Chapter 4. General Tax Considerations

Types of Forest Ownership and Operation

How you may treat the expense and income items associated with your woodland depends on your purpose for owning the property, your use of it, your taxpayer classification with respect to the property, and the nature of the expense or income item itself. For example, property tax payments on nonbusiness property (personal or investment) are deductible by individual taxpayers because they are among the allowable itemized deductions for individuals. Property tax expenditures on business property are deductible business costs. The expenses of protecting your woodland from fire, however, can be deducted only if you hold the property for the production of taxable income, either as an investment or as a business. If you do not materially participate in the business, the passive loss rules, discussed on page 40, will apply.

Hunting lease income or other fees received for using your land are ordinary income under all types of ownership. Income from the disposition of timber, however, may qualify for long-term capital gain treatment. Capital gain status depends on how long you have owned the timber, how it is disposed of, and whether or not you hold it as an investment or as part of a business. See Chapter 6 for a detailed discussion of how to meet the qualifications for capital gain treatment.

Purpose for Holding Timber

Timber property essentially can be held for one of the three basic purposes discussed below, or some combination of them.

Personal Use. Property not used to produce income is classed as being held for personal use. The house and land that serve as your residence is an example. Even though you might expect to sell it some day for more than you paid, the primary reason for having a residence is to give you a place to live. Likewise, you may own forest property primarily as a residence, for personal enjoyment—such as for hunting, fishing, or other recreational pursuits—or as a second-home site.

Investment. Woodland used to produce income may in many cases be investment property rather than a business. If timber production is not your principal—or a major—source of income, but you otherwise manage the property for the eventual realization of a profit, you may be holding it as an investment. Absentee owners often qualify as investors because their timber-related activities are motivated primarily by profitability rather than by other purposes.

Business. Property is considered as held for use in a business if it is part of an activity entered into and carried out for profit on a more regular basis than in the case of an investment. In addition, you may be holding your timber “primarily for sale” to customers in the ordinary course of a trade or business. Two characteristic elements of a business are: (1) regularity of activities and transactions and (2) the production of income (see IRS Publication 334, *Tax Guide for Small Business*, Chapter 1). Your relationship with any business in which you own an interest is considered to be either “active” or “passive” in nature.

Active Business Interest. You are actively engaged in a business if you “materially participate” in conducting it. To materially participate, you must personally participate on a regular, continuous, and substantial basis in the conduct of the activity.

Passive Interest. Your relationship with your trade or business is passive if you do not materially participate in its operations.

These distinctions are discussed in more detail in Chapter 5.

The determination of your primary reason for holding a particular woodland property is based on all the facts and circumstances related to your intended and actual use of the property. No single factor is controlling, but your activities at the time of determination are very important. Because of the unique nature of most forest property, there usually are elements of personal use associated with its status as an investment or as a business. You should be careful to distinguish those activities associated with profit from those associated with personal pleasure in your recordkeeping and tax reporting. That is, you should have a clear business or investment purpose for each deduction taken. Adequate records should be kept as proof.

Types of Taxpayers

The two basic types of taxpayers are individual and corporate. An individual engaged in a business as a sole proprietor reports all income except capital gains and all expenses on either Schedule C or Schedule F of Form 1040. The net income (or loss) from these forms is transferred to the first page of Form 1040 for inclusion in the taxpayer's gross income. Investment income from timber is virtually always a capital gain.

Although partnerships file tax returns, they are information returns only. Partnerships do not pay taxes themselves. Information returns report the income and other tax items associated with the activity for the year and how these items have been distributed (passed through) to the individual partners. Income from all sources is consolidated on the individual tax return, and the appropriate individual tax rate is then applied to total taxable income. Note that joint ownership of property does not necessarily create a partnership for tax purposes. A partnership for tax purposes exists if two or more persons or other legal entities join together to carry on a trade or business, or investment, with each contributing to the venture and each expecting to share in the profits and losses of the activity. A woodland ownership may be a partnership if its operations are treated as a partnership under the law of the State where the property is located.

Certain corporations may elect to be taxed as partnerships. Corporations making this election are referred to as Subchapter S corporations. Those not making the election are referred to as C corporations.

Individual taxpayers report their portion of partnership or Subchapter S corporation income (or loss) on Form 1040, Schedule E. Net income (or loss) from Schedule E then is transferred to the first page of Form 1040 for inclusion in the taxpayer's gross income.

A new organizational structure called a limited liability company (LLC) now is permitted in all States. It provides the limited liability of a corporation and the pass-through tax treatment of a partnership.

Estates and trusts represent a special case. They may or may not pay income tax as separate taxable entities, depending on the particular circumstances involved. However, if income is earned or received by either an estate or a trust, a fiduciary return must be filed by the executor of the estate or by the trustee of the trust. The current rate structure for retained income, with very low thresholds for the higher income tax brackets, encourages passing income through under ordinary circumstances rather than retaining it. See IRS Publications 448, *Federal Estate and Gift Taxes,* and 559, *Tax Information for Survivors, Executors, and Administrators.*

Forms of forest land ownership and business organization are discussed in greater detail in Chapter 12.

Structuring Your Timber Activities

It is important for you to consider your ownership and financial goals, the extent of your woodland resources, and perhaps other factors, before deciding which organizational structure is best for you and what income tax strategy you will use. Once you have made these decisions, they should guide a consistent approach to recordkeeping, tax reporting, and management decisions until your circumstances change.

How your timber-related activities are classified generally is dictated by their scope and nature. If you own a small acreage and have only occasional transactions, you may wish to treat the activity as an investment for tax purposes. If your holdings generate fairly regular and continuous transactions, your activities may constitute a business. In this case, you should evaluate which organizational structure your business should have to best achieve your objectives. You may decide to treat it as a sole proprietorship. If your family is involved, however, you may prefer to execute a partnership agreement, incorporate, or consider the new LLC form of organization.

There are tax advantages and disadvantages associated with both the investment and the business categories. While they are important, tax considerations usually should not be the primary factor that determines what structure you use. The decision should be made only after careful consultation with your legal, financial, and forestry advisors.