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## Chapter 10. Christmas Tree Production

### General Considerations

Christmas tree producers are subject to the same Federal income tax provisions as forest owners in general. There are several distinctions that you should be aware of, however. Unless stated otherwise in this discussion, the assumption is that the Christmas trees are more than 6 years old when cut and sold and, therefore, qualify as *timber* for income tax purposes.

Because of the nature of the activity, Christmas tree growing usually constitutes a business rather than an investment. Therefore, sections 631(a) and (b) of the Internal Revenue Code (IRC) are particularly relevant. Sections 631(a) and (b) and the regulations relating thereto (discussed and explained in chapter 5) provide that the term *timber* includes evergreen trees that are 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, but unlikely, that a person who grows and sells standing Christmas trees on an occasional basis could be considered an investor as opposed to the owner-operator of a business. In that case, the rules for investors, instead of those for a business, as discussed in chapters 4 and 5, would apply.

### Treatment of Costs

#### Establishment Costs

The general rule with respect to establishment costs, as discussed in chapter 4, is that all such costs—including replanting—are capital expenditures and must be capitalized to the timber account. This rule applies to Christmas trees exactly as it does to other timber, whether you use the cash method or the accrual method of accounting. The only exception is that Christmas trees do not qualify for the reforestation tax incentives under IRC section 194—deduction and amortization (see chapter 4, “Reforestation Tax Incentives”). All capitalized costs associated with Christmas trees, therefore, are recovered by deducting them at the time of cutting or sale, through timber depletion, unless recovered previously through casualty loss or involuntary conversion (chapter 7).

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 or balled nursery stock? If the trees are harvested or sold within 10 years, any tax saved by taking amortization deductions would be subject to recapture (see chapter 4, “Reforestation Tax Incentives”).

#### Operating Expenses and Carrying Charges

The rules for deducting timber-related operating expenses and carrying charges, as set out in chapter 4, apply as well to Christmas tree production if the trees in question are more than 6 years old when cut or sold. The Internal Revenue Service (IRS) has specifically ruled that shearing and basal pruning costs are deductible business expenses (see the summary of Revenue Ruling (Rev. Rul.) 71-228, appendix A). Because growing Christmas trees is nearly always a business, the rules for deducting business costs are applicable. The passive loss rules also apply to everyone with an ownership interest in the Christmas tree farm. Only those who materially participate in the business can deduct current expenses against non-Christmas tree income, unless the passive owner has passive income to offset passive losses (see chapter 4, “The Passive Loss Rules”).

#### 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 expenses and carrying charges. These rules require that preproductive costs must be capitalized if the preproduction period of a crop is more than 2 years (see IRS Publication 538, *Accounting Periods and Methods*). The law, however, permits certain farmers to elect not to have the uniform capitalization rules apply. If this 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. This election does not apply to Christmas tree growers who sell trees more than 2 years old but not more than 6 years old.

## Treatment of Income

### Christmas Tree Sales Income

Income realized from the sale or cutting of Christmas trees is subject to the same rules as for other types of timber—both IRC section 631(a) and 631(b) apply (chapter 5). There are some unique aspects of Christmas tree production, however, that you should be aware of.

**Outright Sale of Capital Asset.** As mentioned previously, 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 IRC section 1221 (see chapter 5, “Sale of Standing Timber for a Lump Sum”). In most situations, however, growers will be considered to be holding the Christmas trees primarily for sale to customers in the ordinary course of a trade or business, not as a section 1221 capital asset.

**IRC Section 631(b).** If capital gain treatment is desired for trees sold on the stump, you should use the provisions of IRC section 631(b). This means that a designated lot of trees could be sold for a lump sum amount, or sold based on a unit price and the number of units actually cut. In most cases of this kind, the unit of measurement would be either the individual tree or linear feet of tree height.

**IRC Section 631(a).** IRC section 631(a) will apply to most producers, particularly those who sell cut trees on the wholesale

market. It makes no difference whether you cut the trees yourself or pay to have 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 5. Section 631(a) requires that you determine, as of the first day of your tax year, the fair market value (FMV) of the uncut trees.

**Making the Election.** As noted in chapter 5, “IRC Section 631(a) Cutting of Standing Timber With an Election to Treat as a Sale,” an IRC section 631(a) election is binding with respect to all timber cut and converted into products for sale in the year you make the election, and in all subsequent years. As well, your ability to revoke or reinstate a section 631(a) election is limited. You have considerable flexibility, however, in making the initial election. You are not required to make it in the year you first establish Christmas trees or even the year you first cut trees for sale. Also, making the election does not limit your options. You may, for example, cut Christmas trees for sale—or pay an operator to cut them for you—under a section 631(a) election and also dispose of standing Christmas trees under an IRC section 631(b)-type arrangement in the same year. Alternatively, you may sell standing trees lump-sum under section 631(b) for a number of years, then begin cutting trees for sale on the wholesale market under section 631(a).

**The Computation.** Often the IRC section 631(a) FMV is calculated based on (1) the amount of linear footage harvested, times the value per foot or (2) the number of trees harvested, times the value per standing tree (see Example 10.1).

#### Example 10.1.—Application of IRC Section 631(a) to Christmas Trees.

You are a calendar year taxpayer who established 5 Christmas tree plantations in 5 successive years, each comprising 10 acres and each containing 12,000 trees of a fast growing pine species. Two-year-old nursery stock was used, so the trees in the first plantation are now older than the minimum age (more than 6 years) required to qualify as timber under IRC section 631(a).

You spent \$1,210 to establish the first plantation. Later, you incurred \$1,060 in capital costs, representing (1) certain carrying charges you had elected to capitalize, and (2) the cost of replanting lost trees. The adjusted basis directly before the first cutting in November of that year thus amounted to \$2,270 (\$1,210 + \$1,060). An inventory showed that 11,000 well-formed trees were now 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 the 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).

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 ( $i$ ) is 6 percent.

$$\frac{\text{Value}}{[1 + (i \div 12)]^{10}} = \frac{\$3.60 \text{ per tree}}{[1 + (0.06 \div 12)]^{10}} = \$3.42 \text{ per tree}$$

You determine your taxable gain as follows:

Gain from cutting:	
6,000 trees cut with an estimated FMV of \$3.42 per tree as of Jan. 1 .....	\$ 20,520
Less depletion allowance of \$0.21 per tree.....	– 1,260
Gain on timber (taxed as IRC section 1231 gain) .....	\$ 19,260
Income on sale of trees:	
6,000 trees sold for \$4.30 per tree .....	\$ 25,800
Less FMV of the trees sold (Jan. 1 value of \$3.42 per tree) ....	– 20,520
Less cost of cutting and delivery.....	– 1,800
Income from harvesting and delivering (taxed as ordinary income).....	\$ 3,480

**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 the agreement results in a partnership for tax purposes, a partnership return must be filed, and the IRC 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 (see, however, chapter 9, “Qualified Joint Ventures”).

**Determination of Fair Market Value.** Difficulty may arise in determining the FMV 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 10.1 illustrates a recommended procedure for the computation of gains for a Christmas tree operation. Example 10.2 illustrates the tax treatment of trees sold on the stump to a jobber.

Example 10.2.

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 depletion allowance of \$0.21 per tree.....	- 1,260
Less expenses for administering cutting contract.....	- 120
Income.....	\$ 20,220
If the cutting contract qualified as a disposal under the provisions of IRC section 631(b), the \$20,220 would be reported as a capital gain. Otherwise, it would be reported as ordinary income.	

## Choose and Cut Operations

“Choose and cut” Christmas tree sales typically do not qualify for capital gain treatment under IRC section 631(b) (see the summary of Rev. Rul. 77-229, appendix A). In this type of operation, the grower usually provides a saw to the customer who proceeds to choose and cut his or her own tree. The customer then pays a previously agreed-upon price and takes ownership of 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 election. 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.

Although it may be possible for you to establish an onsite sales procedure to meet the IRC section 631(b) requirements, the process probably would not be worth the trouble. Choose-and-cut operators who want capital gain treatment should elect to treat the cutting as a sale under IRC section 631(a).

