

## Chapter 11. Christmas Tree Production

### GENERAL CONSIDERATIONS

Most Christmas tree producers are subject to the same Federal income tax provisions as forest owners in general. There are, however, several important distinctions. 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 tax purposes.

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 (Code) is particularly relevant. Both Section 631 and the regulations relating thereto (discussed and explained in Chapter 6) 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, 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 elsewhere in this handbook, would apply.

### TREATMENT OF COSTS

#### Establishment Costs

The general rule with respect to establishment costs, as discussed in Chapter 5, is that all such costs—including replanting—are capital expenditures and must be capitalized to the timber account. This applies to Christmas trees, just 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 amortization and tax credit. 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 or balled nursery stock? The issue is more-or-less moot because of recapture provisions. If the trees are harvested or sold within 10 years, the amortization deduction would be subject to the amortization recapture rules (see page 28). If harvested or sold within 5 full years, the tax credit recapture rules also would apply (see page 29).

#### Operating Expenses and Carrying Charges

The rules for deducting timber-related operating expenses and carrying charges, as set out in Chapter 5, apply as well to Christmas tree production if the trees in question are more than 6 years old when cut or sold. The IRS has specifically ruled that shearing and basal pruning costs are deductible business expenses (see the summary of Revenue Ruling 71-228, page 139). Because Christmas tree growing is almost always a business, rules for deducting business costs are applicable. The passive loss rules (see Chapter 5) also apply to everyone with an ownership interest in the Christmas tree farm. Only those who materially participate in the business (see page 40) can deduct current expenses against non-Christmas tree income, unless the passive owner has passive income to offset passive losses.

#### 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 (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 Sections 631 (a) and 631 (b) apply (see Chapter 6). There are, however, some unique aspects of Christmas trees 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 52). 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.

**Section 631 (b).** If capital gain treatment is desired, you should use the provisions of Section 631 (b) for sales of uncut trees. In most such cases, the unit of measurement would be either the individual tree or linear feet of tree height. The same rules and procedures to qualify as a disposal with an economic interest retained apply for Christmas trees as for other timber (see Chapter 6).

**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 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 6. Section 631 (a) requires that you determine, as of the first day of your tax year, the fair market value of the uncut trees.

- **Making the Election.** A Section 631 (a) election (see page 56) 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 also can 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) the 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 11-1 illustrates a recommended procedure for the computation of gains for a Christmas tree operation.

**Example 11-1**

You are a calendar-year taxpayer who established five 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 above the minimum age (more than 6 years) required to qualify as timber under Section 631 (a) of the Internal Revenue Code (Code).

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 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 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) of the Internal Revenue Code (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 (i) is 6 percent.

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

You determine your taxable gain as follows:

**Gain from cutting:**

6,000 trees cut with an estimated fair market value of \$3.42 per tree as of January 1 . . . . .	\$ 20,520
Less depletion allowance of \$0.21 per tree . . . . .	<u>- 1,260</u>
Gain on timber (taxed as Section 1231 gain) . . . . .	\$ 19,260

**Gain on sale of trees:**

6,000 trees sold for \$4.30 per tree . . . . .	\$ 25,800
Less fair market value of the trees sold (Jan. 1 value of \$3.42 per tree) . . . . .	- 20,520
Less cost of cutting and delivery . . . . .	<u>- 1,800</u>
Gain from harvesting and delivering (taxed as ordinary income) . . . . .	\$ 3,480

**Example 11-2**

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 .....	<u>- 120</u>
Income .....	\$ 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 capital gain. Otherwise, it would be reported as ordinary income.

**Choose and Cut Operations**

Typically, “choose and cut” Christmas tree sales do not qualify for capital gain treatment under Section 631 (b) (see the summary of Revenue Ruling 77-229, page 141). 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 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 procedures to meet the 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 Section 631 (a).