William C. Siegel, J.D.

Tax Considerations Associated With Different Types of Forest Ownership

How expenses and income associated with woodland ownership are treated for tax purposes depends on the reason for owning the property, the use being made of it, the owner's taxpayer classification with respect to the property, and the nature of the income or expense item in question. For example, property tax payments can always be deducted by individual taxpayers because they are included in the allowable itemized deductions for individuals. It doesn't matter whether the land is being held for the production of income or not.

Unlike property taxes, however, the costs of such practices as fire protection or pre-commercial thinning can only be deducted if the woodland is being held for the production of taxable income—either as an investment or as a business.

Purpose for Holding Woodland

Forest land essentially can be held for one of three basic reasons, or some combination of them. These are discussed in the following paragraphs.

Personal Use

Property not owned to produce income is classed as being held for personal use. An example would be a house and lot that serve as a taxpayer's residence. Even though the owner might expect to sell it some day for more than was paid, the primary reason for having it is to provide a place to live. Likewise, woodland may be held primarily for residence (including second home) purposes, and perhaps also for personal enjoyment such as for hunting, fishing or other recreational pursuits.

Investment

Forest land used to produce income may in many cases be investment rather than business property. If timber production is not the principal—or a major—source of income, but the woodland is otherwise managed for the eventual realization of a profit, it is probably being held as an investment.

Absentee forest owners often qualify as investors because their activities with respect to the land, although often limited, are usually motivated by profitability rather than by other purposes.

Business

Property may be 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 intensive and more regular basis than is the case with an investment. Two characteristic elements of a business are: (1) regularity of activities and transactions, and (2) the production of income. For more information see Chapter 1 of IRS Publication 334, *Tax Guide for Small Business.* The taxpayer's relationship with any business in which he or she owns an interest, including a woodland business, is considered to be either "active" or "passive" in nature.

Active Business Interest: A taxpayer is actively engaged in a business if he or she "materially participates" in conducting it. Material participation means personally participating on a regular, continuous and substantial basis in the management and operation of the activity. The IRS has developed a number of tests to define material participation in more detail. These have been discussed in several of my previous articles in *National Woodlands.*

Passive Business Interest. The taxpayer's relationship with the business is passive during any year in which one of the material participation tests has not been met. The tax rules are quite different for active versus passive woodland owners. These, too, have been the subject of a previous article in *National Woodlands.*

Determination of the Primary Reason for Ownership

Establishment of the primary reason for owning a particular woodland property is based on all the facts and circumstances related to its intended and actual use. No single factor is controlling, but activities that are in place at the time of determination are very important.

Because of the unique nature of most forest property, there are usually elements of personal use associated with its status as an investment or as a business. The owner should thus be careful to distinguish those activities associated with profit from those associated with personal pleasure in his or her record-keeping and tax reporting. A clear business or investment purpose must exist for each tax deduction taken. Adequate records should be kept as proof.

Types of Taxpayers

The two basic types of taxpayers are individual and corporate. Either can be involved as an investor or as a business or both. An individual engaged in a business as a sole proprietor reports all income except capital gains, and all expenses, on either Schedule C or Schedule F of Form 1040. The net income (or loss) from these forms is transferred to the front page of Form 1040 for inclusion in gross income. A sole proprietor investor reports income in various places depending on its nature, and expenses on Schedule A of Form 1040.

Both business and investment income realized by an individual taxpayer from timber sales is virtually always a capital gain. Thus, unless the woodland is producing non-timber income as well—such as from hunting leases—the Schedule C or Schedule F will most likely always show a loss. The profit (capital gain) will be reported on Schedule D by an investor, and on both Form 4797 and Schedule D by a business. Hunting lease income and other fees received for using the land are always ordinary income, whether associated with a business or an investment.

Partnerships

Although partnerships file tax returns, they are information returns only. Part-

nerships themselves, except in rare circumstances, do not pay taxes. The information returns report the income and other tax items associated with the partnership for the year and how these items were distributed (passed through) to the individual partners. Each partner then reports the tax items passed through on his or her individual tax return.

Joint ownership of property does not necessarily create a partnership for tax purposes. A partnership for tax purposes exists if two or more persons or other legal entities join together to carry on a business or investment, with each contributing to the venture and each expecting to share in the profits and losses. A woodland ownership may be a partnership if its operations are treated as such under the law of the state where the property is located.

Corporations

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 major tax disadvantage is that earnings are taxed at the corporate level when earned and again at the shareholder level when received as dividends.

Another disadvantage is that corporate long-term capital gains may be taxed as high as 35 percent in contrast to a 15 percent maximum for most noncorporate capital gains. Also, timber held by a corporation never receives a stepped-up basis because corporate stock shares are inherited at the death of a shareholder, not the underlying timber assets.

Certain corporations, however, may elect to be taxed as partnerships. Taxation at the corporate level is thus eliminated, and long-term capital gains are taxed at the lower noncorporate levels. Corporations making this election are referred to as Subchapter S corporations. Those not making the election are called C corporations.

Limited Liability Companies

A relatively recent hybrid organizational structure called a limited liability company (LLC) is now permitted in all states. It combines the corporate benefit of limited liability for the owners with a partnership's advantage of pass-through income tax treatment. To take advantage of the latter benefit, an LLC must elect to be classed as a partnership for tax purposes; most LLCs make the election.

Reporting Pass-Through Tax Items

Individual taxpayers generally report their portion of pass-through partnership and Subchapter S corporation income (or loss) on Schedule E of Form 1040. In certain cases, some pass-through items are reported elsewhere. Net income (or loss) from Schedule E is then transferred to the front page of Form 1040 for inclusion in the taxpayer's gross income.

The Special Case of Estates and Trusts

Estates and trusts represent a special case. They may or may not pay income tax as separate taxable entities, depending on the particular circumstances involved. However, if income is earned or received by either an estate or a trust, a so-called fiduciary tax return must be filed by the executor of the estate or by the trustee of the trust. The current rate structure for income retained by estates and trusts, with its very low thresholds for the higher income tax brackets, encourages passing income through rather than retaining it. For more information, see IRS Publications 448, *Federal Estate and Gift Taxes,* and 559, *Tax Information for Survivors, Executors and Administrators.*

Structuring Woodland Activities

It is important for woodland owners to consider their ownership and financial goals, the size of the property, and per-

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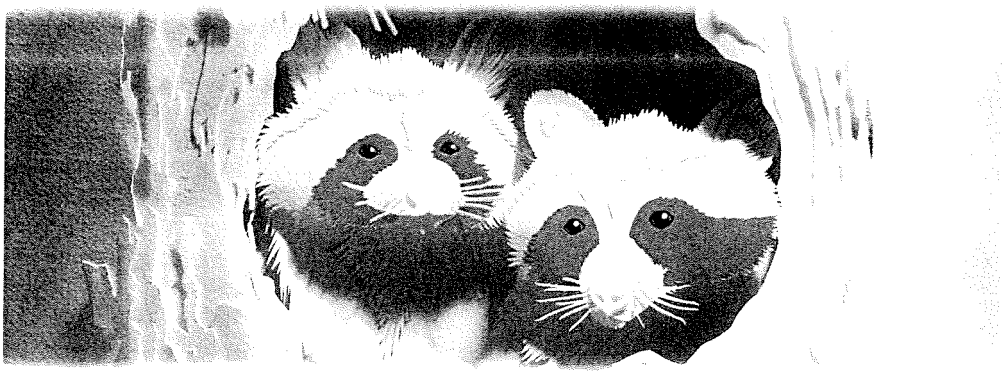

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FLTC Tax Report

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.

Sec. 631(b) Issue: The Senate Committee on Finance and House Committee on Ways & Means have both approved the *Jumpstart Our Business Strength Act* (FSC/ETI) bill (S.1637 & H.R. 2896, respectively), which replaces a tax regime that is very important to U.S. exporters. This legislation cuts taxes for U.S. manufacturers, sole proprietors, partnerships, farmers, small businesses, forest landowners and simplifies international taxes for U.S. companies operating overseas. The legislation is meant to head off trade sanctions from the European Union that likely would force U.S. manufacturers and agricultural producers to slice jobs. But, the great result for forest landowners are the following provisions:

- Reforestation Tax Reform—Taxpayers can expense the first $10,000 in reforestation expenses. All expenses above $10,000 would be amortized over seven years. The current law rules (credit, amortization, cap on expenses) are repealed. (10 Year Cost: $106 million).
- Section 631(b) Modification—allow capital gains tax treatment for outright timber sales. (No Revenue Impact).

On March 1, EU retaliatory sanctions began phasing-in. At this writing, we expect the Senate to again debate the bill after March recess. Senator Jeff Sessions, the IRC Sec. 631(b) Senate-side bill sponsor, is working strategically with colleagues to urge support/passage of the entire bill. The schedule for House consideration less clear, as Chairman Bill Thomas (R-CA), of the Ways and Means Committee, had indicated discussions this week. However, Rep. Mac Collins (D-GA), co-sponsor of H.R. 974 (the IRC Sec. 631(b)-correcting bill), is working with Chairman Thomas to keep all small business provisions on the FSC/ETI bill, whatever the final version.

Death Tax: We may see the profile of permanent and immediate elimination of the death tax raised in the U.S. Senate in April, according to what we hear of a plan by Majority Leader Bill Frist (R-TN). Three new factors will play a role in the April debate: 1.) The 2004 election, 2.) The new CONSAD report that permanent, immediate elimination of the tax will increase the economy by $38 billion over ten years, and 3.) The idea—raised at the Department of the Treasury Roundtable on the Death Tax—that a tax on capital reduces an economic system's capacity to generate income. However, a new pay-as-you-go Senate rule to manage expenses—many say, implemented to confound permanent/immediate death tax passage—disallows passage of any legislation that does not stipulate the source from whence the cost of new legislation will be deducted.

Passive Loss: Rep. Wally Herger (R-CA) has introduced a "free standing" bill that provides an exception to the passive loss rules for small timber owners (H.R. 3346) "The Timber Tax Fairness Act of 2003." FLTC is working with Mr. Herger's office to further support of this legislation. But, a slow calculation of the cost of the bill to the U.S. Treasury (by the Joint Committee on Taxation) is stalling action.

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.

haps other factors before deciding which organizational structure is best for them, and what income tax strategy will be followed. Once these decisions have been made, they should be the guide for a consistent approach to record keeping, tax reporting and management decisions unless circumstances change.

How woodland activities are classified generally is dictated by their scope and nature. If the acreage owned is small, and income is not a consideration, the owner may wish to treat it as personal use property. If there are occasional income producing activities, but the woodland is relatively small, the investment category may be the correct choice. On the other hand, if the holdings generate fairly regular income, the activities may rise to the level of a business. In that case, an evaluation should be made as to which organizational structure would be best for the owner's particular objectives.

Conclusion

There are tax advantages and disadvantages associated with both the investment and the business categories. While these are important, tax considerations usually should not be the only factors that determine the choice. Making the decision should be done only after careful consultation with legal, financial and forestry advisors as appropriate.

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.