

Chapter VI. Income Considerations

Timber Sale Receipts

When you dispose of standing timber, you must determine the type as well as the amount of gain or loss for Federal income tax purposes. The type of gain or loss will depend upon how long you have owned the timber, your purpose for owning it, how you dispose of it, and what kind of timber-related activities you normally engage in.

Determining the Amount of Gain or Loss

Net gain or loss from the disposition of timber is generally determined in the same way as for most other assets. The total amount received is reduced by any expenses directly related to the transaction and by the adjusted basis of the timber. A special rule applies to certain timber cut by the owner, as explained later on page 36. When timber acquired as a single unit is disposed of in more than one transaction over a period of years as the trees mature, special procedures must be used to determine the deductible basis of the timber disposed of at any one time. The procedures and rules for doing this have not changed since the last edition of this publication.

Costs of Sale—Timber selling expenses are those costs incurred by you that are directly related to the sale or disposal of timber. They include, but are not limited to, the costs of advertising, timber cruising, travel, marking and scaling; as well as fees paid to consulting foresters, appraisers, and selling agents. Such expenditures cannot be deducted from ordinary income not resulting from the sale, but instead reduce the amount received for the purpose of computing gain or loss from the sale.

Adjusted Basis—As discussed on page 17, once you have established the original basis of your timber, you must adjust it as needed. For large properties, adjustments may have to be made in the timber accounts from year to year to keep current the dollar amounts and volumes shown in the accounts. These annual adjustments should reflect additional timber acquired, timber cut or sold since the last adjustment, timber losses claimed on your tax return, and capitalized costs as discussed in Chapter V. They should also include transfers during the year from young growth or plantation subaccounts to merchantable timber subaccounts, and the amount of growth since the last adjustment. In addition, the number of units shown in a timber account should be changed to correct inaccuracies or to reflect changed standards of utilization. You should additionally adjust accounts if you change to a different log rule or other unit of measure. All such adjustments should be shown on Schedule F of Form T. At the end of any year in which a disposition occurs, but before basis recovery is computed, each timber account should reflect how much merchantable timber in that account was available for cutting.

If you own a small tract, and sell or cut timber infrequently, you may need to make adjustments—including those reflecting growth—only at times of disposal. In the case of a

timber sale, the growth determination can easily be made by reestimating the total volume of merchantable timber present on the tract at the same time that the trees to be cut are marked or otherwise selected. Adjusting a timber account is discussed and illustrated in detail in Chapter V.

How to Recover Your Basis—Once the adjusted basis has been calculated, it is necessary to determine the depletion unit. This is done by dividing the adjusted basis shown in the timber account by the total volume of timber in the account. The depletion unit is usually expressed in dollars per unit of measure, such as thousand board feet, cubic feet, tons, cords, etc. However, the unit for Christmas tree operations may be the individual tree. A depletion unit should be determined for each timber account. Although the depletion unit is always determined in the same way, how you use it to recover your basis in timber depends on whether you disposed of standing timber or, alternatively, cut it yourself.

Recovery of Basis—Disposal of Standing Timber—Standing timber may be disposed of by either a lump-sum sale or under a pay-as-cut contract. Both are discussed in detail later in this chapter. With either method, basis is recovered by reducing any proceeds received by the adjusted basis of the timber disposed of. Example VI-1 illustrates use of the depletion unit to recover basis, and the determination of net gain from the disposal of standing timber.

Example VI-1

Disposal of Standing Timber: In 1994, you sold 1,000 cords of the merchantable timber on your 150-acre tract. The sale price was \$22,000 payable in cash on the effective date of the contract. You had not sold, cut, or otherwise disposed of any timber from the property in prior years. You contracted with a consulting forester to cruise, mark, and sell the trees. The consultant charged 10 percent of the gross sale proceeds or \$2,200 for his services.

You determine your deductible basis for the timber sold by multiplying the depletion unit by the number of units sold. The adjusted dollar basis of your timber account available for depletion as of the end of 1994 was \$32,408. The adjusted volume at the end of 1994, after adding the growth that occurred since the last adjustment, was 2,320 cords. The depletion unit was thus \$13.97 per cord, obtained by dividing the adjusted dollar basis by the adjusted volume. The deductible basis for the sale was therefore \$13,970—determined by multiplying the \$13.97 depletion unit by 1,000 cords (the number of units sold). The net gain (profit) from the sale was \$5,830—determined by subtracting the deductible basis (\$13,970) and the costs of sale (\$2,200) from the sale proceeds. The allowable deductible basis of the timber sold is reported on Schedule F of Form T as shown in Figure VI-1, and the profit from the sale is reported on Schedule C of Form T as shown in Figure VI-2 (the figure shows only part of Schedule C).

Figure VI-1—Schedule F (Form T) Capital Returnable Through Depletion

Line number on Form T	Quantity in board feet, log scale, or other unit		Cost or other basis
		(1)	(2)
28.	Estimated quantity (at end of 1993)	2,100 cords	\$32,408
30a.	Addition for growth (1 year)	220	
33.	Total at end of 1994, before depletion	2,320	\$32,408
34.	Unit rate		\$ 13.97
37.	Quantity of timber sold	1,000	
38.	Allowable as basis of sale		\$13,970
41.	Total reductions during year		
	(a) Sum of lines 35, 37, and 39		
	(b) Sum of lines 36, 38, and 40	1,000	\$13,970
42.	Net quantity and value at end of year (1994)	1,320 cords	\$18,438

Schedule C Profit or Loss From Land and Timber Sales (Continued)

14a Purchaser's name and address					b Date of sale
15 Amount received: a In cash					\$22,000.00
b In interest-bearing notes					
c In non-interest-bearing notes					
16 Amount received in other consideration					
17 Explain the nature of other consideration and how you determined the amount shown on line 16 ▶					
18 Total amount received for property (add lines 15 and 16)					\$22,000.00
19 Cost or other basis of property:	Unit	Number of units	Cost or other basis per unit	Total cost or other basis	
a Forested land	Acre				
b Nonforested land	Acre				
c Improved land (describe) ▶	Acre				
d Merchantable timber. (Estimate in detail the quantity of merchantable timber on the date of sale or exchange. Include the quantity of timber in each species of timber by diameter at breast height (DBH) classes. State the log rule used if the unit of measure is thousand board feet (MBF), log scale.)	Cords	1,000	\$13.97	\$13,970.00	
e Premerchantable timber					
f Improvements (list separately)					
g Mineral rights				\$13,970.00	
h Total cost or other basis				2,200.00	
i Direct sale expenses (cruising, marking, selling)					
20 Profit or loss (line 18 less the total of lines 19h and 19i)					\$ 5,830.00

Schedule D Losses

21 If you had losses during the tax year from fire, wind, theft, or other causes, and you claimed the loss on your income tax return, show separately the proof of loss for each timber account and complete lines 22 through 25.	
22 Cause of loss	
23 Location and area of land on which loss took place	
24a Total loss before any insurance recovery	
b Less amount received from insurance	
c Loss as claimed on tax return	
25 Explain in detail how you determined the total loss on line 24a:	

Recovery of Basis—Cutting of Standing Timber—Instead of selling standing timber that is cut by the purchaser, you may cut your timber yourself or have someone cut it for you. Your adjusted basis may then be recovered by subtracting it from the proceeds received from sale of the logs, or from sale of products you produce from them. This type of recovery is termed timber depletion. Example VI-2 illustrates the recovery of basis when you cut your own timber.

You cannot claim a depletion allowance for timber cut for personal use, such as firewood for your home, and you do not adjust the dollar amount in the account when you do this type of cutting. However, if you cut very much timber for personal use, you may need to adjust the account to reflect the decreased quantity that is available for commercial cutting or sale.

Example VI-2

Recovery of basis when you cut standing timber: You cut 500 cords of your timber from the 150-acre tract. The cutting was completed in 1995 at a cost of \$7,520 for fuel and depreciation on equipment. However, you could sell only 300 cords by the end of your 1995 tax year. You received \$45 per cord for the wood sold. Your depletion unit for the timber cut was \$12.89 per cord, determined as shown on Schedule F of Form T (Fig. VI-3), where the values are carried forward from Example VI-1, page 31.

You report the profit on the sale of the wood on Schedule C of your Form 1040, as follows:

1995 Income on sale of wood	\$13,500
Proceeds from wood sales—(300 cords x \$45 per cord)	
Less:	
Depletion allowance—(300 cords x \$12.89 per cord)	\$ 3,867
Logging expenses—(300 cords x \$15.04 per cord)	\$ 4,512
Total expenses	\$ 8,379
Profit on wood sales	\$ 5,121

If you had elected and qualified under the provisions of Section 631(a), such an election would qualify a portion of the income for capital gain treatment. Section 631(a) procedures are discussed on page 33.

The wood not sold in 1995 is entered into a wood inventory account, as follows:

Closing 1995—opening 1996 wood inventory account	200
Volume (cords)	
Cost: Depletion allowance—(200 cords x \$12.89 per cord)	\$2,578
Logging expenses—(200 cords x \$15.04 per cord)	\$3,008
Total	\$5,586

Determining the Kind of Gain or Loss

Standing timber may be treated for income tax purposes as either a capital asset or a noncapital (ordinary) asset. This distinction is critical in determining whether a timber owner's gain or loss is considered "ordinary" or "capital" in nature and in determining how timber gains and losses are reported.

Prior to 1987 noncorporate taxpayers paid Federal income tax on only 40 percent of their net capital gains (that is, the excess of net long-term capital gains over net short-term capital losses). Since the maximum marginal noncorporate Federal income tax rate was 50 percent, this meant that the maximum effective tax rate on net capital gains was only 20 percent (40 percent of net capital gain included in income taxed at a 50-percent rate), as compared with a maximum rate of 50 percent on ordinary income. For corporations, the maximum tax rate was 46 percent on ordinary income, but only 28 percent on net capital gains. Thus, both noncorporate and corporate taxpayers generally benefited if the proceeds of their timber sales qualified as long-term capital gains rather than as ordinary income.

In enacting the 1986 Tax Reform Act, Congress lowered the maximum tax rates on ordinary income and repealed the differential between the respective rates at which ordinary income and net capital gains were taxed. Since that time, however, there have been several additional changes in tax

rates. Today, noncorporate taxpayers are taxed at five levels for ordinary income, with a maximum of 39.6 percent. Noncorporate long-term capital gains, on the other hand, are taxed no higher than 28 percent. Ordinary income and long-term gains are taxed at exactly the same rates for corporate taxpayers. Tables VI-1 and VI-2 reflect how noncorporate and corporate taxpayers are currently taxed.

Capital Gain Status is Still Important—Even if your taxable income is low enough so that net capital gains are taxed at the same rate as ordinary income, it may still be important for you to be certain that income from the sale or cutting of timber qualifies to the extent possible as a long-term capital gain. For example, net capital losses may be used to offset only \$3,000 of ordinary income per year, but there is no limit on using capital losses to offset capital gains. Thus, if you have large capital losses from any source, you may be able to deduct a greater proportion of those losses during any year in which you have timber capital gains. Also, if you are a sole proprietor or partner whose timber holdings are considered to be a business (see page 15), you are subject to self-employment tax (see page 55) on ordinary income from the business. If your timber proceeds qualify for and are reported as capital gains, however, they will be exempt from this tax. This is an important consideration, particularly for those timber owners who are retired or semi-retired and who have little or no income from wages or salary. The self-employment tax is discussed more fully in Chapter IX.

Table VI-1—How Noncorporate Taxpayers are Currently Taxed¹

Married taxpayers filing joint return	Single taxpayer	Estates and trusts	Ordinary income	Net capital gains
	Taxable income		Maximum marginal tax rate, percent	
0-\$39,000	\$0-23,350	\$0-1,550	15	15
\$39,000-94,250	\$23,350-56,550	\$1,550-3,700	28	28
\$94,250-143,600	\$56,550-117,950	\$3,700-5,600	31	28
\$143,600-256,500	\$117,950-256,500	\$5,600-7,650	36	28
\$256,500+	\$256,500+	\$7,650+	39.6	28

¹ As of 1995. Two other categories of noncorporate taxpayers are not shown in the table—married taxpayers filing separate returns and heads of households.

Table VI-2—How Corporate Taxpayers are Currently Taxed¹

Taxable income	Maximum marginal tax rate, percent	
	Net capital gains	Ordinary income
0-\$50,000	15	15
\$50,001-75,000	25	25
\$75,001-100,000	34	34
\$100,001-335,000	39	39
\$335,001-10,000,000	34	34
\$10,000,001-15,000,000	35	35
\$15,000,0001-18,333,333	38	38
\$18,333,333+	35	35

¹ As of 1995.

Capital Gains from Timber Transactions—Whether your timber gains and losses qualify for capital gains treatment or not depends on these three factors:

Primary Purpose for Holding the Timber: Standing timber is a capital asset if it is neither used in a trade or business nor held primarily for sale to customers in the ordinary course of a trade or business. Gain on the outright (lump-sum) sale or exchange of such timber, if owned for more than the required holding period (see below), is a long-term capital gain. Although timber used in a trade or business is not a capital asset, its outright sale may, nevertheless, also result in a long-term capital gain under Section 1231 of the Internal Revenue Code if the holding period has been met.

How the Timber is Disposed of: You may dispose of your timber in one of three ways, namely (1) by lump-sum sale or exchange, (2) under a pay-as-cut contract where you retain an economic interest as described in Section 631(b) of

the Internal Revenue Code, or (3) by cutting the timber yourself; converting it to salable products such as logs, pulpwood or lumber; and making a specific election under Section 631(a) of the Code. If your timber is held primarily for sale to customers in the ordinary course of business, generally only the last two methods will provide capital gains. The complexity of tax treatment of revenues and expenditures associated with timber leases/long-term cutting contracts is beyond the scope of this publication. For information on the subject, consult Revenue Rulings 62-81, 62-82, 75-59, and 78-267. All are summarized in Appendix I.

How Long the Timber Has Been Held: To qualify for long-term capital gains, you must have held purchased timber for more than 1 year prior to sale, if sold lump-sum. If disposed of under Section 631(a) or 631(b), it must have been held for more than 1 year prior to cutting. The 1-year holding period must also be met when disposing of timber acquired by gift. However, both the donor's and donee's time of ownership

may be counted; thus the holding period with respect to the donee may be entirely met before the gift is even made. For inherited timber, there is no holding period required in order to qualify for long-term capital gain status.

Sale of Standing Timber for a Lump Sum

A sale for a lump sum is the outright sale (usually by means of a timber deed or sale contract) of standing timber for a fixed total amount agreed upon in advance. The sale may cover all timber on a specified tract; or only certain species, diameter classes, or individually marked trees on the tract.

Capital gains treatment will apply if the timber is a capital asset in the hands of the seller. Timber will be a capital asset in your hands if it is not held primarily for sale to customers in the ordinary course of a trade or business and is not property that is used in a trade or business. This means that timber is a capital asset if you are holding it primarily for personal use or as an investment, as discussed in the section "Types of Forest Ownership and Operation," page 15. Whether timber is held primarily for sale in the ordinary course of a trade or business is not always easy to determine. There is no generally applicable definition of "trade or business" in the Internal Revenue Code or in the Income Tax Regulations. There is also no broadly applicable judicial definition of the phrase. Thus the question can only be answered by weighing all the facts and circumstances of each particular situation. Although no single factor is determinative, the following factors are important:

- (1) the purpose for acquiring and holding the timber, whether for sale or investment;
- (2) the number, continuity, and frequency of timber sales, as opposed to isolated transactions;
- (3) the extent to which you solicit or promote timber sales, as opposed to merely letting prospective purchasers approach you, and
- (4) any facts that indicate that timber transactions are part of your occupation or contribute substantially to your livelihood. In general, if you only make an occasional timber sale that is unrelated to any trade or business in which you are engaged, the timber will qualify as a capital asset, and the proceeds will thus qualify for capital gains treatment.

If you intend to sell standing timber, and are in doubt about its capital asset status, you should consider entering into a contract for disposal with an "economic interest retained" (see below).

Capital gains and losses are reported differently from ordinary income on your tax return. The rules are discussed in Publication 544, "Sales and Other Dispositions of Assets." To report lump-sum timber sales whose proceeds qualify as capital gains, Schedule D of Form 1040 should be used. Nontimber capital gains transactions are also reported on Schedule D. If the long-term gain holding period has been met, the timber transaction is entered in Part II. If the holding period has not been met, the information is entered in Part I (short-term capital gains and losses). The use of Schedule D is shown in the following example.

Example VI-3

Sale of standing timber: You sold 60 thousand board feet (MBF) of standing timber in a lump-sum sale on August 15, 1995. The contract price was \$15,000. The timber was located on land purchased on March 1, 1974, as part of a farm. Your adjusted basis in the timber sold was \$2,413, computed according to the procedures discussed in the section "Determining the Amount of Gain or Loss," page 31, and as illustrated in Chapter XIV, "Forest Records." The State service forester marked and tallied the trees sold and estimated the volume. This service was provided free. However, you paid \$325 in legal fees to have the contract checked and to close the sale. You are primarily engaged in crop and livestock production on the farm and sell timber infrequently. The timber should be considered to be a capital asset in your hands, and the proceeds therefore reported on Schedule D. The sale resulted in a long-term capital gain of \$12,262 (sale proceeds of \$15,000 less \$325 for sale expenses and less the allowable basis of \$2,413). This transaction is entered in Part II of Schedule D as shown in Figure VI-4.

If your sale involves payments extending beyond the year of sale, see the discussion of installment sales on page 53.

Gains and losses from lump-sum sales of standing timber that do not qualify for capital gains treatment because the timber was held primarily for sale to customers in the ordinary course of business are ordinary gains and losses. If you are a sole proprietor, these have to be reported on a business schedule, either Schedule C or Schedule F. Other forms are used by partnerships, corporations, trusts, and estates. Include an attachment on a plain sheet of paper giving the details of the sale, and showing the calculation of the deductible basis, if any. Alternatively, Form T can be used to report this information.

Disposal of Standing Timber With an Economic Interest Retained (Section 631(b))

Timber cut under a contract that requires payment at a specified rate for each unit of timber actually cut and measured, rather than as a lump-sum amount of money agreed on in advance, is a disposal with an economic interest retained rather than a sale of timber. This type of transaction is often called a "pay-as-cut" contract. It obligates the purchaser to cut the designated trees and purchase them at the unit price designated in the contract.

The term "economic interest" arises from the fact that the owner has an investment in the timber and secures income from its cutting, to which he (she) must look for a return of the investment. The seller usually retains legal title to the trees until they are cut and thus bears the risk of any damage to or loss of the standing timber. Advance payments are permitted under a Section 631(b) contract. However, in such a case, the contract has to clearly stipulate that, upon completion of the cutting, adjustments must be made, as required, in order that the total amount paid is determined by the volume of timber actually cut multiplied by the specified unit price.

Figure VI-3—Schedule F (Form T) Capital Returnable Through Depletion

Line number on Form T	Quantity in board feet, log scale, or other unit (1)	Cost or other basis (2)
28. Estimated quantity [at end of 1994]	1,320 cords	\$18,438
30a Addition for growth (1 year)	110	\$18,438
33. Total at end of year (1995) before depletion	1,430	\$ 12.89
34. Unit rate		\$ 6,445
35. Quantity cut	500	
36. Depletion sustained		
41. Total reductions during year		
(a) Sum of lines 35, 37, and 39	500	
(b) Sum of lines 36, 38, and 40		\$ 6,445
42. Net quantity and value at end of year (1995)	930 cords	\$11,993

Figure VI-4—Schedule D (Form 1040) Capital Gains and Losses

(a) description	(b) date acquired	(c) date sold	(d) sales price	(e) cost or other basis	(f) loss	(g) gain
Line 9c 60 MBF Timber	3/1/74	8/15/95	\$15,000	\$2,738	---	\$12,262

Scaling the cut timber is the usual but not the only acceptable method of measurement. The volume can also be determined by cruising the standing timber subject to the contract. The amount actually disposed of is then the cruised volume before cutting minus the cruised volume of any contract timber that was not cut (see the digest of Revenue Ruling 78-104, page 92).

Two important advantages are offered by Section 631(b) contracts. First, the gain realized is treated as a capital gain regardless of whether the timber was held primarily for sale as part of a business—even if you are a dealer in timber.

The second advantage is that timber qualifying under Section 631(b) is Section 1231 property, which means that you are entitled to capital gains treatment when aggregate Section 1231 gains exceed aggregate losses from the disposition of such property. Section 1231 gains and losses are reported on Form 4797 and totaled. If a net gain results, it is treated as a net long-term capital gain and is transferred to Part II of Schedule D. There it is combined with any other long-term capital gains and losses for the year. If the summation of Section 1231 gains and losses results in a net loss, however, it is treated as an ordinary loss. This means that it is fully deductible from ordinary income in the current year. The net loss is transferred to Part II of Form 4797 where it is combined with any other ordinary gains and losses for the year (see IRS Publication 544, "Sales and Other Dispositions of Assets").

Three provisions of Section 631(b) will be discussed in more detail. **The first provision** concerns the definition of "owner" for purposes of qualifying under Section 631(b). The term is broadly defined to include any person or legal entity, including sublessors and holders of contracts to cut timber. To qualify as an owner, you must also have an "interest" in the timber. An interest means that you have the right (before entering into the 631(b) contract), if you so choose, to cut the timber in question for sale on your own account or for use in your trade or business.

The second provision concerns the definition of "timber." "Timber" for Section 631(b) purposes includes the part of standing trees usable for lumber, pulpwood, veneer, poles, piling, crossties, and other wood products. Also included are evergreen trees that are more than 6 years old when severed from their roots and that are sold for ornamental purposes, such as Christmas trees (see Chapter X). Section 631(b) does not apply to evergreen trees sold in a live state (such as balled and burlapped Christmas trees), whether or not for ornamental purposes. Tops and other parts of standing trees utilized separately from the main stem are not considered as either evergreen trees or timber for purposes of Section 631(b). They may, however, be considered as "timber" if utilized as part of the tree as a whole in the manufacturing process. The term "evergreen" is used in the commonly accepted sense and includes pine, spruce, fir, hemlock, cedar, and other coniferous trees.

The third provision concerns the date of disposal. This is the date the timber is cut. However, it is not usually practical to measure timber in the woods as the trees are severed.

Therefore, timber is considered "cut" when, in the ordinary course of business, the quantity felled is first definitely determined. This means the date of disposal is the date on which the volume of cut timber is first determined—whether at a log landing, wood yard, or mill—or after a follow-up timber cruise has been completed.

This definition of "cut" could help in determining whether a Section 631(b) disposal of timber qualifies for long-term capital gains status. You may not have owned the timber for the required holding period at the time it was felled. But, by the time it was measured, the holding period may have been met. However, the time of measurement cannot be purposely shifted merely to obtain a tax advantage.

If you include advance payments on your tax return as capital gain realized from the disposal of timber, and the cutting right expires, is terminated, or is abandoned before the timber that was paid for is cut, you must file an amended return. Such payments are then treated as ordinary income.

Your gain or loss from a Section 631(b) timber disposal is determined in exactly the same way as for a lump-sum sale, as discussed on page 36. It is reported as a Section 1231 transaction on Form 4797, as covered earlier in this chapter.

The Cutting of Standing Timber with an Election To Treat as a Sale (Section 631(a))

When standing timber is cut by the owner and the logs or products manufactured from them are sold, the entire proceeds must be reported as ordinary income unless a Section 631(a) election is in effect. However, by making an election under Section 631(a), you may cut timber for sale or for use in your trade or business and receive long-term capital gains treatment on the gain from holding it—just as if you had sold the standing timber outright instead of converting it yourself. In this case, the proceeds have to be divided into two segments: (1) the value added to the standing trees by converting them into products, and (2) the gain that resulted from holding the standing timber until the year cut. Any profit realized from converting standing timber into products is always ordinary income, not capital gain. If you elect to use Section 631(a), and the Section 631(a) holding period has been met, the transaction is reported in two parts, as follows:

- (1) Report as a Section 631(a) gain or loss the difference between the adjusted basis for depletion of the timber that was cut and its fair market value as standing timber on the first day of the tax year in which it was severed. This is treated as a Section 1231 gain or loss that is netted with other Section 1231 gains and losses you may have, and net gain is treated as long-term capital gain.
- (2) Report as ordinary gain or loss the profit or loss resulting from conversion of the standing timber into products, such as sawlogs or pulpwood. The profit or loss is determined just as for any other business operation. The income received from the sale of the products is reduced by the cost of the timber plus the cost of converting it. The cost of the timber is the fair market value described in (1) above.

Six aspects of Section 631(a) will be discussed in more detail—the meanings of owner, timber, timber use, holding period, fair market value, and how the election to use Section 631(a) is made. An owner for Section 631(a) purposes is essentially the same as for purposes of Section 631(b). For purposes of 631(a), an owner is any taxpayer who has owned or held a contract right to cut timber for the required holding period. In order to have a contract right to cut timber, you must have the unrestricted right to sell the timber cut under the contract or to use it in your trade or business (see digest of Revenue Ruling 58-295, page 92). This means that if you were, for example, a logger who bought timber under a cutting contract, you would be the owner of that timber for Section 631(a) purposes just as if you had outright title to it, or to the land and timber together.

If, however, you have only a contract to cut timber and must deliver the logs back to the owner or to a buyer specified by the owner, you are merely performing a logging service and do not qualify as an owner or holder of a contract right to cut timber. A logging service contract that uses the terms "buy" or "sell" or "stumpage charge" will not meet the requirement to have a contract-right-to-cut in order to be considered an owner of the timber.

Timber for the purposes of Section 631(a) is defined exactly the same as for Section 631(b).

To qualify under Section 631(a), the trees must be cut for sale or for use in your trade or business, not for personal use. This includes timber cut and sold as rough products (logs, pulpwood, fuel wood, etc.) or cut and used in a conversion business such as sawmilling. "Timber cut by taxpayer" includes what you personally cut, as well as trees severed by other persons who do so at your direction.

The holding period under Section 631(a) runs from the date you acquired the timber or the contract right to cut it to the date it is actually cut. As explained on page 38, timber is considered cut when, in the ordinary course of business, the quantity felled is first definitely determined.

The fair market value used as the sales price is that price at which the standing timber that was felled would have changed hands between a buyer and a seller on the first day of the tax year (usually January 1) in which the trees were cut, assuming that both parties had reasonable knowledge of all the necessary facts and neither was required to buy or sell. The trees must be valued as they existed on the first day of the tax year regardless of any changes that occurred to them between that date and the date of the actual cutting.

The best indicators of fair market value are the actual prices paid for similar timber in the area in which the timber being valued was located. Such prices, however, have to be adjusted to account for any differences between the condition of the trees being valued and the markets for them, as compared to the timber for which actual prices are known. The fair market value used must be for the actual trees cut; they must be valued on their own merits and not on the basis of a general average for the region. Among the factors to be considered are the following:

- (1) The character and quality of the timber as determined by species, age, size, and condition.
- (2) The quantity of timber per acre, the total volume under consideration, and its location with reference to available markets.
- (3) The accessibility of the timber from the standpoint of the probable cost of cutting and transportation.
- (4) The competition likely to develop from other timber buyers.

Example VI-4

Election to treat cutting as a sale: You file your tax return on a calendar year basis, and you cut 60 MBF of timber during 1995 from a tract purchased in 1979. The sawlogs were piled at the roadside and sold, also in 1995. You received \$18,000 for the logs. The fair market value of the standing timber that was cut was \$260 per MBF, or \$15,600, as of January 1, 1995. Your basis in the timber cut (determined as explained in "Determining the Amount of the Gain or Loss," page 31) was \$2,460. Your logging and skidding costs totaled \$1,800. Since you had owned the timber cut for more than one year, you elect to report the cutting under Section 631(a). You determine the gain or loss on the cutting of the timber separately from the gain or loss from the sale of the sawlogs, as follows:

Gain from cutting—	
Fair market value as of January 1, 1995, of timber cut during 1995	\$15,600
Less: Allowable basis	<u>2,460</u>
Section 1231 gain	\$13,140
Gain from sale of sawlogs at roadside—	
Proceeds from sale of sawlogs	\$18,000
Less: Fair market value as of January 1, 1995, of timber cut and sold during 1995 (depletion allowance)	\$15,600
Logging costs	<u>1,800</u>
Cost of logs sold	<u>\$17,400</u>
	\$ 600

You have a \$13,140 gain to report with any Section 1231 gains or losses on Form 4767, Part I. You also have income of \$18,000 and expenses of \$17,400 to report on either Schedule C or Schedule F of Form 1040. How to report Section 1231 gains and losses on Form 4797 was discussed on page 38.

If you cut only a relatively small amount of timber during the year, you may be able to estimate its value by obtaining price information from mill operators and timber buyers in your area. However, if you cut a large amount, you should probably obtain an appraisal by a qualified timber appraiser such as a consulting forester.

You elect to use Section 631(a) by merely computing your taxes according to its provisions. You indicate the election by answering the question in item 44 and supplying the information asked for in items 45 through 51 of Schedule F of Form T (see Appendix III). The election must be made on the original tax return (including extensions) for the year to which it applies, and not on an amended return for that year.

An election under Section 631(a) is binding with respect to all eligible timber you cut in the year of the election and in all subsequent years. The basic rule of discontinuance is that consent must be obtained from the IRS. This permission may be given only where there is a showing of undue hardship and—if given—consent to reelect must also be obtained. The 1986 Tax Reform Act, however, contains a special rule that permits timber owners who had been cutting under a Section 631(a) election with respect to a tax year beginning before January 1, 1987, to revoke it one time, and reelect one time, without such permission. Since the tax rate differential between ordinary income and net capital gains has been eliminated for some taxpayers, revocation may be advantageous in the event cut timber is not sold in the same tax year in which it is severed. Without the revocation, you will be taxed in the year of cutting on the timber's gain in value as stumpage, even though no income has yet been realized from the sale of the products. For some owners, however, it may, as discussed earlier in this chapter, be more advantageous to retain capital gain status rather than revoke the election. The one-time revocation permitted by the 1986 Tax Reform Act can be made by simply attaching a statement made on a plain sheet of paper to the tax return for the year in which the revocation is to be effective.

Reporting requirements under Section 631(a) are the same as for Section 1231 gains and losses in general and for any other income realized from a trade or business. The gain or loss on the standing timber is reported on Form 4797 with other Section 1231 transactions for the year, as discussed on page 38. The profit or loss from the sale of the cut products is reported by sole proprietors on a business schedule—either Schedule C or Schedule F of Form 1040. Other forms, as applicable, are used by partnerships, corporations, trusts, and estates. The cost of the timber cut (the fair market value used for computing gain or loss) and the expenses of cutting and sale are listed as "other" expenses on Schedule F or Schedule C.

An attachment giving the details of the cutting and sale should be included with your tax return. Attach Schedule F of Form T or provide the information required by Schedule F on a plain sheet of paper attached to your tax return. Be certain to include the details of how the depletion basis that was used, if any, was determined. Also include the information that was used to estimate the fair market value.

Example VI-4 illustrates how to determine the two parts of the gain realized under a Section 631(a) election.

Government Program Payments

Generally, a taxpayer who receives a cost-share payment from Government must report its value as gross income unless a specific exclusion is provided by law. Under Section 126 of the Internal Revenue Code, all or part of certain Government cost-share payments made to landowners under approved conservation programs may be excluded from gross income. This provision has been available since 1979.

In general, a portion or all of a cost-share payment is excludable from taxable income if two conditions are met:

- (1) the payment is determined by the Secretary of Agriculture to be made primarily for the purpose of conserving soil and water resources, protecting or restoring the environment, improving forests, or providing a habitat for wildlife; and
- (2) it is determined by the Secretary of the Treasury or the Secretary's designate as not substantially increasing the annual income derived from the property.

According to Section 126, and the IRS regulations for Section 126, nine Federal conservation cost-sharing programs and some State programs where payments are made primarily for certain conservation or environmental purposes meet the above requirements. Federal programs that most often affect timberland owners include the Forestry Incentives Program (FIP), the Agriculture Conservation Program (ACP), and the Stewardship Incentive Program (SIP). SIP was recently approved for those SIP practices carried out in small watersheds (see summary of Revenue Ruling 94-27, page 92). Since new programs are occasionally added to the list, you should check with the IRS, your State forestry office or the local office of the USDA Consolidated Farm Service Agency (CFSA), formerly Agricultural Stabilization and Conservation Service (ASCS), to see if a particular program qualifies.

The regulations for Section 126 specifically eliminate any Government payment that is in the nature of rent or compensation for services from qualifying for exclusion from gross income; therefore, recurring annual payments under the Conservation Reserve Program (CRP) do not qualify for exclusion. CRP cost-sharing payments also are always reportable as income; they are never eligible for exclusion. But reforestation costs incurred under the CRP are eligible for the amortization and credit as discussed in Chapter V, including the expenditure of cost-share payments received. Also, as an alternative to the amortization and credit for those taxpayers who are engaged in the business of farming, some or all of the reforestation expenses incurred for CRP planting may be deductible annually under Section 175 as discussed on page 24.

Based on Section 126 and the regulations thereunder, there are two options for reporting cost-share payments for Federal income tax purposes:

Option 1: Exclude all or part of the cost-share payment from gross income.

Option 2: Include the cost-share payment in your gross income. The procedure for computing the excludable portion of the cost-share payment is explained in the following paragraph. However, you may elect to include the payment in your gross income even if you are eligible to exclude it. In some cases, inclusion may provide a tax benefit.

Determining the Excludable Amount

The regulations for Section 126 provide that the maximum amount of a cost-share payment that can be excluded from gross income is "the present fair market value of the right to receive annual income from the affected acreage of the greater of: (1) 10 percent of the prior average annual income from the affected acreage, or (2) \$2.50 times the number of affected acres." In other words, the excludable portion is that portion not substantially increasing income from the property concerned. Prior average annual income is defined as the average of the gross receipts from the affected acreage for the last 3 years preceding the tax year in which installation of the improvement is commenced.

IRS regulations do not spell out in detail how to calculate the "present fair market value of the right to receive annual income." A common method of determining the present value of the right to receive annual income over an indefinite period is to capitalize it (i.e., divide the annual income by an appropriate interest rate). Also, the IRS regulations do not specify an appropriate interest rate to use. However, a procedure is specified in the Internal Revenue Code for valuing farm and forest lands for estate tax special-use valuation purposes, which divides annual income by the Federal Land Bank (now Farm Credit Bank) interest rate (IRC Section 2032A (e)(7)(A)). Although this procedure does not apply to Section 126, it has been informally accepted by the IRS. The interest rate used for calculating the present value will strongly affect the amount that can be excluded. The lower the interest rate used, the larger will be the exclusion. The following procedure shows a step-by-step approach for computing the excludable portion:

Step 1: Compute the following two values:

- (1) 10 percent of the average annual income derived from the affected acreage prior to the improvement.
- (2) \$2.50 times the number of acres affected by the improvement.

Step 2: Calculate the present value of the larger of the two values from Step 1.

Step 3: Compare the cost-share payment to the value computed in Step 2.

- (1) If the cost-share payment is less than or equal to the computed value, it may be entirely excluded from gross income.
- (2) If the cost-share payment is greater than the computed value, only an amount equal to the value from Step 2 can be excluded from gross income. The remainder must be included in gross income.

Example VI-5

Last year a taxpayer harvested 100 acres and received \$120,000 for the timber. This was the first income the taxpayer had obtained from the property for many years. This year he replanted the 100 acres at a total cost of \$15,000 (\$150 per acre). To help cover the cost of the replanting, he had applied for and received a Government cost-share payment of \$10,000. How much of this \$10,000 payment can be excluded from his gross income?

Computing the excludable portion:

Step 1: (1) Compute 10% of average annual income for the three previous years:

$$\$120,000/3 = \$40,000$$

$$\$40,000 \times .10 = \$4,000$$

(2) Compute \$2.50 times the affected acreage(100):

$$\$2.50 \times 100 = \$250$$

Step 2: Compute the present value of the larger amount from Step 1. Assume the interest rate used to compute the present value is 7% (the applicable mid-term federal rate for October 1994 is 7.10%).

$$\$4,000/.07 = \$57,143$$

Step 3: Compare the payment to the computed value: \$10,000 is less than \$57,143, thus the entire payment (\$10,000) can be excluded from gross income.

Example VI-6

Assume the taxpayer did not have any income from the property in the last 3 years. This year he received a cost-share payment of \$10,000 for implementing approved conservation practices on the 100-acre woodlot. How much of this \$10,000 payment can be excluded from his gross income?

Computing the excludable portion:

Step 1: (1) Compute 10% of average annual income

$$\$0/3 = \$0$$

$$\$0 \times .10 = \$0$$

(2) Compute \$2.50 times the affected acreage (100):

$$\$2.50 \times 100 = \$250$$

Step 2: Compute the present value:

$$\$250/.07 = \$3,571$$

Step 3: Compare the payment to the computed value: \$10,000 is greater than \$3,571, thus only \$3,751 can be excluded from gross income. The remainder of \$6,429 (\$10,000 - \$3,571) must be included in gross income.

If you decide to exclude part or all of a cost-share payment from gross income, attach a statement to your tax return stating specifically the amount of the cost-share payment you received, the date you received it, the amount of the cost-sharing payment that qualifies for the exclusion, the amount you choose to exclude, and how you determined that amount.

Including Cost-Share Payments in Gross Income

After determining the excludable amount of the cost-share payment, the nonexcludable portion must be reported as gross income. Cost-share payments received by individual taxpayers that are included in gross income are reported as miscellaneous income on the first page of Form 1040, or on Schedule C or F of Form 1040, depending on your particular tax status. That part of a cost-share payment included in gross income may be subject to the self-employment tax, because self-employment income generally includes all items of business income—including Government conservation cost-share program payments. The self-employment/social security tax is discussed in more detail in Chapter IX.

To the extent that a cost-share payment is included in gross income, and is used for planting or seeding of trees for commercial production of timber products, it may qualify for the 7-year reforestation amortization and the 10 percent reforestation investment tax credit under Sections 194 and 48 of the Internal Revenue Code as discussed earlier in Chapter V. A detailed explanation of the reforestation amortization and credit can be found beginning on page 19.

If the cost-share payment received is used for timber stand improvement practices, it must always be included in gross income. However, it is then generally eligible for deduction as a current expense in the year expended—subject to the passive loss rule limitations as discussed in Chapter V.

Recapture Provisions

If the property established with an excluded cost-share payment is disposed of within 20 years of establishment, recapture provisions apply. The recapture amount during the first 10 years is the lesser of: (1) the amount of gain from the disposal, or (2) the amount of cost-share payment excluded. It is recaptured as ordinary income. This base recapture amount is reduced by 10 percent for each year or portion of a year if disposal occurs between 10 and 19 years. IRS Form 4797 is filed to declare the recaptured amounts as income.

Other Timber-Related Receipts

Ordinary gains or losses result from the sale of products produced from timber. This rule applies to all products derived from harvested trees such as logs, lumber, pulpwood, poles, mine timbers, crossties, fence posts, fuelwood, and chips. It

also applies to products derived from the trees as they stand, such as gum naval stores, maple syrup, fruit, nuts, bark, and Christmas greens. Gains from the sale of trees for landscaping purposes, such as balled nursery stock, are also ordinary income.

Tree stumps from cutover land are sometimes an exception. If you make a lump-sum sale of tree stumps from cutover timberland acquired for investment, you may be entitled to treat any gain from the sale as a capital gain (see summary of Revenue Ruling 57-9, page 93). However, you must sell all the stumps on the property at one time. Capital gains treatment does not apply to gains from the sale of stumps by persons in the timber or stump business—either as a buyer, seller, or processor. Therefore, proceeds from the sale of tree stumps by timber operators after the trees have been harvested are ordinary income.

Gains from the sale of limbs and tops that are left after logging are also ordinary income, even if the timber was subject to a Section 631(a) election.

Information Returns

When you sell or dispose of standing timber, the purchaser may file a Form 1099 (information return) with the Internal Revenue Service. The Form 1099 reports the gross proceeds paid to you for your timber. You will also be sent a copy of the Form 1099. Purchasers of timber under a lump-sum sale are not required to file a Form 1099, although many will do so. Purchasers under a Section 631(b)-type contract are required to file one, however. Whether or not you receive a Form 1099 with respect to your timber sale, you must report the sale proceeds as discussed earlier in this chapter. Government agencies who make cost-share payments to forest landowners also are required to file information returns with the Internal Revenue Service, reporting the amounts of the payments. These payments should be treated for tax purposes as discussed earlier in this chapter.

Chapter VII. Casualties, Thefts, and Condemnations

If part or all of your timber is destroyed or stolen, or if your forest land is condemned for public use, you may be entitled to claim a deduction on your income tax return. These types of losses are termed involuntary conversions. To do this, you need to know the kinds of losses that are deductible, the tax and business structure of your activity, how to determine the amount of loss recognized for tax purposes, and how to determine the type of deduction—capital or ordinary. The nature of the deduction also depends on your purpose for holding the timber. If, because of salvage operations, insurance recovery, or other compensation, the destruction, theft, or condemnation results in a gain, you must include the gain in your income, unless you elect to postpone reporting such gain, as explained later in this section. The passive activity loss restrictions, discussed beginning on page 28, generally do not apply to casualty and theft losses.

Operating losses, discussed in Chapter V, are created when expenses associated with a trade or business, or an investment activity, exceed income in a tax year. Such losses do not involve the involuntary conversion of property discussed in this section.

The three basic categories of involuntary losses—physical damage or destruction, thefts, and condemnations—are discussed in this chapter. Note that under certain circumstances a deductible loss results from the destruction or damage to property held as part of a trade or business or for the production of investment income even if the loss is not caused by a "casualty." Since losses resulting from theft (sometimes referred to as "timber trespass") and condemnation of property for public use are treated similarly to casualty losses, the discussion focuses on casualty losses first. The unique aspects of thefts and condemnations are then discussed separately.

Discussion Limited to "Timber"

This publication discusses timber held for the production of income as either a business or investment. If your timber is held for personal use see the discussion of "Restoration of Landscaping" in IRS Publication 547 "Nonbusiness Disasters, Casualties, and Thefts." You should consult IRS Publication 547 for the treatment of losses involving shade trees.

Normal Losses Not Deductible

To be allowed as a deduction, a loss must be evidenced by a closed and completed transaction fixed by an event or identifiable events and must actually have been sustained during the tax year. Timber lost due to natural factors typically associated with timber stands, referred to as natural mortality, is not a casualty loss. Natural mortality includes trees killed by overtopping of larger, faster growing trees; normal levels of disease and insect infestations; and low rainfall. Natural mortality is reflected in your timber volume accounts, as discussed on page 18.

Physical losses of timber will generally come under the heading of casualties, that is, losses caused by natural or other external forces acting in a sudden, unexpected, and unusual manner. A sudden event is one that is swift, not gradual or progressive. An unexpected event is one that is ordinarily unanticipated and one that you do not intend. An unusual event is one that is not a day-to-day occurrence and one that is not typical for the activity in which you were engaged when the damage or destruction occurred.

Noncasualty Losses

A deductible noncasualty loss may result if the precipitating event is unusual and unexpected. The suddenness test does not have to be met. Circumstances generating noncasualty losses are contrasted with casualty losses in the discussion below.

Casualty Losses

Casualty losses include but are not limited to those resulting from fire, hurricane, or other casualties such as windstorm, sleetstorm, and hail. Casualty losses also include destruction or damage from plane crashes, automobile accidents, and similar events.

Disease or Insect Infestation—Trees grown for timber that are killed by disease or insect infestation do not ordinarily result in a casualty loss. Losses resulting from a low level of pest incidence, usually present under normal conditions, are not deductible. If the trees killed are shade trees, the sudden, unexpected, and unusual damage resulting from the southern pine bark beetle or other species of insects may be deductible as a casualty loss (see summary of Rev. Rul. 79-174, page 94). In addition, some attacks of southern pine bark beetles or other species of insect may result in an unexpected and unusual noncasualty loss of timber, which gives rise to a deductible loss (see summary of Rev. Rul. 87-59, page 94).

Drought Loss—A casualty loss does not usually result when trees being grown for timber are killed by drought. In some cases, however, drought losses may result in an unexpected and unusual noncasualty loss, which is deductible (see summary of Rev. Rul. 90-61, page 94).

Loss of Potential Income Is Not Deductible—A loss of future profits is not deductible. For example, if an ice storm damages standing timber and reduces its rate of growth or the quality of future timber, the loss is not deductible. The same is true for site damage. To qualify as a casualty, the damage should cause existing timber to be unfit for use.

Combinations of Factors—Combinations of factors sometimes cause timber damage. A nondestructive fire may be followed by insect attacks. Trees weakened by interior rot or characterized by shallow root systems may be uprooted or

broken off as a result of repeated windstorms or may die as a result of drought. When combinations of factors are involved, it may be necessary to consider the length of time from the precipitating event to the eventual loss of the timber to determine the suddenness of the loss.

Salvage Requirement—Every reasonable effort should be made to salvage the affected timber. A reasonable effort includes offering the damaged timber for sale. You should use the same marketing procedures as for any other timber sale. The market value may however, be lower depending on the extent of damage to the timber, the volume of damaged timber on the market, and increased harvesting costs. If you do not normally harvest your own timber, you would not be expected to do so in order to recover some of the value in damaged timber for which you cannot find a buyer. If you are not able to salvage the timber after making a bona fide attempt to do so and claim a loss deduction, you should keep a record of your efforts in order to show that the timber was not salvageable.

When losses of this character are heavy but the timber is not salvageable, you should adjust your timber account to reflect the loss of timber volume as an offset against growth in computing the depletion unit.

Determining the Amount of Deductible Loss—If your timber is destroyed by fire or other casualty, your deductible loss is the allowable basis in the timber destroyed less any insurance or other compensation received (see summary of Rev. Rul. 66-9, page 93). Timber damaged but not made unmerchantable should be salvaged if possible, as explained above. If a gain results from the salvage activity, there is no casualty loss with respect to the salvaged timber. Determine your gain or loss from the salvage cutting, sale, or other disposal as you would for timber sales in general.

Determining Volume of Timber Destroyed—To claim a loss deduction, the single identifiable object damaged or destroyed must be identified. For timber, this is expressed in terms of the specific units destroyed. The units of measurement used should be those utilized to maintain your timber accounts, such as board feet, cords, or cubic feet.

The number of units of timber destroyed must be established by fair and reasonable measurement to justify a deduction. You may wish to employ a consulting forester to cruise the timber if the area is extensive and much work is involved. In some cases, however, the local representative of the State forestry agency may be able to furnish you with an estimate of the quantity destroyed.

Determining Basis of Timber Destroyed—Determine the basis of timber destroyed as you would for a sale or other disposition, as discussed in "Determining the Amount of Gain or Loss," page 31.

First determine the depletion unit by dividing the adjusted basis for depletion as shown in your timber account by the quantity of merchantable timber in the account. Then, multiply the depletion unit by the number of units destroyed to find the

amount allowable as a loss. The volume used to calculate the depletion unit for the loss should include adjustments for growth for the year of the casualty but is not reduced by the volume of timber destroyed. If the timber has no basis, you will not have a deductible loss.

Year of Deduction—A loss arising from a casualty generally is deducted in the year in which the casualty occurs. This is true even if you have not yet settled a reimbursement claim or have not received an agreed upon insurance settlement or other compensation. If a claim for reimbursement has been made, and you think you will recover all or part of the loss even though you have not yet received payment by the time the tax return for the year of the casualty is due, reduce the reported loss by the amount you expect to recover. If you later recover less than the amount you estimated, you may deduct the difference for the year in which you become certain that no more reimbursement or recovery can be expected (see Example VII-1).

Example VII-1

Adjustment of loss deduction claimed: Timber that you owned was destroyed by fire in 1994. The fire was accidentally started by a contractor working on the property. The allowable basis of the timber destroyed was \$5,500, and you expected to recover \$3,500 of the loss from the contractor's liability insurance. Even though the insurance company does not make payment to you in 1994, your loss for 1994 is limited to \$2,000, the difference between the loss and the amount you expect to recover. In 1995, the company offers to settle the claim for \$3,000 and you accept. The \$500 difference between the amount you expected and what you actually received may be claimed as a casualty loss on your return for 1995.

Report as income any reimbursement for more than the amount expected. If, after you have claimed a deduction for loss, you receive reimbursement for more than you estimate would be recovered (but not more than the total amount of the loss computed), you must include such excess as income on your return for the year received. Do not file an amended return for the year in which you claimed the deduction (see Example VII-2).

Example VII-2

Adjustment of loss deduction claimed: Timber that you owned was destroyed by fire in 1994. For tax purposes, your loss from the casualty was \$5,000, and you estimated that insurance would cover \$4,500 of the loss. You therefore claimed a loss of \$500 on your 1994 return. In 1995, the insurance company pays you \$5,250, or \$250 more than you estimated in computing your deductible loss for 1994. The \$250 difference is included as income on your return for 1995.

Destruction of Unmerchantable Timber—The destruction of premerchantable plantation or stand of naturally regenerating young growth may result in a deductible casualty loss. You can claim a loss only if (1) you maintain separate plantation

or young growth accounts, as explained in "Timber Accounts," page 18, and (2) you have costs allocated to such accounts (see summary of Rev. Rul. 81-2, page 91). In addition, under certain circumstances the death of newly planted seedlings due to an unusual and unexpected drought may qualify as a noncasualty loss (see summary of Rev. Rul. 90-61, page 94).

If these requirements are satisfied, generally you may figure your allowable basis for the unmerchantable timber destroyed by dividing the cost shown in the account by the number of acres in plantation or young growth, and then multiplying that amount by the number of acres destroyed.

Buildings and Equipment—If buildings and equipment used in your business or held for the production of income (investment) are totally destroyed, your deductible loss is the adjusted basis of each specific item of property destroyed, less salvage value less any insurance or other compensation received or expected to be received (see Example VII-3). If such property is only partially destroyed, your deductible loss is limited to the lesser of your adjusted basis reduced by any compensation you receive, or the decrease in the fair market value of the property reduced by any compensation (see Example VII-4).

Example VII-3

Loss when property is totally destroyed: Your portable sawmill was completely destroyed by a fire and you carried no insurance on the property. The adjusted basis for depreciation of the sawmill building and equipment at the time of the fire was \$6,500, and its fair market value was \$5,000. The value of the equipment after the fire was only scrap value, amounting to \$300. Your deductible casualty loss is \$6,200, the adjusted basis of \$6,500 less salvage value of \$300.

Example VII-4

Loss when property is partially destroyed: Assume that the sawmill in example VII-3 was damaged by the fire but not completely destroyed. Just before the fire the sawmill had a fair market value of \$5,000 and immediately after the fire its fair market value was \$3,500. Under these facts, your loss is limited to \$1,500, the decrease in the fair market value, since this amount is less than the adjusted basis of \$6,500.

Had the fair market value of the sawmill been \$8,000 just before the fire and \$1,000 just afterward, the decrease in fair market value would be \$7,000 and your deductible casualty loss would be limited to your \$6,500 adjusted basis in the property.

Determining the Decrease in Fair Market Value—The decrease in the fair market value of property resulting from a casualty should be determined by an appraisal of the values of the property immediately before and immediately after the casualty. The decrease is the difference between these two values. Your cost of restoring and cleaning up after the casualty may be acceptable as evidence of the decrease in

the value of the property if: (1) such costs are necessary to restore the property to its precasualty condition, (2) the amount spent for restoration is not excessive, (3) the expenses do no more than take care of the damage suffered, and (4) the value of the property after restoration is not more than its value before the casualty.

Theft Losses

Determine the amount of loss you can claim from a theft of timber, frequently referred to as "timber trespass," as you would for a casualty loss. Your deductible loss is the allowable basis of the timber stolen—that is, the depletion unit multiplied by the number of units stolen—less insurance, damages, or other recoverable amounts received.

Year Deducted—Generally, theft losses are deducted in the year the theft is discovered. To establish a theft loss, you do not have to prove when the timber was stolen, only that the theft occurred, that you owned the property, and when you discovered it. Thus, the quantity of timber used in determining the depletion unit is the quantity at the time the theft was discovered.

Reduce Theft Loss by Anticipated Recovery—Your theft loss must be reduced by any amounts you expect to receive as a result of the theft. This is required even though you do not receive payment until after the close of the tax year. If you later recover less than the amount you estimated, you may deduct the difference for the year in which you became certain that no more reimbursement or recovery can be expected. Also, if you are reimbursed in a later year for more than you anticipated when you estimated the amount of the deductible loss, include the excess as ordinary income on your return for the year in which you receive it, as discussed with respect to casualty losses.

Multiple Damages—In many States, successful prosecution of timber trespassers results in the awarding of compensation to the victim. The award is sometimes two or three times the fair market value of the timber stolen. In the case of double or treble damages, one-half, or one-third, respectively, of the award represents compensation for the timber stolen. This amount should be reported as proceeds of an involuntary conversion. The gain is determined as for any other disposal. The other one-half or two-thirds, representing a damage award, is fully taxable as ordinary income. It must be reported as "other income." An attachment explaining the entries made on your return should be filed with the return.

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 the same if you sell property under the threat of condemnation. Therefore, if the public condemning authority tells you that it intends to acquire your property by negotiation, or if necessary by condemnation, and you sell the property to the authority at a mutually agreeable price, treat the sale as if your property had actually been condemned and you were granted an award.

The computation of your gain or loss when your forest land is condemned or sold under the threat of condemnation will in all cases involve the land, but may or may not involve standing timber, depending on whether you are permitted to harvest it. Determine the basis of your timber as you would for an ordinary sale. Your land account should show the part of the original basis that was allocated to land, exclusive of timber and any improvements (see page 18). The basis of the land condemned or sold under threat of condemnation is its basis as shown in the land account (see Example VII-5).

Example VII-5

Condemnation. You purchased a 50-acre timber tract and allocated \$200 per acre, or \$10,000, to the land account. A strip of land totaling 5 acres and running through the property was condemned for use in building a new highway. The basis of the land (exclusive of timber) to be used in computing the gain or loss on the condemnation is 5/50ths of \$10,000 or \$1,000.

Condemnations for Right-of-Way Easements—Condemnation of forest land for utility or other right-of-way easements generally involve 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 power lines or pipe lines, the landowner may be allowed to grow crops on the right-of-way. The production of timber is generally not allowed because the tops and roots would interfere with the power lines or pipe lines. Any loss of future timber income should be included in the negotiations for the condemnation award. No deduction is allowed for future timber income foregone. The award received is reported as described on page 47.

Basis for Figuring Gain or Loss—The basis of the timber condemned is your depletion unit multiplied by the number of units standing on the property condemned, or by the number of acres times the basis per acre for plantations or stands of young growth. If, however, the condemning authority allows you to harvest the merchantable timber before the land is taken, and you sell the timber, or cut and sell the logs or other products, only the land would be involved in the computation. The gain or loss on the timber would be reported separately as described above.

Condemnation of property for public use can raise many specialized questions. For example, besides receiving an award for your condemned property, you might also receive severance damages or consequential damages resulting from a decrease in value or damage to that part of your property not condemned. A condemnation might also result in a special assessment being charged to you because of resulting improvements to your retained property. For a detailed explanation of the treatment of these special problems, see IRS Publication 549, "Condemnations and Business Casualties and Thefts."

Recovery of Expenses

Expenses are handled differently for casualties and thefts than they are for condemnations.

Casualties and Thefts—Appraisal, timber cruising, and other ordinary and necessary expenses for determining your loss are expenses in determining your tax liability. They are not part of the loss, but may otherwise be deductible (see Chapter V).

Condemnations—Legal, appraisal, timber cruising, and other expenses incurred to receive a condemnation award are deducted from the award to determine the net award reported on your return.

Postponing Gains From Involuntary Exchange

You may be able to defer gains realized from a forced disposition of timber as a result of an unexpected and unusual event, such as when the trees are killed by fire or an insect attack of epidemic proportions, or downed by high winds, earthquake, fire, ice storms, or volcanic eruption. These events generally require a conversion of the timber soon after the event or you will suffer a complete loss of it. To defer any gains realized you must use the proceeds (amount realized) to purchase qualifying replacement property (see summary of Rev. Rul. 80-175, page 94). Amounts realized from the involuntary conversion of timber include the amount realized from a lump sum sale of the timber, the amount realized under Section 631(b) in the case of disposition of the timber under a pay-as-cut contract, and the fair market value under Section 631(a) in the case of cutting of the timber by the taxpayer. The purchase of qualifying replacement property includes the purchase of replacement timber sites; the cost of seeds and seedlings; your costs to plant the trees or sow the seed on currently owned, leased, or replacement timber sites; and the cost of purchasing stock in the acquisition or control of a corporation owning timber, timberlands, or both.

An involuntary exchange occurs when your property is completely or partially destroyed, stolen, requisitioned, condemned for public use, or disposed of under the threat or imminence of condemnation and you receive insurance or a condemnation award. Involuntary exchanges are also called involuntary conversions. If you have a gain resulting from an involuntary exchange, you may elect to postpone paying tax on all or part of the gain even though the involuntary exchange may not necessarily qualify as a casualty. This occurs, for example, when damages are awarded by court order, or when parties who have damaged your property make a voluntary settlement. An example would be a settlement made by a logger working on property next to yours who inadvertently removed timber from your side of the property line.

Determining the Gain—A gain is realized on an involuntary conversion when the salvage sale proceeds, insurance, condemnation award, or other compensation that you receive is greater than your basis in the property. The amount of the gain is determined as described above for casualties, thefts, and condemnations. If you salvage your involuntarily converted timber by harvesting it instead of disposing of it on the stump, and a Section 631(a) election is in effect, the amount of the gain, if any, is based on the fair market value of the stumpage cut as described on page 38. Ordinarily, you would

include the gain from an involuntary conversion in your income for the year it is realized. However, under certain conditions, you may defer the gain or a portion of it until you sell the replacement property you bought with the proceeds. The amount of the gain qualifying for deferment cannot exceed the fair market value of the assets converted.

Requirements to Postpone Gain—Your gain is not taxed in the year realized if within the allowable replacement period you purchase other property that is similar or related in service or use to the property converted, or the controlling interest in a corporation owning such property, at a cost that equals or exceeds the amount you received as compensation. For the condemnation of real property, such as standing timber, the replacement period ends 3 years after the close of the first tax year in which any portion of the gain from the conversion is realized. The replacement period is 2 years for property other than real property. The replacement period for both real and personal property is always 2 years from involuntary conversions other than condemnations. Note, however, that under State law standing timber may not be classified as real property under all circumstances.

If you elect to defer reporting the gain, you must file a statement with your tax return that the election is being made and include all the pertinent information concerning the conversion and the replacement property. If you make the election, but do not spend all of your compensation, reimbursement, or proceeds on qualifying replacement property, you must report the difference as income.

Basis of replacement property—Your basis in replacement property is its cost minus any gain that you postpone. In this way, tax on the gain is deferred until you dispose of the replacement property.

Reporting Gains and Losses From Casualties, Thefts, Condemnations, and Noncasualty Losses

Gains and losses are reported differently for casualties and thefts than they are for condemnations, and for noncasualty business losses.

Casualties and Thefts—You first use Form 4684, "Casualties and Thefts," to calculate and report casualty and theft losses and gains. Section B of Form 4684 is used for losses and gains from business and income-producing property. Your losses and gains are reported according to how long the property was held and the purpose for which it was used—such as business, rental, to produce royalties, or for investment. You may also be required to file Schedules C, D, and F of Form T.

Each item of property for which you are claiming a loss or gain must be listed separately. If more than four items were involved in any one casualty or theft, attach additional copies of the form. If you incurred losses or gains from more than one event you must use a separate Form 4684 for each event. Form 4684 summarizes your casualty and theft losses and gains and directs you to the proper form for reporting each.

Reporting Gain or Loss—Property Held for 1 Year or Less—Short-term losses (held 1 year or less) on business, rental, or royalty-producing property are combined on Form 4684 with your short-term gains from casualties and thefts. The resulting net gain or loss is reported on Form 4797.

Reporting Gain or Loss—Property Held for More than 1 Year—Long-term losses (held more than 1 year) on business, rental, or royalty-producing property are combined with your other long-term casualty and theft losses on Form 4684. Compare the combined losses to your long-term gains from casualties and thefts of business, rental, or royalty-producing property. If the combined losses are the same as or less than the gains, net the combined losses against your gains. Then enter the net gain on Form 4797.

If your combined losses are more than the gains, your long-term gains and losses are treated as ordinary gains and losses. Merge your long-term losses with your long-term gains.

Reporting Gain or Loss From Income Producing Property—Your short-term losses from income producing (investment) property are reported on Schedule A of Form 1040. Gains from short-term income producing property are added to your gains from business, rental, and royalty-producing property to be offset against short-term losses from business, rental, and royalty-producing property on Schedule E of Form 1040, and are reported on Form 4797. Your total long-term loss on income producing property is reported on Schedule A, Form 1040.

Condemnations—The way in which you include a taxable gain or deductible loss from a condemnation in computing your income depends on the kind of property involved, when you acquired it, how long you held it, and whether or not a part of your gain is due to depreciation. Do not include condemnation gains in taxable income if you elect to defer tax on the gain by acquiring replacement property, as discussed above.

Property Held for 1 Year or Less—You treat a gain or loss from property used in your business or held for the production of rents or royalties as ordinary gain or loss on Form 4797. You report a gain or loss from property you held for investment as a short-term capital gain or loss on Schedule D, Form 1040.

Business or Investment Property Held for More Than 1 Year—If you held property for more than 1 year before it was condemned or sold under a threat of condemnation, you must list the gain or loss on Form 4797, together with any other gains and losses from business property.

Property Held Primarily for Sale—You report a gain or loss from property you held primarily for sale to customers in the ordinary course of business as ordinary income or loss. You use the appropriate business schedule, either Schedule C or F of Form 1040, regardless of how long the property was held. You never report such transactions on Schedule D of Form 1040 or on Form 4797.

Property Held for Personal Use—You report the gain from property held for personal use as a short-term or long-term gain on Schedule D of Form 1040. Under no circumstances may you deduct a loss from the condemnation of property that you held for personal use.

For more information, see IRS Publication 334, "Tax Guide for Small Business," or IRS Publication 549, "Non-business Disasters, Casualties and Thefts."

Noncasualty Losses—Losses to timber held for use in a trade or business, such as those described in Rev. Rul. 87-59 and Rev. Rul. 90-61, page 94, are reported on Form 4797 to be netted against other gains and losses from disposals of business property.

Example VII-6

Comprehensive example: Walter Green owns 320 acres of timberland, which was affected by hurricane force winds on April 10, 1994. Walter is a calendar-year taxpayer and holds the timber for use in a trade or business activity. He maintains one timber account for all of the stands. The damage varied among the stands of loblolly and shortleaf pine of various ages. Almost all of the trees in some stands were uprooted and splintered so as to be unsaleable. Some stands or parts thereof were subject only to windthrow. Other stands or parts thereof suffered little damage.

Walter identified the stands that were undamaged and instructed his consulting forester to cruise all the other stands to determine the extent of the damage. He used the cruise data and on-the-ground inspections to determine the stands that needed to be treated by a salvage cut. These stands were put up for sale in July, but by December 31, 1994, no offers had been received. The timber buyers

Walter contacted all told him that because of the large acreage of timber damaged that spring there was more timber available than could be absorbed by the market. They suggested he contact them next spring.

Walter claimed as a loss his basis in the 1,200 cords of wood totally destroyed. The basis was determined as shown in Figure VII-1. Walter reported the loss on Form 1040, Schedules D and F (Form T), Form 4684, and Form 4797.

On November 10, 1995, Walter was able to sell the stands identified for salvage. In 1994 the forester estimated that these stands contained 2,100 cords. The buyer, however, estimated that the stands contained only 1,800 cords of merchantable wood. The difference was due to the degradation over two summers since the hurricane. Walter received \$16,500 for the 1,800 cords. The allowable basis for this sale was determined as shown in Figure VII-2. The \$1,233 loss should be reported as a noncasualty loss in 1995. The \$9,102 gain on the salvage sale (\$16,500 - \$7,398) is reported on Schedule C of Form T. If he elected to pay tax on the gain he would report it on Form 4797 as an involuntary conversion. If Walter elected to postpone paying tax on the gain by replanting the stands, or otherwise acquiring qualifying replacement property, he would file an attachment to his 1995 return detailing such things as all facts relating to the hurricane, the amount realized on the sale, his computation of the gain, any gain to be reported, and the type and cost of replacement property acquired. If the replacement property would be acquired after the time for filing the return, Walter should indicate in the statement that he intends to acquire replacement property within the required time period. In the subsequent year of acquiring replacement property, a statement should be attached to the return giving detailed information on the replacement property.

Figure VII-1—Schedule F (Form T)

Capital Returnable Through Depletion			
Line number on Form T	Quantity in MBF, log scale, cords, or other unit (1)	Cost or other basis (2)	
28.	Estimated quantity...[at end of 1993]	5,000 cords	\$22,300
30a.	Addition for growth (1 year)	220	
33.	Total at end of year, before depletion	5,220	22,300
34.	Unit rate		4.27
39.	Quantity of timber lost by fire or other cause during year	1,200	
40.	Allowable basis of loss		5,124
42.	Net quantity and value at end of year	4,020	17,176

Figure VII-2—Schedule F (Form T)

Capital Returnable Through Depletion			
Line number on Form T	Quantity in MBF, log scale, cords, or other unit (1)	Cost or other basis (2)	
28.	Estimated quantity [at end of 1994]	4,020 cords	\$17,176
30a.	Addition for growth (1 year)	160	
33.	Total at end of year, before depletion	4,180	17,176
34.	Unit rate		4.11
37.	Quantity sold	1,800	
38.	Allowable as basis of sale		7,398
39.	Quantity of timber lost by fire or other cause during year	300	
40.	Allowable basis of loss		1,233
42.	Net quantity and value at end of year	2,080	8,545

Chapter VIII. Tax Implications of Forest Stewardship

Introduction

Most timber owners get many benefits from owning forest land. You may have a special interest in providing wildlife habitat, conserving soil and water, protecting endangered plants and animals, or other activities that may not be related to the production of income, except by increasing the market value of the property should you sell it. Forest stewardship simply refers to the care of forest land in the best sense of conservation and wise use. Tax law may be of benefit in these efforts. You need to be aware, however, that the current tax laws may not support all your efforts. This chapter discusses the tax incentives for wise stewardship of forest land.

Tax Law Keyed to Production of Income

Tax law is keyed to the production of income. Expenses incurred for an activity carried out to produce income as either a trade or business, or investment can generally be recovered as discussed in Chapter V. A critical factor is that the expense incurred for an activity be directly related to its potential to produce income. Even though you may expect to sell timber sometime during your life, timber production may not be the primary factor motivating your activities.

You may have a special interest in wildlife and manage your forest land to attract certain species. In some regions of the country wildlife activities, such as planting food plots and shrubs for food and cover, and maintaining a timber species and stocking mix to favor certain species, may be related to the production of income by leasing your land for hunting. In other cases expenditures for these activities may be made strictly to increase your enjoyment of the property. To expense your management costs for tax purposes, you'll need to manage your property so that your activities do not bring into question your intention to eventually make a profit from the property, as discussed on page 27.

In many cases it is possible to carry out wildlife habitat management activities as part of your timber management program, and receive income from both activities. Your wildlife management expenses may be incidental to your timber management activities. In such cases the expenses could be treated as timber management expenses. If, however, wildlife management activities dominate your management program and you don't receive any income related to wildlife, the expenses may not qualify as ordinary and necessary business or investment expenses. In some cases the expenses might qualify to be added to the basis of your property, as discussed on page 27.

Many of the best opportunities to promote stewardship with your forest land are associated with forest estate planning. This topic is the focus of a companion publication, *Estate Planning for Forest Landowners: What will become of your timberland?* (General Technical Report SO-97, Sept. 1993,

U.S. Dept. of Agriculture, Forest Service, Southern Forest Experiment Station, New Orleans, Louisiana). One such opportunity, conservation easements, is discussed here because of its potential to significantly increase long-term stewardship.

Conservation Easements

If you are highly motivated to engage in activities that improve the ecological value of forest land, it may be in your best interest to sell, donate, or otherwise transfer all or part of your ownership interest in the property to an organization specializing in the management of forest and other lands for conservation purposes. The possibilities are not limited to the outright transfer of all ownership interests. You can legally transfer less than your entire interest in your forest land. For example, you can transfer a restriction on the use of the property for purposes other than forest land, such as housing, commercial, or industrial development. You could transfer this restriction and retain the right to live on and produce timber on the property. Such transfers are a way for you to control the use of the land during and after your lifetime. By selling such a restriction, you would get some income from the development rights, or by donating the restriction (in perpetuity) to a qualifying organization, you may qualify for a charitable deduction on your income tax return.

For additional information on this topic, you may want to consult *Preserving Family Lands* by Stephen J. Small, P.O. Box 2242, Boston, MA 02107.

Qualifications for Charitable Deduction of Conservation Easement—Under some circumstances, a donation of a restriction on the development of your forest land may qualify as a charitable contribution. The criteria necessary to qualify for a charitable deduction need to be carefully evaluated. You should seek legal counsel to facilitate the process. Three basic criteria must be considered.

Qualified organization—Your contribution must be made to one of the following qualified organizations:

- (1) A unit of local, State, or U.S. government,
- (2) A publicly supported charitable, religious, scientific, educational, etc., organization, or
- (3) An organization that is controlled by, and operated for the exclusive benefit of, a governmental unit or a publicly supported charity.

Conservation purpose—Your contribution must be made only for one of the following purposes:

- (1) Preservation of land areas for outdoor recreation by, or for the education of, the general public.
- (2) Protection of a relatively natural habitat for fish, wildlife, or plants, or a similar ecosystem.
- (3) Preservation of open space, including farmland and forest land. The preservation must yield a significant public benefit. It must be either for the scenic enjoyment

of the general public, or under a clearly defined Federal, State, or local governmental conservation policy.

- (4) Preservation of a historically important land area or a certified historic structure.

Qualified real property interest—Any of the following interests in real property qualify. Forest land and associated timber are real property.

- (1) Your entire interest in real estate other than a mineral interest.
- (2) A remainder interest, that is the interest after an interest you hold for some designated time period or a time period fixed by an identifiable event, such as your death.
- (3) A restriction on how the property may be used if the restriction is perpetual.

Valuation of Donation—The value of a donation of a conservation easement generally is equal to the value of the entire property before the donation minus its value after the donation. The best evidence of this difference in value often is sales of similar properties in the area that were bought and sold, some without any restrictions, and some with restrictions similar to those you're considering for your property. The basic principle is demonstrated in Example VIII-1.

Example VIII-1

Value of Donated Conservation Easement: You own 300 acres of forest land. Similar land in the area has a fair market value of \$1,200 per acre. However, land in the general area that is restricted solely to forestry uses consistent with the county's open-space program has a FMV of \$600 per acre. Your county wants to preserve green space in the area of your property and prevent further development. The county is most interested in preserving the 200 of your acres which are visible from a major highway.

You grant the county an enforceable open space easement in perpetuity on the 200 visible acres, restricting its use to selective timber harvesting consistent with the open-space easement. The value of the easement is

FMV of the property before granting easement:

\$1,200 x 300 acres	\$360,000
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FMV of the property after granting easement:

\$1,200 x 100 acres	\$120,000
\$600 x 200 acres	<u>120,000</u>
	<u>240,000</u>

Value of easement	\$120,000
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Because of the need for accuracy a professional appraisal should be used to determine the value of your donation. If you claim a deduction for donated property of more than \$5,000, in addition to filing the information required on claimed deductions of over \$500, you must get a qualified written appraisal made by a qualified appraiser, and you must attach an appraisal summary to your tax return. The amount of deduction you claim may be subject to other restrictions, as discussed in IRS Publication 526, Charitable Contributions.

Installment Sales

Introduction

It may be to your advantage to receive at least one payment from the sale of timber after the tax year in which the disposition occurs. Such sales are referred to as installment or deferred payment sales. The installment sale provisions apply automatically whenever at least one payment is received in a tax year after the tax year of the sale. An installment sale is the only way to spread the tax burden from a lump sum timber sale over more than one tax year. The installment sale provisions may also be beneficial if you sell your forest land. If your activities are subject to the passive activity loss rules and you have a loss, special rules will apply, as discussed on page 28.

The receipt of payments in more than one tax year could arise from either a lump-sum sale or a "pay-as-cut" contract. A typical lump-sum sales contract might require an initial down payment, a minimum annual payment, and payment in full before timber cutting starts. A typical pay-as-cut contract might require an initial down payment and monthly payments based on the volume cut and scaled during the previous month. If a pay-as-cut contract qualifies for treatment under Section 631(b), the contract is not treated as an installment contract and the Section 631(b) rules apply as discussed in Chapter VI.

There are limitations on the use of the installment sale method. The method does not apply to dispositions of real property held for sale to customers, but an exception allows this method to apply to the disposition of timber by taxpayers whose timber ownership qualifies as a farm business under Section 2032A of the Internal Revenue Code. The installment sale provisions do not apply to rent received from a timberland lease. Nor do the provisions apply to sales resulting in a loss. Losses must be reported in full in the year incurred. If a transaction qualifies, the installment sale provisions apply automatically whenever at least one payment is received in a tax year after the tax year of the sale.

Calculating Installment Sale Income

Each installment payment usually consists of three parts:

- (1) Return of your investment (basis) in the timber sold,
- (2) Gain on the sale, and
- (3) Stated or unstated interest

Any interest included in a payment is reported separately as ordinary income. This is also the case for unstated (imputed) interest, discussed later in this chapter. Expenses you incur to sell timber are added to your allowable basis in the timber sold, and the total is subtracted from the sale price. The difference is the gain. The gain will be a capital gain if the timber you sold was a capital asset and was held for more than one year. The gain to be reported each year a payment

is received is calculated using the gross profit percentage. If recapture applies because of amortization of reforestation expenditures or exclusion of cost-sharing payments from gross income, some of the gain will be reportable as ordinary income.

Gross Profit Percentage—The percentage of a payment that is gain usually remains the same for each payment. In the absence of any recapture, this percentage is determined by dividing the gross gain from the sale by the contract price, as explained on Form 6252. The method of calculating gross profit percentage is shown in Example IX-1.

Example IX-1

Calculating gross profit percentage: You sell timber at a contract price of \$10,000, and your allowable basis in the timber sold is \$2,000. Your cost to sell the timber was \$500. The total gain on the sale is \$7,500 (\$10,000 - \$500 - \$2,000) and your gross profit percentage is 75 percent ($\$7,500 \div \$10,000$). After subtracting out interest, 75 percent of each payment, including the down payment, is reportable as your gain from the sale in the tax year in which you receive the payment.

Selling price—The selling price is the entire cost of the timber to the buyer. It includes any money and the fair market value of any property you are to receive from the buyer. It also includes any debt associated with the property sold for which the buyer takes the property subject to, pays, or assumes. The debt could be a note, mortgage, or any other liability, such as a lien, accrued interest, or taxes you owe on the timber. If the buyer pays any of your selling expenses for you, that amount is also included in the selling price.

Generally, if the selling price is reduced at a later date, the gross profit (gain) on the sale must be refigured. You calculate a new gross profit percentage that applies to any remaining payments. The gain still to be reported is then spread evenly over the remaining installments. You cannot go back and refigure the gain you reported in earlier years.

Adjusted allowable basis—The adjusted allowable basis for timber sold is the allowable basis determined by multiplying the appropriate depletion unit by the number of units sold, explained more fully on page 31. From the selling price you subtract the selling expenses paid in connection with the sale and your adjusted allowable basis to determine the gain.

Payments—You must figure your gain on the payments you receive each year from an installment sale, including the down payment and each later payment of principal on the buyer's debt to you. The buyer's note (unless it is payable on demand) is not considered a payment on the sale. Its full face value is included when figuring both selling price and contract price. The payments you receive on the note generally are reported on the installment method.

Escrow Accounts—In some cases, the sales agreement, or a later escrow agreement, may call for the buyer to establish an irrevocable escrow account out of which some or all of the remaining installment payments, including interest, are to be made. An escrow account is irrevocable if the buyer cannot revoke the account and recall the funds to his own use. Generally, these sales may not be reported on the installment method. The buyer's obligation is paid in full when the balance of the purchase price is deposited into the escrow account. When the escrow account is established, you no longer rely on the buyer for the rest of the payments, but on the escrow arrangement.

If an escrow arrangement imposes a substantial restriction on your right to receive the sale proceeds, the sale may be reported on the installment method, provided it otherwise qualifies. In order for an escrow arrangement to impose a substantial restriction, it must serve a bona fide purpose of the buyer—that is, a real and definite restriction placed on the seller or a specific economic benefit conferred on the buyer. Because of the nature of most timber sale transactions, irrevocable escrow accounts will usually preclude installment reporting.

Electing Out—You can choose not to have the installment sales rules apply to your sale. If you make this election, you must report your entire gain from the sale on your return for the year of sale, even though you will not be paid all of the selling price until later. The election is made by not reporting the sale on Form 6252. Instead, report it on Schedule D of Form 1040, or Form 4797 if the timber is used in a business. This election does not apply to disposals under Section 631(b) because they are not treated as an installment sale. To figure the selling price under the election, you must compute the buyer's installment obligation to you at its fair market value.

Unstated Interest and Imputed Interest—If the note or other document of indebtedness you receive from the buyer provides for no interest on the deferred payments or provides for inadequate interest as defined in IRS regulations, you are required to impute interest. Imputed interest is reported in the same manner as stated interest by the seller. Likewise, the buyer must treat imputed interest in the same manner as the payment of stated interest.

Generally, a document of indebtedness provides for adequate stated interest if it calls for interest at a rate no lower than the test rate of interest. For seller financing of less than \$3,332,400 the test rate of interest is the lower of the applicable Federal rate of interest or 9 percent compounded semiannually. Each month, the IRS issues tables giving three sets of the applicable Federal rate. The tables applicable to your sale can be obtained by calling the IRS's toll free taxpayer assistance number.

Imputed interest rules may apply to any document of indebtedness issued for the sale or exchange of your property if some or all of the payments scheduled under the debt instrument are due more than 6 months after the date of the sale or exchange under a contract which: (1) some or all of the payments are due more than 1 year after the date of the

sale or exchange, and (2) there is total unstated (or inadequately stated) interest. The imputed interest rules do not apply if the sales price will not exceed \$3,000. IRS Publication 537 provides information for determining imputed interest.

Reporting Installment Sales—Installment sales are reported on Form 6252. This form is used to report the original sale in the year it takes place, and to report payments received in later years. The sale also should be reported in the year it takes place on Form T, discussed on page 31.

Sales to Related Parties—If you make an installment sale of timber to a related party who then makes a second disposition within 2 years of the first disposition, and before all payments are made under the first disposition, a special rule may come into effect. Under this rule, part or all of the amount the related party realizes as a result of the second disposition is treated by you at the time of the second disposition as if you had received it from the first disposition. See IRS Publication 537 for details.

Alternative Minimum Tax

The purpose of the alternative minimum tax (AMT) for individuals is to make certain that if your income tax liability is reduced because of certain tax benefits, you will pay at least a minimum amount of tax.

Your potential liability for the alternative minimum tax depends on the structure of your timber activities, your other sources of income, and the deductions you claim. Timber income does not generate a tax preference subject to the AMT, nor does the depletion allowance for timber you cut. Timber sale income may, however, increase your total taxable income sufficiently to indirectly trigger an alternative minimum tax liability. This would be the case if your income is increased above the exemption amounts specified for the alternative minimum tax and you have realized certain tax benefits related to all of your activities.

The deduction of your timber management expenses may also trigger an alternative minimum tax liability. This is the case if you recover your expenses as miscellaneous itemized deductions on Schedule A, Form 1040, discussed in more detail on page 30. Also, if you are not materially participating in the conduct of your timber activity, as discussed on page 29, any passive loss generated by your timber activity may trigger an alternative minimum tax liability. For additional information see IRS Publication 909 "Alternative Minimum Tax for Individuals."

The alternative minimum tax is determined by completing Form 6251. A worksheet in your tax booklet is used to determine whether or not you need to file Form 6251. However, you are required to complete and file it if you, among other things, had during the tax year (1) accelerated depreciation in excess of straight line, (2) income or loss from tax shelter farm activities, (3) income or loss from passive activities, or (4) investment interest expense. See IRS Publication 909 for a complete list. Note that all references to

depletion in Publication 909 refer to percentage depletion, not to cost depletion applicable to timber.

The alternative minimum tax is calculated by first determining your alternative minimum taxable income, defined as the sum of (1) the taxable income as determined on your Form 1040; (2) any regular tax net operating loss deduction claimed; and (3) adjustments pertaining to the standard deduction, medical and dental expenses, miscellaneous itemized deductions, taxes, certain interest, depreciation, tax shelter farm loss, and passive activity loss, among others. To this sum you also add your alternative minimum tax items relating to accelerated depreciation on real property placed in service before 1987; accelerated depreciation on leased personal property placed in service before 1987; incentive stock options; tax exempt interest on certain private activity bonds; and percentage depletion (this does not apply to timber) among others (see IRS Publication 909 "Alternative Minimum Tax"). The final step is to subtract from this total your alternative tax net operating loss deduction.

Alternative Minimum Tax Calculation

(1) Subtract your exemption amount from your AMT taxable income. Your exempt amount in 1994 was \$45,000 if married filing jointly, \$33,750 if single or head of household, and \$22,500 if married filing separately. (2) Multiply the balance by 26% on the first \$175,000 (\$87,500 if married filing separately), and 28% on any amount in excess of the first \$175,000 (\$87,500 if married filing separately). Add these two amounts to get your tentative minimum tax. The AMT is the difference between this tentative tax and your regular tax.

Self-employment, Social Security Tax

You may owe self-employment tax if you are engaged in a timber trade or business as a sole proprietor, independent contractor, or member of a partnership or member of a limited liability company. This tax is used to provide social security and Medicare coverage to self-employed taxpayers. The tax is imposed on net earnings from self-employment, which includes earnings derived by an individual from a trade or business, less all business deductions allowed for income tax purposes. You must pay self-employment tax if you have net earnings from self-employment of \$400 or more. The self-employment tax is composed of two parts. The tax rate is 15.3% (12.4% social security tax plus 2.9% Medicare tax). Net earnings from self-employment up to \$61,200 for 1995 are subject to the social security portion of the tax. If you also earn wages as an employee in 1995 that are subject to social security tax, only the first \$61,200 of your combined wages and net earnings from self-employment are subject to social security tax. All net earnings from self-employment are subject to the Medicare portion of the self-employment tax. You are not exempt from self-employment tax if you are receiving social security benefits, are fully insured under social security, or are not otherwise required to file an income tax return. Nor are you exempt on account of age.

If income from your timber operations is considered as received in the course of a trade or business, it may be subject to the self-employment tax even though your timber

transactions are infrequent and you are primarily engaged in some other business, trade, or profession. For example, a farmer whose property includes a tract of timber or a person employed in the city and owning woodland outside the city, who occasionally cuts timber for firewood and sells it, may be liable for self-employment tax on the income received.

Treatment of Spouses

If you are the sole proprietor of a trade or business and your spouse works for you, he or she may be your employee. The treatment of employees for employment tax purposes is explained on page 56. Alternatively, both you and your spouse may be engaged in a trade or business. In that case, each individual's net earnings from self-employment are subject to self-employment tax. If, however, you and your spouse join together in the conduct of a business and share in its profits and losses, a partnership may have been created. If so, you and your spouse should report the business income on a partnership return, Form 1065. Attach Schedules K-1 to Form 1065 to show each partner's share of the net income, and file separate Schedules SE (Form 1040) to report self-employment tax.

Excluded Income Items

The following timber-related items are not included in computing net earnings from self-employment:

- (1) Rental payments received for the use of real estate and personal property leased with real estate if you are not a real estate dealer and you do not provide substantial services in the rental activity.
- (2) Gains that qualify for capital gains treatment. Gains from the sale or other disposal of standing timber generally qualify for capital gains treatment if the timber is not held primarily for sale to customers in the ordinary course of a trade or business in which you are engaged or you dispose of it under the provisions of Section 631(b), as discussed on page 36. If you cut the timber yourself or have a contract logger cut it for you, and elect to treat the cutting as a sale under the provisions of Section 631(a), as discussed on page 38, the gain determined under Section 631(a) would not be included in net income from self-employment. Your profit on the sale of the logs or manufactured products, however, may be subject to the self-employment tax.

Christmas Tree Growers

Growers of Christmas trees are subject to the rules applicable to timber producers in general. The self-employment tax applies to ordinary income received from the sale of trees. Gains from the sale of Christmas trees may qualify as capital gains, as discussed on page 59, and therefore not be subject to the self-employment tax.

Forest Products

The sale of forest products other than standing timber, and a cutting not under a Section 631(a) election, usually produce ordinary income. Receipts from these sources are therefore included in self-employment income.

Cost-Share Payments

Net payments received under the Agricultural Conservation Program (ACP), the Forestry Incentives Program (FIP) and Stewardship Incentive Program (SIP), as well as those received under State cost-share programs, are included in self-employment income if your activity is considered a business, unless specifically excluded from reportable income for Federal income tax purposes. All or some portion of such program payments may qualify for such exclusion under rules discussed on page 40. Only the portion actually excluded from taxable income may be excluded from self-employment income.

Net Conservation Reserve Program (CRP) payments (both cost-share and rental) are also generally included in self-employment income. CRP cost-share payments do not currently qualify for income tax exclusion under the rules discussed on page 40. However, if the payments are treated as a conservation expense under Section 175 of the Code, as discussed on page 24, they become a deduction in determining net earnings from self-employment.

How to Calculate Self-Employment Tax

The self-employment tax is calculated by completing Schedule SE of Form 1040, "Computation of Social Security Self-Employment Tax." If you work as an employee and earn wages or salary subject to withholding that equal or exceed the maximum amount subject to the social security portion of the social security tax, and also have income from a trade or business, you do not pay self-employment tax on your earnings from the trade or business. However, if you earn wages subject to withholding that total less than the maximum amount, and also have income from timber operations subject to the self-employment tax, the net income from timber operations will be taxed to the extent of the difference between your wages and the maximum. In addition, all self-employment income is subject to the Medicare tax.

Including Timber Gains In Self-Employment Income To Guarantee Benefits

Qualification for social security benefits for you or your dependents depends in part on how much social security and/or self-employment tax you have paid. In 1995, you receive a quarter of social security credit for each \$620 of income earned during the year that is subject to the social security tax. If you are not certain that you will qualify for full benefits on retirement, you should check on your status by contacting the Social Security Administration Office listed in your phone book under "United States Government, Social Security Administration."

If you need to make additional contributions you may prefer not to make an election under Section 631(a) to treat the cutting of timber as a sale. If you are a farmer who cuts and sells timber, you may, for the sake of obtaining benefits, decide not to make the election. If so, include your timber income and expenses, and the basis of the timber sold, as farm income and expenses on Schedule F of Form 1040. Such income would be subject to self-employment tax and

would be reported on Schedule SE of Form 1040. Remember, however, that if the Section 631(a) election has been made in prior years, you may not forgo the election in any following year without permission of the IRS. There is a one-time exception to this rule, however, as discussed on page 40.

If you dispose of standing timber held primarily for sale to customers in the ordinary course of a trade or business, the gain will be ordinary income subject to the self-employment tax, unless you dispose of it in such a way that the provisions of Section 631(b), discussed on page 36, apply.

If your timber is not held primarily for sale and you sell it "on the stump" (lump-sum sale), the gain usually is a capital gain and is not subject to the self-employment tax.

For more information on the self-employment tax, see IRS Publication 533, "Self-Employment Tax." If you are a farmer, refer to Publication 225, "Farmer's Tax Guide."

Employment Status

If you hire an individual to perform work on your forest property, that person may be your employee. As an employer, you will have several tax responsibilities. Most employers must withhold, deposit, report, and pay the following employment taxes:

- Income tax withheld from employee's wages.
- Social Security and Medicare taxes (employer and employee portion).
- Federal unemployment tax (FUTA). FUTA tax is not withheld.

An IRS Form W-2, which shows wages paid and taxes withheld during the year, must be prepared at the end of each year. Copies are sent to the Social Security Administration and to the employee. Internal Revenue Service Publication 15, Circular E, Employer's Tax Guide, provides information concerning an employer's tax responsibilities. You should check with your State concerning any State income and unemployment tax requirements.

An individual is an employee, for Federal employment tax purposes, if he or she has the status of an employee under the common law rules applicable in determining an employer-employee relationship. Generally, the relationship of employer and employee exists when the person for whom the services are being performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work—but also as to the details and means by which that result is met. That is, an employee is subject to the will and control of the employer not only as to what shall be done, but also as to how it shall be done. It is not necessary that the employer actually direct or control the manner in which services are performed, it is sufficient if the employer has the right to do so. Independent contractors are not subject to this right of control and direction.

If the tests for defining an employee are met, it doesn't matter that the person is designated as anything other than an employee—or how the payments are measured or paid or

what they are called. Thus, it is irrelevant that an employee is called an independent contractor, partner, or agent.

The Internal Revenue Service has developed a 20-factor test to use as a guide in determining whether a worker is an employee or an independent contractor. These factors can help ascertain whether sufficient control is present to establish an employer-employee relationship. The twenty factors should be used with caution. The degree of importance of each factor varies depending on occupation and the factual context in which services are performed. They are:

1. Instructions. The right to give instructions is relevant, not whether they are actually given.
2. Training. If the worker is required to receive training to learn how to do the work, an employment relationship is likely.
3. Integration. The more the worker is integrated into the business operations, the more likely he (she) is an employee.
4. Services rendered personally. This tends to indicate an employment relationship when required.
5. Hiring, supervising, and paying assistants. If the worker is responsible for his assistants, this is indicative of independent contractor status.
6. Continuing relationships. A continuing or recurring nature of work suggests employment.
7. Set hours of work. If hours are established by the business, this tends to indicate employment.
8. Full time required. An independent contractor has more freedom as to when and for whom he (she) will work.
9. Doing work on business premises. If this is required, it suggests control by the employer.
10. Order of sequence set. The more this is controlled for, instead of by, the worker, the more that employment is suggested.
11. Oral or written reporting. The more the worker must

report, the greater is the control of those supervising him (her), indicating employment.

12. Payment by time, not job. Independent contractors are more often paid by the job.
13. Payment of traveling expenses. An employer generally retains the right to regulate the employee's business activities.
14. Furnishing of tools. Independent contractors more often furnish their own tools and materials.
15. Investments. Independent contractors more often invest in facilities that are used in performing services.
16. Realization of profit or loss. A worker who can realize a profit or loss in addition to that ordinarily realized by an employee from his services is generally an independent contractor.
17. Working for more than one person at a time. An independent contractor will often perform services for more than one business at a time.
18. Making services available to the public. This indicates the status of an independent contractor.
19. Right to discharge. An independent contractor cannot be fired as long as he (she) produces a result that meets contract specifications.
20. Right to terminate. If the worker can terminate services without liability, this indicates an employment relationship.

If you pay a worker for services rendered on your timberland and you are not sure whether the payee is an employee or not, you can obtain an IRS ruling by filing Form SS-8.

If a worker is determined to be an independent contractor, and you make payments to that person aggregating \$600 or more in a calendar year, you must file an information return (IRS Form 1099-MISC) reporting the total paid. This return must be filed with the IRS by February 28 of the following year, with a copy to the payee by January 31.

Chapter X. Christmas Tree Production

General Considerations

Most Christmas tree producers are subject to the same Federal income tax provisions, as discussed elsewhere in this handbook, as are timber owners in general. Nevertheless, there are several important distinctions.

Christmas tree growing, because of the nature of the activity, usually constitutes a business rather than an investment. Therefore, Section 631 of the Internal Revenue Code is particularly relevant. Both Section 631 and the regulations relating thereto (discussed and explained in Chapter VI) provide that the term "timber" includes evergreen trees more than 6 years old at the time they are severed from their roots and sold for ornamental purposes. This definition includes Christmas trees.

It is possible that a person who sells standing Christmas trees on an occasional basis could be considered as not being in a business, but only an investor. In that case, the rules for investors versus those for a business, as discussed elsewhere in this handbook, would apply.

Establishment Costs

The general rule with respect to establishment costs, as discussed in Chapter V, is that all such costs—including replanting—are capital expenditures and must be capitalized. This applies to Christmas trees, just as it does to other timber, whether you use the cash or accrual method of accounting. The only exception is that Christmas trees do not qualify for the reforestation amortization and tax credit, as noted earlier. All capitalized costs associated with Christmas trees, therefore, are recovered by deducting them at the time of cutting or sale if not recovered earlier through involuntary conversion.

What if you plant trees with the intention of growing them for commercial timber production, take advantage of the reforestation tax incentives, and then later sell the trees as Christmas trees? You may be required to support your position if challenged by the IRS. In any event, if the trees were harvested or sold within 10 years, the amortization deduction would be subject to the amortization recapture rules (see page 24). If harvested or sold within 5 full years, the credit recapture rules would apply (see page 25).

Operating Expenses and Carrying Charges

The rules for deducting timber-related operating expenses and carrying charges, as set out in Chapter V, apply as well to Christmas tree production if the trees in question are more than 6 years old when cut or sold. Since Christmas tree growing is almost always a business, the favorable rules for deducting business costs are applicable in such cases. However, the passive loss rules (see Chapter V) are also applicable to you or anyone else with an ownership interest in

the Christmas tree farm. Only those who materially participate in the business (see page 28) can deduct current expenses against non-Christmas tree income, unless the other income is passive in nature. The IRS has specifically ruled that shearing and basal pruning costs are deductible business expenses (see summary of Rev. Rul. 71-228, page 91).

Uniform Capitalization Rules

Producers of Christmas trees that are 6 or fewer years of age when sold or cut are subject to the uniform capitalization rules with respect to operating costs and carrying charges. These rules require that preproductive costs must be capitalized if the preproduction period of a crop is more than 2 years. The law, however, permits certain farmers to elect not to have the uniform capitalization rules apply. If the election is made, (1) any gain on the sale of the crop is recaptured as ordinary income to the extent of the deductions permitted by the election, and (2) you must use the alternative depreciation system (straight line method) for all assets placed in service in any year for which the election is in effect.

Timber Sale Income

Income realized from the sale or cutting of Christmas trees is subject to the same rules as for other types of timber. Both Sections 631(a) and 631(b) apply (see Chapter VI). There are, however, some unique aspects of application that must be considered.

Section 1221

As mentioned above, it is theoretically possible for an occasional producer of Christmas trees who sells the standing trees on a lump-sum basis to qualify for capital gains treatment as an investor under Section 1221 (see page 36). In most situations, however, growers will be considered to be in a business. Therefore, you should not rely on Section 1221 if you wish to report sale proceeds as capital gains.

Section 631(b)

If capital gains treatment is desired, you should use the provisions of Section 631(b) for sales of standing trees. In most such cases, the unit of measurement would be either the individual tree or expressed in terms of linear feet. The same rules and procedures apply for Christmas trees as for other timber (see Chapter VI).

Section 631(a)

Section 631(a) will apply to most producers—particularly those who sell cut trees on the wholesale market. It is immaterial whether you cut the trees yourself or hire them cut. Reporting the cutting of Christmas trees as a sale under Section 631(a) is done in exactly the same way as for other types of timber, as discussed in Chapter VI. Thus, the fair market value of the trees before they are cut should be

determined as of the first day of the tax year for the purpose of determining the Section 631(a) gain.

Making the Election—A Section 631(a) election (see page 38) generally can be made for any year. It does not have to be made for the first year of eligibility. Making the election does not limit your options. For example, you may cut Christmas trees under a Section 631(a) election and also dispose of standing Christmas trees under a Section 631(b)-type arrangement in the same year. A grower can also harvest trees under Section 631(a) for a period of years and then begin to "sell" trees under Section 631(b).

The Computation—Often the Section 631(a) fair market value is calculated based on (1) the amount of linear footage harvested times the value per foot, or (2) number of trees harvested times the value per standing tree.

Partnership Considerations—Two or more growers should be careful if they enter into an agreement to grow Christmas trees and harvest the trees themselves. If this results in a partnership for tax purposes, a partnership return must be filed and the Section 631(a) election must be made on the partnership return. An election on the individual returns of the partners is not a valid election.

Determination of Fair Market Value—Difficulty may arise in determining the fair market value of Christmas trees on January 1 of the sale year. The value to be used should be your best estimate of what the trees could be sold for on the first day of the tax year based on their condition on that date. Example X-1 illustrates computation of gains for a Christmas tree operation.

Example X-1

Capital gains on Christmas tree operations: You are a calendar-year taxpayer, and you established 5 Christmas tree plantations in 5 successive years, each comprising 10 acres and each containing 12,000 trees of fast growing pine species. Two-year-old nursery stock was used, so the trees in the first plantation are now above the minimum age (more than 6 years) required to qualify as timber under Section 631(a) of the Internal Revenue Code.

You spent \$1,210 to establish the first plantation. Later, you incurred \$1,060 in capital costs, representing (a) certain carrying charges you had elected to capitalize; and (b) the cost of replanting lost trees. The adjusted basis just before the first cutting in November of that year thus amounted to \$2,270. An inventory showed that there were now 11,000 well-formed trees present. Of these, 6,000 were of sizes to be cut this year and 5,000 were to be left for further growth. A depletion unit of \$0.21 per tree was derived by dividing the \$2,270 adjusted basis by 11,000 trees.

You cut the 6,000 salable trees yourself and delivered them to a wholesaler. You received \$4.30 per tree from the wholesaler. The total cost to you for cutting and delivering the trees was \$1,800. You elect on your tax return to treat the cutting of the trees as a sale under Section 631(a) of the Internal Revenue Code.

The value on January 1 can be estimated by discounting the value when cut for 10 months as follows. Assume the trees were worth \$3.60 each on November 1 when cut and that the applicable local interest rate is 10 percent.

$$\frac{\text{Value}}{(1.0 + (i/12))^{10}} = \frac{\$3.60}{(1 + 0.10/12)^{10}} = \$3.31$$

You determine your taxable gain as follows:

Gain from cutting:

6,000 trees cut with an estimated fair market value of \$3.31 per tree as of January 1	\$19,860
Less:	
Basis for gain or loss at \$0.21 per tree	(1,260)
Gain on timber (taxed as Section 1231 gain)	\$18,600

Gain on sale of trees:

6,000 trees sold for \$4.30 per tree	\$25,800
Less:	
Depletion allowance (Jan. 1 fair market value of \$3.31 per tree)	\$19,860
Cost of cutting and delivery	1,800 (21,660)
Gain from harvesting and delivering (taxed as ordinary income)	\$ 4,140

Example X-2

If you had not harvested the trees but had entered into a cutting contract with a jobber, you would calculate the gain as follows:

6,000 trees sold for \$3.60 per tree	\$21,600
Less:	
Basis for gain or loss at \$0.21 per tree	
Expenses for administering cutting contract	\$1,260
Income	120
	<u>(1,380)</u>
	\$20,220

If the cutting contract qualified as a disposal with an economic interest retained under the provisions of Section 631(b), the \$20,220 would be reported as a Section 1231 gain. Otherwise, this amount would be reported as ordinary income.

Choose and Cut Operations—Typically, “choose and cut” Christmas tree sales do not qualify for capital gains treatment under Section 631(b)—see summary of Rev. Rul. 77-229, page 92. In this type of operation, the grower usually provides a saw to the customer who proceeds to choose and cut a tree. The customer then pays a previously agreed upon price and takes the tree. Under these circumstances, buyers do not have a contract-right-to-cut the tree as required under Section 631(b)—they may choose not to cut and purchase a tree at all, at their option. Although it may be possible for you to establish sales procedures to meet the Section 631(b) requirements, the process would probably not be worth the trouble.

Section 631(a) may be used for most “choose and cut” operations, however. The IRS position is that such sales are of “cut timber” because the buyer never acquires title to or a contract right to cut any tree. The buyer, in effect, acts as the agent of the grower in cutting the tree and purchases a cut Christmas tree.

Chapter XI. Form of Timberland Ownership and Business Organization

The form of ownership in which you hold your woodland property is important from a tax standpoint. Further, if your timberland 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 your forest management goals, size of the property, family considerations, and income needs, among others. In the final analysis, the decision should be based on the facts and circumstances of each personal situation.

Basic Ownership Considerations

Sole Ownership

Ownership of property in one name is normally the simplest type of ownership. Transfers to others can usually be done with a minimum of red tape. Sole ownership typically affords the most complete control possible. In a business, sole ownership means an unincorporated business owned by a single individual (sole proprietor). A significant advantage is that profit or loss from the business can be calculated separately from the owner's other sources of income. An individual whose timberland is structured as a business reports most income and all expenses associated with the forest property as a sole proprietor on either Schedule C or Schedule F of Form 1040. The net income or loss reflected on these forms is then transferred to the first page of Form 1040 for inclusion in gross income.

Co-ownership

The undivided ownership of property by two or more persons is called co-ownership. This method of holding property is often used as a substitute for more complex ownership or business 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 realizing fully what it means in terms of loss of freedom and control. Sales may be difficult to accomplish—one co-owner may want to sell, the other may not.

Tenancy in common—Each tenant in common can sell or divide his/her share and transfer his/her interest as he/she wishes. Upon death of a tenant in common, that person's undivided interest passes to the heirs under State law or provisions of the 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. Upon the death of a joint tenant, that person's undivided interest passes to the surviving joint tenants. This is a fragile device for property ownership.

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

Life Estates

A life estate is a limited property interest. Title to the property is transferred, but the transferor 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 timberland acreage is small and you have only occasional transactions, you are most likely treating it as an investment for tax purposes. If your holdings involve continuous transactions and generate fairly regular income, they may constitute a business. If so, you should evaluate which structure your business should have to best achieve your objectives. A sole proprietorship, as discussed above, is the simplest structure. If others are involved, you may want to form a partnership, incorporate, or consider the new limited liability company form of organization. Tax considerations, although important, are usually only one of the factors that should be analyzed in determining type of organization.

Partnerships

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 is and what is not a partnership have been developed in each State and vary from one State to another. Although usually an oral partnership agreement is valid, it is best to set out all details of the agreement in writing in order to help avoid misunderstandings.

Upon formation, no tax gains or losses are ordinarily recognized with respect to the transfer of assets to the partnership by the partners. The partnership takes the partners' basis (see page 17 for a discussion of basis) for property

transferred to it. The contributions of the partners to the partnership need not be equal. Generally, assets brought into the partnership, or purchased with partnership funds, become partnership property.

Unlimited liability—Except in the case of a limited partnership (discussed below), each partner has unlimited liability for obligations of the partnership. Creditors must first go against the partnership assets; they can then proceed against the assets of the individual partners.

Minors as partners—Financial planning for partners in a family timberland 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 of the woodland. Minors as partners, however, may create problems. They are not legally competent to manage their property 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 and to participate in partnership activities equally with adults.

Partnership taxation—Although a partnership files an income tax return, it is an information return only. Partnerships as entities do not pay taxes themselves. Income and losses are passed through to each individual partner in proportion to his/her interest in the partnership and then entered on their individual returns. Schedule E of Form 1040 is used for this purpose.

Limited Partnerships

A limited partnership is one with one or more general partners and one or more limited 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. They are liable only up to the amount of their investment in the partnership. Because of this status, they have no right of control over the business. A general partner also contributes cash or property but additionally has management rights. The income tax rules with respect to a limited partnership are generally the same as for a general partnership.

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 corporation's most notable feature is the limited liability enjoyed by the shareholders. Legal actions against a corporation are satisfied out of corporate assets—the assets of the shareholders are generally shielded from liability.

Corporate taxation—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. 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 ordinary income is also lower than the maximum noncorporate rate. Corporate capital gains, however, may be taxed as high as 35 percent in contrast to a 28-percent maximum for noncorporate gains. Another major 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 Corporations

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 35 and there are numerous other requirements.

Tax considerations—With a Subchapter S corporation, there is no double taxation as with a normal corporation—that is, no Federal income tax at the corporate level. Corporate earnings, losses, deductions, capital gains, credits, etc., are passed through by means of a corporate information return to the shareholders for inclusion on their individual income tax returns. The shareholders use Schedule E of Form 1040 for this purpose. 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. This is the same treatment as for a partnership. Also, as with a normal corporation, timber never receives a stepped-up basis at the death of a shareholder.

Limited Liability Companies

A limited liability company (LLC) is a hybrid entity that can combine the corporate benefit of limited liability for the 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. There must generally be at least two members. For income tax purposes, an LLC may be classified as a partnership or a corporation, depending on State law requirements and the LLC's operating agreement.

Income tax features—From an income tax perspective, an LLC that is classified as a partnership compares favorably with both Subchapter S corporations and partnerships, but has additional advantages not available with the other two. Like a partnership, an LLC is usually permitted under State law 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 organization's 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 loss rules (see page 28) may risk liability as a general partner for the partnership's obligations.

Other Tax Entities

Estates and trusts represent a special case. They may or may not pay income tax as separate taxable entities. However, if income is retained by either an estate or trust, and not

passed through to the heirs or beneficiaries, a fiduciary income tax return must be filed by the executor of the estate or by the trustee of the trust. The current tax rate structure with its very low thresholds for the higher brackets, discourages retaining income under ordinary circumstances. The 28-, 31-, 36- and 39.6- percent tax rates begin at \$1,500, \$3,500, \$5,500, and \$7,500, respectively.