Chapter 12. Form of Forest Land Ownership and Business Organization

The form of ownership in which you hold your woodland property is important from a tax standpoint. Further, if your woodland is structured as a business, the type of business organization chosen also has significant tax implications. Additionally, nontax factors bear on choosing an ownership and/or business format. These include your forest management goals, size of the property, family considerations, and income needs, among others. In the final analysis, the decision should be based on the facts and circumstances of each personal situation.

Basic Ownership Considerations

Sole Ownership

Ownership of property in one name is normally the simplest type of ownership. Transfers to others usually can be done with a minimum of red tape. Sole ownership 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 business reports most income and all expenses associated with the forest property as a sole proprietor on either Schedule C or Schedule F of Form 1040. The net income or loss reflected on these forms then is transferred to the first page of 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. There are disadvantages, however. Individuals often become involved in co-ownership without realizing fully what it means in terms of loss of freedom and control. Sales may be difficult to accomplish—one co-owner may want to sell while the other may not. The laws governing co-ownership vary widely among the States.

Tenancy in Common. Each tenant in common can sell 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 tenants. This is a fragile device for property ownership.

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. However, unlike joint tenancy, 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 transferor or other designated person (the life tenant) retains for a specified period of time the right to use, enjoy, and receive income from the property transferred. In addition to rights, however, 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

There are nine community property States: 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 (half owned by each spouse).

Business Management Organization

If your forest land acreage is small and you have only occasional transactions, you most likely are treating it as an investment for tax purposes. If your holdings involve continuous transactions and generate fairly regular income, they may constitute a business. If so, you should evaluate which structure your business should have to best achieve your objectives. A sole proprietorship, as discussed above, is the simplest structure. If others are involved, you may want to form a partnership, incorporate, or consider the new limited liability company form of organization. Tax considerations, although important, usually are only one of the factors that should be analyzed in determining type of 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 what 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 in order to help avoid misunderstandings. A co-ownership arrangement 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.

Upon formation, no tax gains or losses are ordinarily recognized with respect to the transfer of assets to the partnership by the partners. The partnership takes the partners' basis (see page 21 for a discussion of basis) for property transferred to it. The contributions of the partners to the partnership need not be equal. Generally, assets brought into the partnership, or purchased with partnership funds, become partnership property.

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

Minors as Partners. Financial planning for partners in a family forest land partnership often involves the transfer of partnership interests to minors, to reduce the family income tax bill, to lower death taxes, or to involve older children in management of the woodland. 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.

Partnership Taxation. Although a partnership files an income tax return, it is an information return only. Partnerships as entities do not pay taxes themselves. Income and losses are passed through to each individual partner in proportion to his or her interest in the partnership and then entered on their individual returns. Schedule E of Form 1040 is used for this purpose.

Limited Partnerships

A limited partnership is one with 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 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 the business. A general partner also contributes cash or property, but additionally has management rights. The income tax rules with respect to a limited partnership are generally the same as for a general partnership.

Corporations

A corporation is a separate legal entity that has most of the rights of an individual. It is owned by its shareholders and is 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 major tax disadvantage is that earnings are taxed at the corporate level when earned and again at the shareholder level when received as dividends. However, paying earnings as salaries to shareholder-employees may eliminate some of the double taxation problem 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 taxes. Also, the maximum corporate Federal income tax rate for ordinary income is lower than the maximum noncorporate rate. Corporate capital gains, however, may be taxed as high as 35 percent in contrast to a 20-percent maximum for noncorporate gains. Another major disadvantage is that timber held by a corporation never receives a stepped-up basis because corporate stock shares are inherited at the death of a shareholder, not the underlying timber assets.

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 Form 2553 with the IRS. The number of shareholders is limited to 75, and there are numerous other requirements.

Tax Considerations. With a Subchapter S corporation, there is no double taxation as with a normal corporation—that is, no Federal income tax at the corporate level. Corporate earnings, losses, deductions, capital gains, credits, and so forth, are passed through by means of a corporate information return to the shareholders for inclusion on their individual income tax returns. The shareholders use Schedule E of Form 1040 for this purpose; the procedure is the same 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—they are taxed each year to the shareholders whether actually distributed or not. This is the same treatment as for a partnership. Also, as with a normal corporation, timber never receives 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. There generally must be at least two members although a number of States now permit one-member LLC's. For income tax purposes, an LLC may be classified as 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 the other two. 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. An 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 page 40) may risk liability as a general partner for the partnership's obligations.

Other Tax Entities

Estates and trusts represent a special case. They may or may not pay income tax as separate taxable entities. However, if income is retained by either an estate or trust and not passed through to the heirs or beneficiaries, a fiduciary income tax return must be filed by the executor of the estate or by the trustee of the trust. The current tax rate structure, with its very low thresholds for the higher brackets, discourages retaining income under ordinary circumstances. For 1999, the 28-, 31-, 36-, and 39.6-percent tax brackets begin at $1,750, $4,050, $6,200, and $8,450 of income, respectively.