations.

Hanson helped organize the Northwest Woodland Owners Council, a four-state organization (OR, CA, ID, and WA) to promote the interests of family woodlands to the Congress, and served as its president. A frequent visitor to the state capitol, he has been a tireless player in protracted negotiations to protect private landowner interests in state forest regulation and rule making, representing small landowners on the Timber, Fish and Wildlife Initiative. That task is shared with seven other landowners, all of them WFFA and NWOA members.

At the national level, Nels Hanson serves as the western vice president of NWOA, as well as a member of the board of the Forest Industries Tax Council (FITC). He recently participated in the Nonfederal Forest Summit in Washington D.C. *(see page 7).*

** "And Then Some" is a tribute to the memory of W. Pat Jennings, Sr. The southwest Virginia native distinguished himself as a county sheriff, member of Congress and Clerk of the House of Representatives—but he always remained an active farmer and an advocate of the best of rural America. He was a valued counsel to several U.S. Presidents as well as the National Woodland Owners Association. A truly motivational speaker, one of his finest addresses was to the graduating class of Smyth County High School (which included one of his grandsons). The message: the secret of success is dedication to an ideal, giving it your very best...**and then some.***

chantable timber (Revenue Ruling 72-515). An exchange of land only, with retention of the timber rights, for land and timber will also qualify (Revenue Ruling 76-253), as will an exchange of bare land with no timber on it for land and timber (Revenue Ruling 78-163).

As discussed above, property that is stock in trade or is property held primarily for sale to customers in the ordinary course of a trade or business does not qualify for like-kind exchange treatment.

Thus timber considered to be held primarily for sale would not qualify if exchanged separately from the land. However, such timber would qualify if it was exchanged with the accompanying land. In such cases, the timber is classified as an unharvested crop exchanged with the land.

Generally, an exchange of timberland for other real property—such as farmland, commercial real estate, or rental property—will also qualify. However, the exchange of standing timber only, for land and timber, is an unsettled question.

The Internal Revenue Service has not issued a formal position on this question as of this writing, The IRS, however, did deny qualification for such an exchange in a private letter ruling, based on the specific facts set out in the ruling.

Reporting of Like-Kind Exchanges

Like-kind exchanges must be reported on the tax return for the year the exchange is made. Exchanges of investment property (capital assets) are reported on Schedule D of Form 1040. Exchanges of property held for use in a business are reported on Form 4797. Also, Form 8824, "Like-kind Exchanges", is filed to support the entries on Schedule D and Form 4797. If the exchange is between related parties, Form 8824 must also be filed for the two years following the year of the exchange.

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.

THE READERS RESPOND

(Continued from page 2)

with the landowner reaction to what one of our state representatives called the greatest threat and fracturing that has ever hit the WFFA.

Rick Dunning
Past President
Clark County Farm Forestry Assoc.
Battle Ground, Washington

Dear Keith:

Going back a bit in time, I owe you a response to your editorial "Iowa: State Supreme Court Rules Against 'Right to Farm' Law" which appeared in the November 1, 1998 NWOA Newsletter.

None of us are too happy with the Iowa Supreme Court's decision, which was in response to a law that could have been drafted more carefully. Because of the extreme odor and pollution problems associated with poorly-managed large-scale hog operations, the Iowa Legislature politically had to do something, and in retrospect, what they enacted was of definitely questionable legality.

You really had to have been downwind of one of those places or seen the fish kills resulting from the escape of hog sewage to understand the magnitude of the problem. The Legislature will address this problem again in the current session.

I know that you have been pushing for state "Right to Practice Forestry" legislation, and IWOA has been sitting on its hands on the matter. While we like the concept, we are afraid of what the Iowa Legislature will do if we attempt to get such legislation introduced, for the Legislature has a long track record of taking requests for "preventive" legislation and coming up with a convoluted product that is of not much use and may even do more harm than good.

Eugene O. Frye
Secretary
Iowa Woodland Owners Assoc.
Marion, Iowa

Editor's note: *The U.S. Supreme Court recently upheld the Iowa Supreme Court decision.*

Dear Keith:

I hope that in some future publication you will explain why "private property rights groups" joined with environmental organizations to support the Endangered Species Act, as reported in the December 1 *Woodland Report.*

I also hope you'll name some of those groups in case I belong to any.

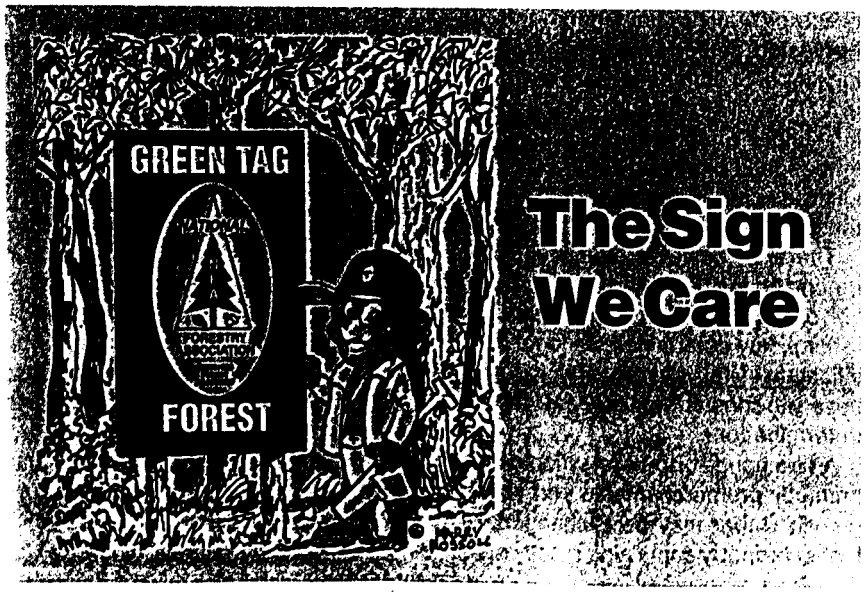
Wish you had more space in *Woodland Report* to explain some of these interesting tidbits.

Larry Q. Hutchins
Knoxville, Pennsylvania

Editor's note: *It's a strange tale, but we'll try in the future.*

Dear Keith:

I just read your December *Woodland Report.* As always, you are enthusiastic about small woodland management.

Let me clarify your use of a preposition. I quote: "carbon storage (carbon combined *with* wood)." Carbon is not combined *with* wood—it is a constituent of at least two of the molecules that make up wood—cellulose and lignin. Moreover, a large share of the sequestration of carbon by trees is in foliage and other non-woody tissues. You might have written more accurately: "combined *in* wood and foliage."

John W. Duffield
Shelton, Washington