

---

## Chapter 12. Form of Forest Land Ownership and Business Organization

The form of ownership in which forest property is held is important from a tax standpoint. Furthermore, if the forest property is operated as a business, the type of business organization chosen also has significant tax implications. In addition, nontax factors can influence the choice of an ownership or business format. These factors include forest management goals, size of the property, family considerations, and income needs—among other things. In the final analysis, the decision should be based on the facts and circumstances of each particular situation.

### Basic Ownership Considerations

#### Sole Ownership

Ownership of property in one name normally is the simplest type of ownership. Transfers to others usually can be done with a minimum of red tape. Sole ownership also 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 forest land is structured as a sole proprietorship reports ordinary income and most expenses associated with the property on Internal Revenue Service (IRS) Form 1040, Schedule C or F, as appropriate. Timber sale receipts that qualify as capital gains are reported as discussed in chapter 5. The net income or loss reflected on these forms is then transferred to the first page of IRS 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 often is used as a substitute for more complex ownership or business arrangements. Transfer of an undivided co-ownership interest at death usually can be done easily and inexpensively; however, there are disadvantages. Individuals often become involved in co-ownership without fully realizing what it means in terms of loss of freedom and control. Sales may be difficult to accomplish—one co-owner may want to sell, whereas the other may not. The laws governing co-ownership vary widely among the States. The three basic forms of co-ownership are tenancy

in common, joint tenancy, and tenancy by entirety. Legal counsel is highly recommended in deciding the best form to use.

**Tenancy in Common.** Each tenant in common can sell, gift, or divide his or her share and transfer his or her interest as he or she wishes. Upon death of a tenant in common, that person's undivided interest passes to the heirs under State law or to the legatees under provisions of a will.

**Joint Tenancy.** This arrangement sometimes is called joint tenancy with right of survivorship. A joint tenant can sell or gift his or 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 tenant(s). Joint tenancy is a fragile device for property ownership and should be used cautiously.

**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. Unlike joint tenancy, however, tenancies by the entirety generally are not severable by action of one of the co-owners. Normally, they can be created only for real estate.

#### Life Estates

A life estate is a limited property interest. Title to the property is transferred, but the life tenant (either the transferor or another designated person) retains for a specified period of time the right to use, enjoy, and receive income from the transferred property. A life estate usually includes the right to cut and sell timber; however, most States have developed their own specific legal rules as to a life tenant's exact timber rights.

In addition to rights, 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

The nine community property States are: 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, one-half owned by each spouse in undivided ownership.

---

## Business Management Organization

If a forest property is small and yields only occasional timber sales, the property most likely is being treated as an investment for tax purposes. If, however, the holdings involve continuous transactions and generate fairly regular income, they may constitute a business. In that case, an evaluation should be made as to what ownership structure the business should have to best achieve the owner's objectives. A sole proprietorship, as discussed previously, is simplest. If other persons are involved, a partnership, limited liability company, or corporation may be a better option. Tax considerations, although important, are usually only one of the factors that should be taken into consideration in determining the type of business organization.

### Partnerships

A partnership generally is 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 is not a partnership have been developed in each State and vary from one State to another. Although an oral partnership agreement usually is valid, it is best to set out all details of the agreement in writing to help avoid misunderstandings. A co-ownership arrangement, such as one of the types discussed previously, may be held to be a partnership for tax purposes upon audit by the IRS, even if not formally structured as a partnership under State law. The determination depends on the facts and circumstances applicable to the co-ownership (see, however, chapter 9, "Qualified Joint Ventures").

Upon formation, no income tax gains or losses ordinarily are recognized with respect to the transfer of assets to the partnership by the partners. The partnership takes the partners' basis (see chapter 5 for a discussion of basis) for property transferred to it. The contributions of the partners to the partnership need not be equal. In general, assets brought into the partnership, or purchased with partnership funds, become partnership property.

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

**Minors as Partners.** Financial planning in a family forest land partnership often involves the transfer of partnership interests

to minors. Such transfers are made for various reasons—including reduction of the family income tax bill, to lower death taxes, and to interest and involve older children in management of the forest land. 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. An additional caution is that the unearned income of minors may be taxed at the parent's income tax rate, as detailed in IRS Publication 17, *Your Federal Income Tax*.

**Partnership Taxation.** Although a partnership files an income tax return, IRS Form 1065: U.S. Return of Partnership Income, it is an information return only. Partnerships as entities do not pay taxes themselves. Income and losses are passed through to each individual partner on Schedule K-1 of Form 1065 in proportion to his or her interest in the partnership, and then entered on the partners' individual returns. IRS Form 1040, Schedule E, is used for most pass-through items.

### Limited Partnerships

A limited partnership has one or more general partners, and one or more limited partners. In many cases, it can be an ideal arrangement for family-owned forest land. A limited partner is one who contributes cash and/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 operation of the business and no management rights. A general partner may also contribute cash and/or property, but in addition, has management rights and thus is personally liable for partnership debts. The income tax rules with respect to a limited partnership essentially are the same as for a general partnership.

### Corporations

A corporation is a separate legal entity that has most of the rights of an individual. Formed under State law, it is owned by its shareholders and 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 generally are shielded from liability.

---

**Corporate Taxation.** A corporation reports income and expenses and computes its tax due on IRS Form 1120: U.S. Corporation Income Tax Return. A major tax disadvantage with respect to a corporation is that earnings are taxed at the corporate level when earned and again at the shareholder level when received as dividends. Paying earnings as salaries to shareholder-employees may eliminate some of the double taxation problem, however, because 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 some taxes.

Another disadvantage is that corporate capital gains may be taxed as high as 35 percent in contrast to a 15-percent maximum for noncorporate capital gains. In addition, timber held by a corporation never receives a stepped-up basis because it is corporate stock shares—not the underlying timber assets—that are passed to heirs upon the death of a shareholder.

## 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 IRS Form 2553: Election by a Small Business Corporation. The number of shareholders in a Subchapter S corporation is limited to 100, and numerous other requirements and restrictions exist.

**Tax Considerations.** In general, with a Subchapter S corporation no Federal income tax is paid at the corporate level—that is, a Subchapter S corporation is not subject to double taxation as is a normal corporation, known as a C corporation. Corporate earnings, losses, deductions, capital gains, credits, and so forth, are passed through to the shareholders using IRS Form 1065, Schedule K-1, as with a partnership—although it is done by means of an information return, IRS Form 1120-S: U.S. Income Tax Return for an S Corporation, which the corporation files with the IRS. The individual shareholders report most of the pass-through items on IRS Form 1040, Schedule E, also 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. The earnings of a Subchapter S corporation are taxed each year to the shareholders, whether actually distributed or not. This again is the same treatment as with a partnership. Furthermore, as with a C corporation, timber held by a Subchapter S corporation does not receive 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. An LLC generally has at least two members, although most States now permit one-member LLCs. For income tax purposes, an LLC may elect to be classified as either 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 those forms of organization. Like a partnership, an LLC usually is 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. Any 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 chapter 4) may risk incurring personal liability as a general partner for the partnership's obligations.

## Other Tax Entities

Forest land also may be held by an estate or a nongrantor trust (a trust that is taxed separately from the person who established the trust). These entities are special cases. If income is retained by either an estate or a nongrantor trust and not passed through to the heirs or beneficiaries, the executor of the estate or the trustee of the trust must file a fiduciary return, IRS Form 1041: U.S. Income Tax Return for Estates and Trusts. The current tax rate structure, with its very low thresholds for the higher brackets, discourages retaining income under ordinary circumstances. For 2012, the 25-, 28-, 33-, and 35-percent tax brackets begin at \$2,400; \$5,600; \$8,500; and \$11,650 of income, respectively (see table 5.1).

