Timber and Taxes

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Special Involuntary Conversion Situations Involving Timberland

If standing timber is destroyed or stolen, or if forest land is condemned for public use, the owner may be entitled to take a deduction on his or her income tax return. These types of losses are called involuntary conversions.

In previous *National Woodlands* articles I've discussed in detail casualty losses, which represent the major type of timber involuntary conversion, and noncasualty timber losses resulting from drought and insect attacks.

This article will address two other aspects of the subject which are perhaps less familiar to woodland owners. These are condemnations and postponing taxable gains from involuntary conversions.

Condemnations

A condemnation is the lawful taking of private property by a government body for public use without the consent of the owner, but with payment of compensation. The tax consequences are exactly the same if the property is sold under the threat of condemnation. For example, the public condemning authority may state that it intends to acquire woodland acreage by negotiation, or if necessary by condemnation.

If the owner then sells his land to the authority at a mutually agreed upon price, the sale is treated as if the property had actually been condemned and a condemnation award received.

The computation of gain or loss when forest property is condemned, or sold under the threat of condemnation, will in all cases involve the land. However, it may or may not involve the standing timber depending on whether the trees are permitted to be harvested.

The basis of the condemned land will be its basis as shown in the owner's land account. The basis of the timber, if it is included, is determined as would be done for an ordinary timber sale.

Right-of-Way Easements

Condemnation of forest land for utility or other right-of-way easements represents a special situation. It generally involves the taking of any timber growing on the right-of-way and the right to grow future timber crops thereon, but not legal title to the land.

In the case of powerlines or pipelines, the landowner may be allowed to grow crops on the right-of-way. The production of timber is generally not permitted because the tops and roots would interfere with the powerlines or pipelines.

Any loss of future timber income should be included in the negotiations for the condemnation award. No tax deduction is allowed for future timber income foregone. The award received is reported on the recipient's tax return as explained later in this article.

Determination of Basis

The basis of condemned merchantable timber is the depletion unit for the timber account multiplied by the number of timber units standing on the condemned property.

For plantations and young natural growth the basis is the number of acres times the basis per acre. If, however, the condemning authority allows the merchantable timber to be harvested before the land is taken, and the timber is sold or cut by the owner, only the land would be included in the computation. The gain or loss on the timber would be reported separately.

Specialized Questions

Condemnation of property for public use can raise many specialized questions. For example, besides recovering an award for the condemned property, the owner may receive severance or consequential damages resulting from a decrease in value or damage to that part of the property not condemned.

A condemnation may also result in a special assessment being charged to the owner because of resulting improvements to the retained property. IRS Publication 547, *Casualties, Disasters, and Thefts (Business and Nonbusiness)*, explains the tax treatment of these situations in detail.

Reporting on the Tax Return

Gains and losses associated with condemnations are reported differently for federal income tax purposes than they are for casualties and thefts.

The way in which a taxable gain or deductible loss from a condemnation is included in computing income depends on a number of factors such as the type of property involved, when it was acquired, how long it was owned, and whether or not a part of the gain is due to depreciation. Taxable gain from a condemnation is not included in taxable income if an election is made, as discussed later in this article, to defer the tax on the gain by acquiring qualifying replacement property.

Property Held for One Year or Less

Gain or loss from condemned woodland used in a business is reported as ordinary gain or loss on Form 4797. An

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example would be where the owner harvests his own timber rather than selling it as stumpage. Gains or losses from timber assets held for investment rather than as part of a business are entered as short-term capital gains or losses on Schedule D of Form 1040.

Property Held for More Than One Year

If property used in a business was held for more than one year before it was condemned, or sold under threat of condemnation, the gain or loss must be reported on Form 4797. The rule is the same for investment property held for more than one year. The transaction is listed on Form 4797 together with other gains and losses from the disposition of business assets. Depending on what other entries are made on the Form 4797, a capital gain or loss may result.

Property Held Primarily for Sale

Gains or losses from property held primarily for sale to customers in the ordinary course of business are always reported as ordinary income or loss. It does not make any difference how long the property was owned.

An example would be standing timber owned by an individual whc level of stumpage sale activity w enough to classify him or her as dealer in standing timber. The app priate business schedule, either Sch ule C or Schedule F of Form 1040 used for proprietorships. Partners and corporations use the forms des nated for those entities. The trans tion is never reported on Schedule as a capital gain or on Form 4797.

Property Held for Personal Use

A condemnation gain associated w woodland held for personal use is ported as either a short-term or lor term gain, depending on the length time owned, on Schedule D of Fo 1040. Under no circumstances may loss from the condemnation of p sonal use property be deducted.

Postponing Gains From Involuntary Conversions

Gains realized from a forced disp sition of timber and/or forest land sulting from an involuntary conversi may be able to be deferred from ta tion under Section 1033 of the T Code. The usual situation involves ceipts from a salvage sale followi casualty damage—such as from fire storm.

Also qualifying, however, are cc demnation awards as discuss above, damages awarded by co order, insurance proceeds, and da ages received through a volunt settlement. An example of the lat would be a settlement made by a l ger working on adjacent property w inadvertently cut timber across t boundary line.

Determining the Gain

A gain is realized on an involunt conversion when the salvage sale p ceeds, insurance payment, conde nation award or other compensati received is greater than the propert adjusted basis. Ordinarily, the gain fr an involuntary conversion would reported as income for the year it realized. However, under certain cc ditions, the gain—or part of it—may deferred until replacement prope bought with the proceeds is sold. T amount of the gain qualifying for def ment cannot exceed the fair marl value of the assets converted.

Qualified Replacement Property

Gains from involuntary conversic are not taxed in the year realized within the allowable replacement p riod, other property that is similar, related in service or use, to the cc

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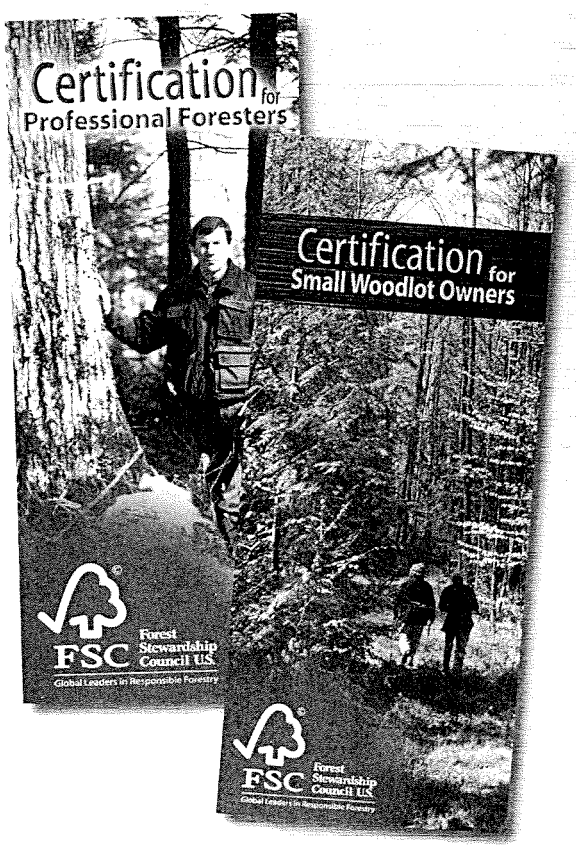

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verted assets is purchased. With respect to timber, qualified replacement property involves a number of options. These include the purchase of replacement timber sites and/or timber; the cost of seeds and seedlings; the costs of site preparation and planting seedlings, or sowing seed, on currently owned, leased, or replacement timber sites; and the costs of replacing fences, roads, gates and culverts. Also qualifying is the purchase of stock which results in obtaining the controlling interest in a corporation that owns timber, timberland or both.

Requirements to Postpone Gain

As mentioned above, the qualified replacement property must be purchased within the allowable replacement period. For the condemnation of real property, such as land and standing timber, the replacement period ends three years after the close of the first year in which any portion of the gain from the conversion is realized. It must be noted, however, that under state law standing timber may not be classified as real property under all circumstances. The replacement period is two years for property other than real property. Thus the replacement period for both real and personal property is always two years for all involuntary conversions other than condemnations.

For involuntary conversions occurring after June 8, 1997, taxpayers generally cannot defer recognition of gain if the replacement property has been purchased from a related person. This rule does not apply to noncorporate taxpayers if the aggregate gain is $10,000 or less. The basis in replacement property is its cost minus any gain that is postponed. In this way, tax on the gain is deferred until disposal of the replacement property.

Reporting the Election

If a woodland owner elects to defer reporting involuntary conversion gain, he (she) must file a statement on a plain sheet of paper with the tax return for the year of the gain stating that the election is being made. All pertinent information concerning the conversion and the replacement property must be included. If the election is made but all of the gain is not spent on qualified replacement property, the difference must be reported as income. If the replacement property is to be acquired after the time for filing the return, it should be noted in the statement that the taxpayer intends to purchase replacement property within the required

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.

IRC Sec. 631(b): Bills that would allow more timber owners to be eligible for lower capital gains tax rates were introduced in the U.S. Senate by Jeff Sessions (R-AL)–S.567–and in the House by Mac Collins (R-GA)–H.R.1341. FLTC worked with these delegates and their staffs to introduce these identical bills, both titled the "Timber Tax Simplification Act of 2001." At this writing S.567 is co-sponsored by the following senators: Cleland (R-GA), Cochran (R-MS), Craig (R-ID), Helms (R-NC), Hutchinson (R-AR), Miller (R-GA), and Lugar (R-IN). Section 631(b) of the Internal Revenue Code requires timber owners to select either the "lump sum" or the "pay-as-cut" method of harvesting. It is clear that many professional timber experts favor the "lump sum" sale because it produces the highest bid for the timber and shifts the risk of loss to the buyer. According to an analysis of the Congressional Joint Committee on Taxation, this modification would result in a negligible change in revenue. Also, the Internal Revenue Service has recommended this modification in the Code.

Death Taxes: The congress has passed a $1.35 trillion tax cut package, the biggest tax reduction in 20 years. The legislation, which lowers all income tax rates, has been signed by the president. The bill contains a gradual repeal of the death tax: 1) The death tax exemption will go to from $675,000 to $1,000,000 in 2002, with a maximum rate of 50 percent (down from 55 percent); 2) There will be a 10-year "phase-out," and during this phase-out the exemption will rise to $3,500,000 in the last year, with a rate reduction to 45 percent. Then, in the next year–after the phase-out–the death tax is eliminated; 3) During the phase-out the step-up (or carryover) in basis will remain intact. But, after the elimination, the step-up will be $1,300,000 at most; 4) The bill leaves the gift tax as is. Finally, in order to fit all provisions within the amount of money available, Congress had to resort to a financial and political gimmick: it provided that all the tax cuts would be rescinded by 2011, the last year in the planning horizon used to calculate the legislation's cost. This requires that congress visit this act in 2011, when all the affected tax modifications–including the death tax–revert to pre-bill status.

Reforestation Tax Credit: Rep. Jennifer Dunn (R-WA) has introduced the "Reforestation Tax Act of 2001." The bill supports private investment in our nation's forests by reducing the capital gains tax paid on timber for individuals and corporations by three percent each year up to 50 percent. It also encourages replanting by lifting the existing $10,000 cap on the reforestation tax credit and the debt repayment provision of the tax code. The bipartisan legislation has 35 original co-sponsors, including 13 Democrats. It has been endorsed by the Conservation Fund, as well as labor and management representatives of 87 major forest products companies.

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.

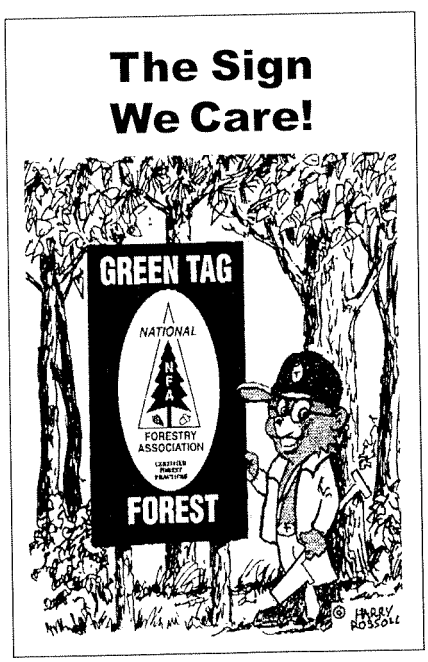
time period. In the subsequent year when the replacement purchase is actually made, a new statement should be attached to the tax return for that year giving detailed information concerning the purchase.

Conclusion

Special rules, as discussed above, apply to the income tax treatment of condemnation awards involving woodland properties, and to the taxation of gains from all types of timber-related involuntary conversions that are invested in qualified replacement property.

In the event a woodland owner is involved with either of these situations, it is incumbent upon him or her to report the transaction correctly on a timely filed income tax return. For more information, IRS Publications 225, *Farmers Tax Guide;* 334, *Tax Guide for Small Business*, and 547, *Casualties, Disasters and Thefts (Business and Nonbusiness)* may be consulted.

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.



News from the Regions

WEST

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Uncertainty Continues In Western Forest Industry

Heading into the third quarter of 2001, the West remains a region of uncertainty, with all the opportunities and hazards that go with fluctuating markets and regulations for private woodland owners.

Due to a change to an earlier deadline for this issue of *National Woodlands,* I was unable to obtain recent news from contacts in other states. However, certain trends noted in earlier regional reports continue.

These include mill closures, changes in ownership among mills, fluctuating prices and specifications, and regulatory pressures that threaten to make the challenges of growing and selling forest products inconsequential when compared to industrial uncertainty and challenges to private property rights from several fronts.

Cooperation on Fire While "Disaster Looms"

Two trends that are positive continue. One of these is interagency cooperation in programs and materials to educate and inform private woodland owners and homeowners on the forest interface, about fire safety for woodlands and wooded homesites.

Many western states are developing partnerships of state agencies with federal agencies and volunteers under the Firewise program. In addition to educational material development, many programs include fire emergency simulation exercises and development of fire emergency plans.

The West remains a disaster waiting for ignition, as fuel loads and other fire hazards remain high. The extensive fires of 2000 really didn't reduce the hazard in many areas. In 2000, millions of trees died from crown fires, and without salvage—which isn't going to happen—they will now topple and create conditions for severely hot ground fires that will cause extensive soil damage when these sites burn again.

Although private woodlands are generally better managed than public lands and have better access for fire fighting, they are often adjacent to lands with severe fire hazards. The only uncertainty is when and where the fires will burn, not if.

Fire-safe woodland management and landscaping can make a huge difference in ecological and financial impacts of wildfires in the west.

Forest Certification Finds Mainstream in the West

The other trend of positive note is the mainstreaming of forest certification in the West. Nearly all major forest industries have embraced the Sustainable Forestry Initiative (SFI), and many have gone through the process of third party certification.

Public lands are now joining the "green frenzy," and recently the Washington Dept. of Natural Resources has had its lands conditionally certified, pending resolution of several minor changes and renovations in practices and forest conditions.

The Tree Farm Program is gaining widespread recognition as the nation's oldest certification program, and has taken the steps towards third party certification. Tree Farm has updated and strengthened its requirements for certification, developed and implemented new training programs for inspectors, and is currently under third party review.

As part of the review process, third party certifiers have inspected Tree Farms across the nation, including Idaho and other western states, and have randomly interviewed a cross-section of state committees and inspecting foresters.

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On the Cover: *The sun may be setting on this Southern Appalachian river valley, but it's a bright future for forestry on the Pisgah National Forest in North Carolina, where the North Mills River Management Project was recently Green Tag certified. Story on page 9.*

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