Timber and Taxes

Types of Timberland Ownership

The form of ownership in which you hold your woodland is important from a tax standpoint. Further, if your forest property is structured as a business, the type of business organization chosen also has significant tax implications. Additionally, non-tax factors bear on choosing an ownership and/or business format. These include forest management goals, size of the property, family considerations, and income needs. Each personal situation is different.

Purpose For Owning Woodland
Woodland property can essentially be held for one of three basic purposes, or some combination of these.

Personal Use
Property not used to produce income is classed as being owned for personal use. The house that serves as your residence is an example. Even though you might expect to sell it some day for more than you paid, the primary reason for owning the house is to give you a place to live. Likewise, forest property may be owned primarily for personal enjoyment—such as for hunting or other recreational pursuits, or as the location of a second home.

Investment
Woodland used to produce income may in many cases be investment property. This is probably the situation if timber production is not the principal—or a major—source of income, but management is nevertheless directed to the eventual realization of a profit. Absentee owners often are classed as investors because their timber-related activities are motivated primarily by profitability related to increases in value over time rather than by other purposes.

Business
Property is normally considered to be held for use as 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. Two characteristic elements of a business are regularity of transactions and production of income. A taxpayer’s relationship with any business in which he or she owns an interest is considered to be either "active" or "passive."

Active Business Interest
An owner is actively engaged in a business if he or she "materially participates" in conducting it. To materially participate, personal involvement on a regular, continuous and substantial basis is necessary.

Passive Business Interest
A taxpayer’s relationship with the business is passive if he or she does not materially participate in its operations, as defined by the passive activity loss rules written by the IRS. These have been discussed in detail in past issues of National Woodlands. Determination of the primary reason for owning the particular woodland property is based on all the facts and circumstances related to its intended and actual use. No single factor is controlling, but the activities being engaged in at the time are very important. Because of the unique nature of most woodland, there are usually elements of personal use associated with its status as either business or investment. For tax purposes, care should be taken to distinguish those activities centered on profit from those concerned with personal pleasure.

Basic Ownership Considerations
It is important to consider your ownership and financial goals, the extent of your woodland resources, and perhaps other factors before deciding which structure is best for your forest property, and on an income tax strategy. Once the decision has been made, it should guide a consistent approach to recordkeeping, tax reporting, and management decisions.

Sole Ownership
Ownership in one name only is normally the simplest type of ownership. Transfers to others can usually be done with a minimum of red tape. Sole ownership normally affords the most complete control possible. With a business, sole ownership means an unincorporated business owned by a single individual who is called a sole proprietor. A significant advantage is that the profit or loss from the business can be calculated separately from the owner’s other sources of income. An individual whose woodland is structured as a sole proprietorship reports income (except capital gains) and most expenses associated with its operation on Schedule C or Schedule F of Form 1040.

Co-ownership
The undivided ownership of property by two or more persons is called co-ownership. This type of structure is often used as a substitute for more complex arrangements. Transfer of an undivided co-ownership interest at death can usually be done inexpensively and easily. There are disadvantages, however. Individuals often become involved in co-ownership without fully realizing what it means in terms of loss of freedom and control. A sale, such as a timber sale, may be difficult to accomplish—one co-owner may want to sell, the other may not. Several types of co-ownership are recognized, with some differences among states.

Tenancy in Common
Each tenant in common can sell or divide his or her share and transfer his or her interest without restriction. At the death of a tenant in common, that person’s undivided interest passes to the heirs and legatees under state law or provisions of a will.

Joint Tenancy
This arrangement is sometimes called joint tenancy with right of survivorship. A joint tenant can sell or gift his/her interest but cannot dispose of it by will. At the death of a joint tenant, that person’s undivided interest passes to the surviving joint tenants, bypassing state inheritance laws.

Tenancy by the Entirety
In some states, tenancy by the entirety can be created between husband and wife with many of the features of joint tenancy. However, unlike joint tenancy...

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ancy, tenancies by the entirety are generally not severable by action of one of the co-owners. They can normally be created only for real estate.

Life Estate
A life estate is a limited property interest. Title to the property is transferred, but the transferee or other designated person (the life tenant) retains for a specified period of time the right to use, enjoy, and receive income from the property transferred. In addition to rights, however, a life tenant also has responsibilities. These include paying mortgage interest and property taxes, and keeping the property in good condition and protecting it.

Community Property
There are nine community property states—Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. In these states, as a general rule, all property acquired during marriage by either spouse—except by gift or inheritance—is community property (half owned by each spouse).

Business Management Organization
If your woodland holdings involve fairly continuous transactions, and generate fairly regular income, they may constitute a business as opposed to an investment. If so, you should evaluate which structure the woodland business should have to best achieve your objectives. Tax considerations, although important, are usually only one of the factors that should be analyzed in determining the type of business organization.

Partnership
A partnership is generally defined as an association of two or more persons to carry on, as co-owners, a business for profit. Legal tests for determining what constitutes a partnership have been developed in each state and vary from one state to another. Upon formation, no tax gains or losses are ordinarily generated with respect to the transfer of assets to the partnership by the partners. The partnership takes the partners’ basis for property transferred to it. The contributions by the partners do not need to be equal.

Unlimited Liability
Except in the case of a limited partnership (discussed below), each partner has unlimited liability for obligations of the partnership. Creditors, after first proceeding against the partnership assets, can then proceed against the assets of the individual partners.

Minors As Partners
Financial planning for partners in a family woodland partnership often involves the transfer of partnership interests to minors—to reduce the family income tax bill, to lower death taxes, or to involve older children in management. Minors as partners, however, may create problems. They are not legally competent to manage their property interests until they are of age. For federal income tax purposes, a minor is not recognized as a partner unless control is exercised by another person for the benefit of the minor, or the minor is competent to manage his or her own property under state law.

Partnership Taxation
Although a partnership files an income tax return, it is an information return only. Partnerships as entities do not pay taxes. Income and losses are passed through to each individual partner in proportion to his or her interest in the partnership and then reported on their individual returns on Schedule E of Form 1040. Capital gains and losses passed through are entered on Schedule D.

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Limited Partnership
A limited partnership is one with one or more limited partners and one or more general partners. In many cases, it can be an ideal arrangement for family-owned timberland. A limited partner is one who contributes cash or property but not services. Limited partners are not personally liable for partnership debts. Because of this status, they have no right of control over the business. A general partner has unlimited liability for partnership debts but in return has management rights. The income tax rules with respect to a limited partnership are generally the same as for a general partnership.

Corporation
A corporation is a separate legal entity that has most of the rights of an individual. It is owned by its shareholders and is governed by a board of directors elected by the shareholders. A corporation's most notable feature is the limited liability enjoyed by the shareholders. Legal actions against a corporation are satisfied by corporate assets—the assets of the shareholders are generally shielded from liability.

Corporate Taxation
A major disadvantage is that earnings are taxed at the corporate level when earned and again at the shareholder level when received as dividends. However, paying earnings as salaries to shareholder-employees may eliminate some of the double taxation problem since salaries qualify as a corporate business deduction. In addition, earnings can be accumulated at the corporate level to a certain limit, which allows postponement of taxes. The maximum corporate federal income tax rate for capital gains may be as high as 35 percent in contrast to a 20 percent maximum for non-corporate capital gains. Another disadvantage is that timber held by a corporation never receives a stepped-up basis since corporate stock shares are inherited at the death of a shareholder, not the underlying timber assets.

Subchapter S Corporation
A Subchapter S corporation is a corporation formed in the regular way under state law that has elected Subchapter S status by filing Form 2553 with the Internal Revenue Service. The number of shareholders is limited to 75 and there are numerous other requirements.

Tax Considerations
There is no double taxation as with a normal corporation. Corporate earnings, losses, deductions, capital gains, credits, etc. are passed through to the shareholders for inclusion on their individual tax returns. The procedure is the same as with a partnership. One tax disadvantage of a Subchapter S corporation is that earnings cannot be accumulated at the corporate level to postpone taxation—they are taxed each year to the shareholders whether actually distributed or not. Also, as with a normal corporation, timber never receives a stepped-up basis at a shareholder's death.

Limited Liability Company
A limited liability company (LLC) is a hybrid entity that can combine the corporate benefit of limited liability for all owners with a partnership's tax advantage of pass-through treatment for income tax purposes. The owners of an LLC are termed "members" rather than shareholders or partners. Many states now permit one member LLCs. For income tax purposes, an LLC may be classified as a partnership or a corporation, although most choose partnership status.

Income Tax Features
For income tax purposes, an LLC that is classified as a partnership compares favorably with both Subchapter S corporations and partnerships, but has additional advantages not available to the other two. Like a partnership, an LLC is usually permitted to customize the distribution of both cash and property, and the allocation of both profits and losses, to its members. Also, neither the LLC nor the member recognizes any gain or loss if the LLC distributes appreciated property to the member.

A Subchapter S corporation, on the other hand, cannot customize distributions and recognizes gain to the extent that the fair market value of any property distributed exceeds the corporation's basis in the property. An LLC member can materially participate in the LLCs business activities, so that income and losses passed through are considered active rather than passive, without risking personal liability. In contrast, a limited partner who materially participates in the partnership business within the meaning of the passive activity loss rules may risk being treated as a general partner and losing limited liability status.

Conclusion
How your woodland activities should be classified will generally depend on their scope and nature. If you own only a small acreage and have only limited transactions, treating the activity as an investment may be the best alternative. Alternatively, you may decide that business status is best for your situation. If so, in many cases a sole proprietorship will be the best fit. For larger properties with family involvement, you may wish to execute a partnership agreement, incorporate, or consider the LLC form of organization.

There are advantages and disadvantages associated with both the investment and the business categories. Tax considerations, however—although important—are not usually the only factor that determines the best structure. This decision should be made only after careful consultation with your legal, financial and forestry advisors.

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.