
Chapter 3. General Tax Considerations

Types of Forest Ownership and Operation

How you treat income and expenses associated with your forest property for tax purposes depends on your purpose for owning the property, your actual use of it, your taxpayer classification with respect to the property, and the nature of the income or expense itself. For example, individuals who hold forest land as an investment or for personal use can fully deduct property tax as an itemized deduction. In contrast, individuals who hold forest land for use in a trade or business can deduct property tax as a business expense, and forest landowners who do not meet the requirements for material participation face restrictions on the amount they can deduct (chapter 4). Continuing the example, only individuals who hold forest land for the production of income can deduct management expenses, such as the cost of protecting their forest from fire—but owners who hold their forest land for personal use cannot. Furthermore, both investors and business owners who do not meet the requirements for material participation face restrictions on how much of such expenses they can deduct (chapter 4).

Income from a hunting lease or other fees you receive for the use of your forest land are considered ordinary income under all types of ownership (chapters 5 and 11). Income from the sale or disposal of timber, however, can qualify as a capital gain. Capital gain status depends on your purpose for holding the timber, how long you have held it, and how you dispose of it. See chapter 5 for a discussion of how to meet the requirements for capital gain treatment.

Purpose for Holding Timber

Forest property can be held for any of the three basic purposes discussed here, or some combination of them.

Personal Use

Property you do not own for the production of income is classified as personal use property. The house and lot you use for your personal residence is an example. Although you might expect to sell it someday for more than you paid, the primary reason you own it is as a place to live. Similarly, you might own forest property primarily as a residence, for personal enjoyment—such as a place to hunt, fish, or pursue other outdoor activities—or as a site for a vacation home.

Investment

If you manage your forest property for the eventual realization of a profit, but it is not your principal—or even a major—source of income, you may be holding it as an investment. Absentee owners often qualify as investors because their management activity does not rise to the level of a trade or business but is motivated primarily by a desire for profit rather than for recreation or other purposes.

Business

If you entered into and carry on the management of your forest property primarily for profit and your activity is more regular and frequent than it might be for an investment, you likely hold it for use in a business. Conversely, you may be holding the timber on your forest land “primarily for sale to customers in the ordinary course of a trade or business.” See chapter 5, “Determining the Type of Gain or Loss.” Two characteristics of a business are (1) regularity of activities and transactions and (2) the production of income (see Internal Revenue Service [IRS] Publication 334, *Tax Guide for Small Business*).

Your relationship with a business in which you own an interest may be either *active* or *passive* in nature.

Active Business Interest. You have an active interest in a business if you *materially participate* in it, that is, you personally participate in the conduct of the business on a regular, continuous, and substantial basis.

Passive Interest. Your interest in a business is passive if you do not materially participate in its operations.

These distinctions in your purpose for holding timber, and their tax implications, are discussed in chapter 4, “The Passive Loss Rules.”

The determination of your primary purpose for holding a forest property is based on the facts and circumstances related to your intended and actual use of the property. No single factor is controlling, but your activities at the time of the determination are very important.

Because of the unique nature of forest property, there are usually elements of personal use associated with property held as an investment or even as part of a trade or business. In your recordkeeping and tax reporting, you should be careful to distinguish between activities associated with profit and those

associated with personal enjoyment. Each expense you deduct should have a clear investment or business purpose, be ordinary and necessary, reasonable in amount, and directly related to the production of income. Your records should be adequate to support the amount and purpose of each deduction (chapter 4).

Types of Taxpayers

There are two basic types of taxpayers: individuals and corporations. Individual taxpayers report income and expenses and compute their tax due on IRS Form 1040: U.S. Individual Tax Return. For tax purposes, there also are two types of corporations, C corporations and Subchapter S corporations. A C corporation reports income and expenses and computes its tax due on IRS Form 1120: U.S. Corporation Income Tax Return. Income the corporation then distributes to its shareholders in the form of dividends is reported on each shareholder's Form 1040, where it may be taxed a second time. In most instances, a corporation that meets the requirements for Subchapter S status avoids the corporate income tax. Income and expenses are passed through to the shareholders and taxed at the individual level, essentially as with a partnership.

Partnerships also file a tax return—IRS Form 1065: U.S. Return of Partnership Income—but it is an information return only. A partnership is a pass-through entity for tax purposes; it reports the income, expenses, and other tax items associated with its activity during the year and how these items have been distributed among its partners. Any tax due is paid at the individual level. Note that joint ownership of property does not necessarily create a partnership for tax purposes. A forest land ownership is taxed as a partnership if its operations are treated as a partnership under the law of the State where the property is located.

Two other forms of business organization have become popular as means for families to hold and manage forest land: the family limited partnership (FLP) and limited liability company

(LLC). An FLP is a type of limited partnership, whereas an LLC is a hybrid organization combining advantages of a corporation and a partnership. Both are pass-through entities for tax purposes. An FLP files as a partnership, using IRS Form 1065. An LLC with more than one member also usually files as a partnership, whereas an LLC with a single member usually files as a sole proprietorship, using IRS Form 1040.

Estates and trusts present a special case. They may or may not pay income tax as a separate entity, depending on their particular situation. If an estate or trust earns or receives income, the executor (for an estate) or trustee (for a trust) must file a fiduciary return—IRS Form 1041: U.S. Income Tax Return for Estates and Trusts. The tax rate structure for income retained by an estate or trust has low thresholds for the higher tax brackets, which encourages passing income through to the beneficiaries rather than retaining it.

Forms of forest land ownership and business organization are discussed in chapter 12.

Structuring Your Timber Activities

It is important for you to consider your ownership and financial goals, the extent of your forest resources, and perhaps other factors before you decide which form of ownership is best for you, as discussed in chapter 12 and illustrated in chapter 15. Once you have made this decision, it should guide you in a consistent approach to managing your forest property, keeping records, and reporting taxes until your circumstances change.

Tax-wise, both the investment and business categories have advantages and disadvantages. Although tax considerations are important, they usually should not be the primary factor that determines which form of ownership to use. You should make that decision only after careful consideration and consultation with your legal, accounting, and forestry advisors.