

Chapter 10. Other Tax Considerations

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 1 tax year. The installment sale provisions also may be beneficial if you sell your forest land. If your activities are subject to the passive activity loss rules and you sell your forest land, special rules will apply, as discussed in IRS Publication 925, *Passive Activity and At-Risk Rules*.

The receipt of payments in more than 1 tax year could arise from either a lump-sum or a “pay-as-cut” contract. A typical lump-sum sales contract might require an initial downpayment, a minimum annual payment, and payment in full before timber cutting starts. A typical pay-as-cut contract might require an initial downpayment 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 6.

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, such as those made by timber dealers. However, 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 (Code). The installment sale provisions do not apply to rent received from a forest land 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. You may, however, elect out of the installment sale provisions by reporting the full fair market value of the contract in the 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.
3. Stated or unstated interest.

Any interest included in a payment is reported separately as ordinary income. This also is 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 1 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-share payments from gross income, some of the gain will be reportable as ordinary income (see pages 28 and 61).

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 10-1.

Example 10-1

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 ($\$10,000 - \$2,000 - \500) and your gross profit percentage is 75 percent ($\$7,500 \div \$10,000$). After subtracting out interest, 75 percent of each payment, including the downpayment, 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 that 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 owed on the timber. If the buyer pays any of your selling expenses for you, that amount also is 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 recalculated. 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 45. 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 downpayment 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 instead rely 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 usually will preclude installment reporting.

Electing Out. You can choose not to have the installment sale 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 on 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 installment sales. 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 calculate imputed interest. The imputed interest rules do not apply, however, if the sale price will not exceed \$3,000. 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 \$3,723,800, 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 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 in 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. IRS Publication 537, *Installment Sales*, 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 on Form T in the year it takes place, as discussed on page 46.

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 FOR INDIVIDUALS

The purpose of the alternative minimum tax (AMT) for individuals is to make certain that if your “regular tax” is reduced because of certain tax benefits, you will pay at least a minimum amount of tax. You owe AMT only if your tentative minimum tax (TMT), which is generally the tax computed on taxable income determined without these tax benefits, exceeds your regular tax. The total tax you owe includes both your regular tax and your alternative minimum tax. Your alternative minimum tax calculations are made on Form 6251, “Alternative Minimum Tax—Individuals.” While not discussed here, corporations are also subject to the alternative minimum tax, although there is an exemption for certain small corporations. A summary of the alternative minimum tax calculations is set forth below.

Your potential liability for the alternative minimum tax depends on the structure of your timber activities, your other sources of income and losses, and the business and itemized deductions you claim. Capital gains on timber disposals do not generate a tax preference subject to the AMT, nor does deducting the allowable basis for timber sold on the stump or 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 resulting from other tax preference items. This could be the case if your income is increased above the exemption amounts specified for the alternative minimum tax.

Deduction of your forest management expenses may trigger an alternative minimum tax liability. This could happen if you recover your expenses as miscellaneous itemized deductions on Schedule A of Form 1040, discussed in more detail on page 42. Also, if you are not materially participating in the conduct of your timber business, as discussed on page 41, the passive activity gain or loss generated by your timber activity must be recomputed for AMT purposes by taking into

account the AMT adjustments and preferences (see the discussion below relating to AMT calculation). AMT liability could be triggered if you have an allowable AMT loss that is less than the allowable regular tax loss, you have a regular tax gain that is less than your AMT gain, or you have an allowable loss for regular tax purposes but a gain for AMT purposes. For additional information, see the instructions for Form 6251.

A worksheet in your tax booklet will alert you if you may need to file Form 6251. Refer to the Form 6251 instructions to determine whether or not you need to file the form. Note that the discussion in the instructions regarding adjustments to depletion deductions (line 8) and adjustments to gain or loss (line 9) does not apply to timber depletion deductions, gains, or losses resulting from a sale or disposition of timber.

Alternative Minimum Tax Calculation

Your alternative minimum tax is calculated by first determining alternative minimum taxable income (AMTI). AMTI is your taxable income computed with the AMT adjustments and preferences. For this purpose, AMT adjustments and preferences are income and deduction items that are treated differently (generally less favorably) in computing AMTI than the manner in which they are treated in computing regular taxable income. For example, the standard deduction allowed in computing regular taxable income is not allowed in computing AMTI. If you itemize your deductions, medical expenses not compensated for by insurance are deductible in computing regular taxable income to the extent that medical expenses exceed 7.5 percent of adjusted gross income (AGI). In computing AMTI, medical expenses not compensated for by insurance are deductible to the extent that medical expenses exceed 10 percent of AGI. State income taxes and property taxes deductible in computing regular taxable income are not deductible in computing AMTI. Also, in computing AMTI, miscellaneous itemized deductions are not allowed. There also are adjustments and preferences (that is, different treatment in computing AMTI) for depreciation, tax shelter farm losses, incentive stock options, and certain types of tax-exempt interest. In computing AMTI, you deduct your alternative tax net operating loss deduction, not your regular tax net

operating loss deduction. Consult Form 6251 and its instructions for a complete list of AMT adjustments and preferences and the manner in which they are computed.

To calculate the alternative minimum tax once your AMTI has been determined:

1. Subtract your exemption amount from your AMTI. Your exemption amount is \$45,000 if married filing jointly or a surviving spouse, \$33,750 if not married and not a surviving spouse, or \$22,500 if married filing separately. Your exemption amount is reduced (but not below zero) by \$0.25 for each dollar that your AMTI exceeds \$150,000 if married filing jointly or a surviving spouse, \$112,500 if not married and not a surviving spouse, or \$75,000 if married filing separately. The instructions to Form 6251 include an Exemption Worksheet to assist you with this calculation.
2. If the balance from step 1 is \$175,000 or less (\$87,500 or less if married filing separately), multiply the balance by 0.26. If the balance from step 1 exceeds \$175,000 (\$87,500 if married filing separately), multiply the balance by 0.28 and subtract \$3,500 (\$1,750 if married filing separately). If you have capital gain distributions or complete Schedule D of Form 1040 in calculating your regular tax, you should refer to Form 6251, Part IV, for the calculation of this step.
3. From the balance in step 2, subtract your alternative minimum tax foreign tax credit, if any, to arrive at your tentative minimum tax. Refer to Form 6251 and its instructions for an explanation of the alternative minimum tax foreign tax credit.
4. Your AMT is the amount by which your tentative minimum tax exceeds your regular tax. Your total tax liability includes both your regular tax and your AMT.

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 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 for the year from self-employment of \$400 or more. The self-employment tax is composed of two parts. The tax rate is 15.3 percent (12.4 percent Social Security tax plus 2.9 percent Medicare tax). Net earnings from self-employment up to \$72,600 for 1999 are subject to the Social Security portion of the tax. If you also earn wages as an employee in 1999 that are subject to Social Security tax, only the first \$72,600 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 who owns 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 a 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 89. 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 gain treatment. Gains from the sale or other disposal of standing timber generally qualify for capital gain 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 if you dispose of it under the provisions of Section 631 (b), as discussed on pages 51 and 53. If you cut the timber yourself or have a contract logger cut it for you, and you elect to treat the cutting as a sale under the provisions of Section 631 (a), as discussed on page 55, 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 92, and therefore not be subject to the self-employment tax.

Other 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 therefore are included in self-employment income.

Cost-Share Payments. Net payments received under the Agricultural Conservation Program (ACP), Forestry Incentives Program (FIP), Stewardship Incentives Program (SIP), Wetlands Reserve Program (WRP), Environmental Quality Incentives Program (EQIP), or Wildlife Habitat Incentives Program (WHIP), as well as those received under certain State cost-share programs, are included in self-employment income if your activity is considered a business, unless you specifically elect to exclude the payments from your 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 58. Only the portion actually excluded from taxable income may be excluded from self-employment income.

Cost-share payments received under the Conservation Reserve Program (CRP) generally are included in self-employment income. CRP cost-share payments currently do not qualify for income tax exclusion under the rules discussed on page 59. However, rental payments received under the CRP program may be excludable. If the payments are treated as a conservation expense under Section 175 of the Internal Revenue Code (Code), as discussed on page 25, 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 self-employment tax, and also have income from a trade or business, you do not pay Social Security 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 1999, you receive a quarter of a Social Security credit for each \$740 of income earned during the year that is subject to the Social Security tax. This amount is increased annually and is available from your local Social Security office and on the Social Security Internet site, at <http://www.ssa.gov>. If you are not certain that you will qualify for full benefits upon retirement, you can check on your status by contacting the Social Security Administration Office listed in your telephone book under "United States Government, Social Security Administration."

If you need to make additional contributions, you may prefer not to elect under Section 631 (a) to treat the cutting of timber as a sale, for the sake of obtaining benefits. If you are a farmer who cuts and sells timber, 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 IRS permission. There is a one-time exception to this rule, however, as discussed on page 57.

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 53, 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. Capital gains cannot be reported as self-employment income simply to receive Social Security credit.

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 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 paid by the employer, not withheld from the employee's wages.

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. IRS 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, a partner, or an agent.

The IRS has developed a set of 20 factors to use as a guide in determining whether a worker is an employee or an independent contractor. These factors, described in IRS Publication 15-A, *Employer's Supplemental Tax Guide*, can help ascertain whether sufficient control is present to establish an employer-employee relationship. The 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 fall into three categories.

Behavioral Control

Facts that show whether the business has a right to direct and control how the worker does the task for which the worker is hired include the type and degree of:

- Instructions the business gives the worker. An employee generally is subject to instructions about when, where, and how to work. Even if no instructions are given, sufficient behavioral control may exist if the employer has the right to control how the work is done.
- Training the business gives the worker. An employee may be trained to perform services in a particular manner. Independent contractors ordinarily use their own methods.

Financial Control

Facts that show whether the business has a right to control the business aspects of the worker's job include:

- The extent to which the worker has unreimbursed business expenses. Independent contractors are more likely than employees to have unreimbursed business expenses. Fixed ongoing costs that are incurred regardless of whether work currently is being performed are especially important. However, employees also may incur unreimbursed expenses in connection with the services they perform for their business.
- The extent of the worker's investment. An independent contractor often has a significant investment in the facilities he or she uses in performing services for someone else. However, a significant investment is not required.

- The extent to which the worker makes services available to other businesses in the relevant market.
- How the business pays the worker. An employee generally is paid by the hour, week, or month. An independent contractor usually is paid by the job. However, it is common in some professions, such as consulting forestry, to pay independent contractors hourly.
- The extent to which the worker can realize a profit or incur a loss. An independent contractor can make a profit or loss.

Type of Relationship

Facts that show the parties' type of relationship include:

- Written contracts describing the relationship the parties intend to create.
- Whether the business provides the worker with employee-type benefits. Employee-type benefits include insurance, a pension plan, vacation pay, or sick pay.
- The permanency of the relationship. If the employer encourages a worker with the expectation that the relationship will continue indefinitely, rather than for a specific project or period, this generally is considered evidence of

an intent to create an employer-employee relationship.

- The extent to which services performed by the worker are a key aspect of the regular business of the company. If a worker provides services that are a key aspect of the employer's regular business activity, it is more likely that the employer will have the right to direct and control his or her activities. For example, if a consulting forestry firm hires a forester to mark timber for its clients, it is likely that the firm will present the forester's work as its own and would have the right to control or direct that work. This would indicate an employer-employee relationship.

If you pay a worker for services rendered on your forest land and you are not sure whether the payee is an employee, you can obtain an IRS ruling by filing Form SS-8, "Determination of Employee Work Status for Purposes of Federal Employment Tax and Income Tax Withholding."

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 amount paid. This return must be filed with the IRS by March 1 of the following year, with a copy to the payee by January 31.