

Chapter 14:

Financial Considerations

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This chapter draws your attention to programs that may save money, provide income, or improve investment returns through income taxes, property tax, financial analysis, land protection options, carbon credits, and estate planning.

Federal Income Tax Guidelines

Federal tax regulations change frequently. Consult the Internal Revenue Service (IRS) or your tax advisor for information on specific situations or to learn about recent changes in tax regulations.

Defining Your Operation

How you report woodland management income and expenses for tax purposes depends on your purpose for owning woodland (personal use, investment, or business) and the type of taxpayer (individual or corporation).

Your purpose in owning woodland, whether for personal use, investment, or business, affects how you should report income and expenses. Property not used to produce income is considered to be held for personal use. For example, if you own woodland primarily for a home site or recreation, that is personal use, even if you someday expect to sell the property for more than you paid for it. If you own woodland primarily to produce income, but it is not a major source of income and you have infrequent business activities (especially product sales), that is an investment. If you own woodland with the intent to make a profit and have frequent activities, including production of income, the IRS may classify that operation as a business. In addition, you may have an active or passive role in a woodland business. This distinction affects how and when you may deduct expenses. You actively participate in a timber business if you materially participate on a regular, continuous, and substantial basis. Any rental business is a passive activity whether or not you materially participate. Material participation rules are explained in IRS Publication 925.

There are two basic types of taxpayers: individual and corporate. This chapter focuses on taxpayers as individuals managing timber as an investment or as sole proprietor of a business.

There are tax advantages to operating your woodland as a business.

- An active business may deduct expenses from any source of income.
- Timber sale income is treated as a capital gain which carries a lower tax rate than ordinary income.
- There is no self-employment tax on capital gains.
- You face no reduction of social security benefits when generating timber sale income since capital gains are not considered earned income.

Take the following steps to help prove to the IRS that you are managing your woodland as a business:

- Get a written woodland management plan that includes
 - a goal to make a profit from forest products.
 - information necessary to make business decisions on each management unit, such as timber volume, value, management actions planned, and a timeline.
- Maintain a timber account showing your basis or original value of all timber and additions or subtractions from that basis.
- Keep a journal of forest management activities and their associated costs or income, e.g.
 - Forest related work completed or proposed
 - Why did or will you conduct the work
 - Relation of the work to increased productivity, production of timber, or resource protection
 - Date of activity
 - Hours you, or your family spent on the activity
 - Hours others spent on the activity:
 - Who:
 - Miles traveled: Odometer Start: Finish:
 - Revenue \$ generated
 - Expenses incurred
 - Acres affected
 - Comments



- Produce a financial analysis for significant management actions.
- Write a Will legally setting up the transfer of your woodland business to heirs.

Expenses

As a general rule you may deduct expenses from taxable income that are ordinary and necessary to make a profit. How and when deductions may be taken depends on the purpose of your woodland ownership and the type of expense: capital expense, operating expense or carrying charge, and sale-related expense.

Capital Expenses

A capital expense is money spent to acquire or make improvements in real property or equipment. Examples include purchase of land, timber, and buildings; purchase or major repair of machinery and equipment with a useful life of more than one year; costs associated with tree planting; and construction of bridges, permanent roads, and firebreaks.

Capital expenses usually cannot be fully deducted in the year they are incurred. Instead, the original cost (or other basis) should be recorded in a capital account and then be deducted as the property is used up, worn out, or sold. The basis in your capital account may need periodic adjustments to the original value. New capital expenses will increase the basis while deductions claimed for depletion, depreciation or amortization will reduce it. Update your capital account to reflect these capital additions or deductions.

Original Basis: Your original basis for a capital asset depends on whether you acquire it by purchase, inheritance, or gift.

If you buy an asset, your original basis is the acquisition cost which includes the purchase price plus any additional costs such as a land survey, forest inventory, or attorney fees. If funds are expended to create a capital asset, such as tree planting, then your basis includes all establishment costs.

The original basis for an inherited asset is its fair market value (FMV) (or special use value, if

elected) on the decedent's date of death (or alternate valuation date, if required by the federal estate tax return). Fair market value is the price at which property would change hands between a buyer and seller, neither being required to buy or sell, and both having reasonable knowledge of all necessary facts.

For assets received by gift, the original basis is the donor's adjusted basis at the time of the gift, plus that portion of the gift tax applicable to the difference between the donor's adjusted basis and the gift's FMV at the time of the gift. If a gift's FMV is less than the donor's basis, then the donee's basis is the gift's FMV.

Allocate Original Basis to Separable Assets:

Woodland you acquire may have several assets. (such as land, timber, buildings). By allocating the basis of this total acquisition among the individual assets in proportion to their FMVs, you can deduct the basis of an asset, such as timber, from income at the time of its sale to reduce taxable income (Example 1). If you do not separate timber and land accounts, you can deduct timber acquisition costs only when the land is sold.

Example 1. In Year 1 you bought 80 acres of woodland, including 70 acres of merchantable timber and 10 acres of premerchantable young trees. The total acquisition cost included the property's cost (\$160,000), boundary survey (\$2,000), title search (\$200), land appraisal (\$500), and timber inventory (\$1,300). Next you obtained appraisals of the FMV of the merchantable timber, young growth and bare land. A consulting forester inventoried and valued the timber, determining there were 1,200 cords of merchantable timber with a FMV of \$36,000 and 10 acres of young growth with a FMV of \$5,000. A land appraisal determined the bare land's FMV to be \$120,000.

Calculate the original cost basis for merchantable timber, young growth, and bare land by determining the proportion of the total FMV represented by each and multiplying this ratio by the total acquisition cost. For example, 1)

divide the merchantable timber's FMV by the total FMV of the property ($\$36,000 \div \$161,000 = 0.22$), then, 2) multiply that by the total acquisition cost ($0.22 \times \$164,000 = \$36,080$) to determine the merchantable timber's original cost basis. Repeat for each asset.

Asset	Fair Market Value	Proportion of Total Fair Market Value	Original Cost Basis	Units
Merchantable timber	36,000	0.22	36,080	cords
Young growth	5,000	0.03	4,920	acres
Land	120,000	0.75	123,000	acres
Total	161,000	1.00	164,000	

If you acquired forest land several years ago, it may be possible to determine the timber's FMV at the time the property was first acquired by having a forester inventory and appraise the timber based on prices at the time it was acquired, then deduct the volume and value that grew since you acquired it.

Establishing Capital Accounts and Deducting their Costs: As discussed above, you should record the original basis of each capital asset in a separate account (land, timber, depreciable land improvements, and equipment).

Land Account—In a land account, record costs for land and permanent improvements to the land. This includes earthworks acquired with the property or constructed later (such as permanent roadbed, land leveling, impoundment). You may deduct their costs when the land is sold or otherwise disposed of. The costs of road building or improvement, if done for the purpose of a timber sale, may be deducted as the timber is removed from the land.

Timber Account—A timber account should include, if applicable, subaccounts for merchantable timber, young growth (naturally regenerated trees of premerchantable size), and plantations (planted trees of premerchantable size). Timber subaccounts may be subdivided by species or location.

In each merchantable timber subaccount show the quantity of timber (in cords, 1,000 board feet, or other appropriate unit) and its original basis.

Change the quantity when an updated timber inventory shows the volume has changed due to timber growth, harvest, or casualty. The basis will change when timber is sold or more is purchased (Examples 2 and 3).

In young growth and plantation accounts show the number of acres and original basis. All costs for materials, labor, tools, equipment rent, and depreciation attributable to equipment used to establish natural regeneration or plantations must be capitalized since they are used to establish your woodland asset. Examples of costs that must be capitalized are costs for site preparation; seedlings; planting; and control of weeds, brush, and rodents until the stand is established. You then increase the basis as more costs are incurred to establish new stands. When trees reach merchantable size, transfer values in these accounts to the merchantable timber account (Example 2). Tree planting or reforestation costs also may be eligible for an immediate deduction or amortization over eight tax years (Example 4).

Example 2. In preparation for a timber sale in Year 5, you hired a forester to remeasure the timber you bought in Year 1 (see Example 1). Your timber on 70 acres had grown by 175 cords so you add this quantity to your merchantable timber account. Young growth on 10 acres had reached merchantable size and was estimated to contain 25 cords. Transfer this quantity and its cost basis (\$4,920) from the young growth account to the merchantable timber account. In Year 5 you purchased an additional 40 acres of forest land containing 800 cords of timber with a cost basis of \$25,000. Add this quantity and basis to your account.

Transactions	Quantity (cords)	Adjusted \$ Cost Basis
Merchantable timber in Year 1	1,600	36,080
Addition for growth (Year 1-5)	175	0
Young growth that became merchantable in Year 5	25	4,920
Timber purchased in Year 5	800	25,000
Net quantity and basis in Year 5	2,600	66,000



Depletion Allowance—When you sell timber, you may deduct that portion of the adjusted basis attributable to the quantity of timber sold. This deductible amount is the depletion allowance. If you acquire standing timber and later sell the entire stand in a single transaction, your depletion allowance would be your entire adjusted basis in the timber. If you acquire standing timber, then sell portions of it in several transactions over a period of years, you need to calculate the depletion allowance for each portion of the timber sold. To do so, first divide the timber's adjusted basis by the total pre-sale quantity of timber in the block to get the depletion unit, or cost per unit of timber. Next multiply the depletion unit by the total quantity of timber sold to get the depletion allowance for that timber (Example 3).

Example 3. In Year 5 you sold 1,000 cords of timber from your 120-acre tract (see Example 2). To calculate your depletion allowance, first divide the adjusted cost basis by the total quantity of timber on the property ($\$66,000 \div 2,600$ cords) to get the depletion unit ($\$25.38$ per cord). Multiply the depletion unit by the number of units sold ($\$25.38 \times 1,000$ cords) to get the depletion allowance that may be deducted ($\$25,380$).

Transactions	Quantity (Cords)	\$ Cost Basis
Merchantable timber in Year 5 before harvest	2,600	66,000
Timber sold in Year 5	(1,000)	(25,380)
Adjusted quantity and cost basis at end of 1998	1,600	40,620

Following this sale you still have 1,600 cords of timber remaining on the property with an adjusted cost basis of \$40,620. In the future when you prepare to sell more timber, you will again need to remeasure the total quantity of timber on the property and calculate the depletion allowance for the quantity sold.

If you harvest timber for personal use (such as firewood for your home), you may not claim a depletion allowance and subsequently reduce the dollar amount in your merchantable timber account. However, if you cut very much timber, you may need to adjust the quantity of timber in the account to reflect the lower quantity available for commercial sale.

Depreciable Land Improvements Account—Depreciable assets are those held for use in a business or for the production of income that have a determinable useful life of more than one year and wear out, decay, get used up, become obsolete, or lose value from natural causes. Depreciable land improvements include bridges, culverts, temporary roads, gravel for roads, fences, and temporary structures. Establish a separate account for each improvement so you can recover its cost over a period of years according to IRS depreciation schedules.

Equipment Account—Set up subaccounts showing costs for each item or class of items of equipment, such as power saws, tractors, trucks, and tree-planting machines. Add costs to these subaccounts for major repairs or reconstruction that significantly increase value or prolong the life of the equipment. Recover these costs through depreciation.

Depreciation and the Section 179 Deduction—The cost of machinery, equipment, and certain land improvements may be reclaimed through annual depreciation deductions. If you actively participate in a timber business, you may be able to deduct up to a fixed amount of the cost (set annually by the IRS) for tangible personal property (such as machinery, equipment, and single-purpose agricultural and horticultural structures), in addition to the normal depreciation deduction, in the year it was first placed in service. This is an IR Code Section 179 deduction. There are no unique rules for forestry-related equipment; read IRS Publication 946 for rules about depreciation and the Section 179 deduction.

Reforestation Amortization and Investment

Tax Credit—Direct expenses incurred to establish a timber stand by planting, seeding, or natural regeneration are capital expenses. There are several ways to deduct these costs, depending on your purpose for tree planting and type of taxpayer.

Under IR Code Section 175, farmers that plant trees under certain conservation programs may annually deduct such tree planting costs up to 25 percent of their gross income from farming during that year. The expenditure must be consistent with a plan approved by the USDA Natural Resources Conservation Service or comparable state agency.

If you plant at least one acre of trees for timber production in the United States, then the first \$10,000 of your establishment costs may be deducted in the year trees were planted. Report the cost as an investment or business expense, depending on your type of operation. Amounts over \$10,000 may qualify for amortization over an 84-month period under IR Code Section 194I(1). You may deduct or amortize the direct costs of stand establishment, such as site preparation, seed or seedlings, labor, tools, and depreciation of equipment used in planting or seeding. Expenses for planting Christmas trees, shelterbelts, windbreaks, nut trees, or ornamental trees do not qualify for amortization. You may not deduct or amortize costs reimbursed by a government cost-share program.

To amortize reforestation expenses, deduct 1/14 of the expense in the year incurred, 1/7 in each of the next six tax years, and the remaining 1/14 in the eighth tax year (Example 4).

Example 4. It cost you \$11,400 to plant 40 acres of trees for timber production and you received no government cost-sharing. You elected to report the first \$10,000 as an investment expense and will amortize the remaining \$1,400. For the tax year in which you incur planting expenses, deduct 1/14 of \$1,400, or \$100. In each of the next six tax years, deduct 1/7 of \$1,400, or \$200. Deduct the remaining 1/14 of \$1,400, or \$100, in the eighth tax year.

Year	Amortization Deduction (\$)
1	100
2-7	200
8	100
Total	1,400

Operating Expenses and Carrying Charges

Operating expenses include costs for tools with a short useful life or low cost (such as axes, hand saws, and tools); equipment operation and maintenance; salaries or other compensation (such as hired labor, consulting forester, lawyer, accountant); travel directly related to your property's income potential; fire, insect, and disease protection; and precommercial thinning and timber stand improvement (such as labor, equipment, materials) after the stand is established. Carrying charges include property taxes, loan interest payments, insurance premiums (such as fire, windstorm, theft, general liability, workers compensation), and certain other expenses related to property development and operation.

Ordinary and necessary expenses for managing, maintaining, and conserving forest land may be deducted if you are growing timber for profit and the expenses are directly related to the property's income potential. An activity is presumed to be managed for profit if there was net income in at least three of the five consecutive years ending with the current year. If this test cannot be met, then other facts and circumstances may be considered in determining whether the activity was engaged in for profit. Fortunately for timber growers, profit includes appreciation in the value of assets which occurs as timber grows in volume and increases in quality over time. If audited, however, you may need to prove by a financial analysis or other means that you expect to make a profit as a result of your timber-related expenses. If your timber management activities do not earn a profit in three out of five years and you cannot show that a profit is likely, based on a financial analysis or appreciation in the value of your timber asset, then you are presumed to manage timber as a hobby.



The extent to which you are permitted to currently deduct operating expenses and carrying charges depends on whether the expenses are for a hobby, an investment, or a business in which you are an active or passive participant.

Hobby: Operating expenses for timber being grown for a hobby may be deducted only from hobby income in years when income is earned. Expenses that exceed hobby income in a year are permanently lost; they may not be capitalized. Report hobby expenses as “miscellaneous itemized deductions” and deduct them only to the extent they exceed two percent of adjusted gross income.

Investment: Corporate taxpayers may deduct operating expenses from any source of income. However, noncorporate taxpayers report operating expenses as “miscellaneous itemized deductions” and may deduct them only to the extent they exceed two percent of adjusted gross income. As an alternative, you may capitalize operating expenses.

Both corporate and noncorporate taxpayers may fully deduct property and other deductible taxes from any source of income or they may be capitalize and deduct taxes from timber sale income.

Corporate taxpayers may deduct unlimited investment interest expense from any source of income. However, noncorporate taxpayers may deduct investment interest expense only up to the total net investment income from all investments. As an alternative, you may elect to capitalize all or part of the interest paid instead of currently deducting it.

Business: The extent to which you may deduct operating expenses, taxes, and interest depends on whether you materially participate in managing the business. To materially participate, you must be engaged on a regular, continuous, and substantial basis. The IRS offers other tests to aid your classification.

If you materially participate in managing a business, you may fully deduct all operating expenses, taxes, and interest from income from any source each year as incurred. If business deductions exceed gross income from all sources for the tax

year, the excess net operating loss generally may be carried back to the two preceding tax years and, if necessary, carried forward to the next succeeding 20 tax years. You may instead elect to capitalize these timber-related expenses and recover them when the timber is sold.

If you do not materially participate in managing a business, you are considered to be a passive participant. C corporations (subject to corporate income tax) that are not classified as closely held or as personal service corporations may deduct operating costs and carrying charges from a passive timber business from income from any source without limitation. Closely held C corporations (other than personal service corporations) may deduct costs associated with a passive timber business from income from active businesses (but not against portfolio income). Other types of passive businesses may currently deduct operating expenses, taxes, and interest only to the extent of their income from all passive activities during the tax year. Expenses that cannot be deducted during the year incurred may be carried forward to years in which you either realize passive income or else dispose of the entire property that gave rise to the passive loss. You may instead elect to capitalize expenses and deduct them from income when the property is sold.

Capitalizing Operating Expenses and Carrying Charges

It generally is advantageous to deduct operating expenses and carrying charges in the year they are incurred, but you may need to capitalize them if you do not have sufficient income to offset the expense deduction. Capitalize such expenses by adding them to the timber's basis and deduct them from income when timber is sold. As a general rule only carrying charges may be capitalized, however, there are exceptions that permit capitalization of some operating expenses, and many timber growing expenses fit within the exceptions. You elect to capitalize expenses by describing them on a written statement attached to your tax return for the year they are incurred.

Employee Expenses

If you hire someone to work on your woodland, that person may be your employee. As an employer you must withhold, deposit, report, and pay:

- Income tax withheld from employee's wages.
- Social Security and Medicare taxes (employer and employee portion).
- Federal unemployment tax (paid by employer; not withheld from wages).
- IRS Form W-2 at end of each year.

You are an employer if you have 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 (see IRS Publication 15-A).

Timber Sale Expenses

Deduct your sale-related expenses from timber sale income to determine net taxable income (or loss). Sale-related expenses may not be deducted from ordinary income that does not result from the sale. Deductible expenses may include advertising, timber cruising, marking, scaling, and fees for a consulting forester or attorney. These expenses are deductible in the year of sale regardless of your purpose for holding timber or the type of taxpayer.

Timber Sale Income

When you sell standing timber or cut logs, you must determine the amount and type of income.

Determining Amount of Income

To determine net income from a timber sale, start with gross income and deduct sale-related expenses (such as advertising, timber cruising, travel, marking, scaling, consulting forester, lawyer). You also may deduct your depletion allowance (Example 3) for the timber sold to reduce your taxable gain (Example 5). If you do not have a timber inventory and valuation from which to calculate your depletion allowance, that allowance may be recovered when you later sell the land.

Example 5. In Year 5 you sold 1,000 cords of timber from your 120-acre tract (see Example 3) for \$30,000. A consulting forester charged \$1,500 to cruise and mark your timber, prepare a timber sale contract, and supervise the sale. Advertising cost \$120. Your depletion allowance for the timber was \$25,380. Deduct your sale expenses and depletion allowance from gross timber sale income, to calculate your net timber income of \$3,300.

Transactions	\$ Amount
Gross timber income	30,000
Consulting forester fee	1,500
Advertising	120
Depletion allowance	25,380
Net timber income	3,000

Determining Type of Gain or Loss

Determining whether your timber sale income is ordinary or capital income is a necessary step in determining how to report the transaction and subsequently the tax rate that applies to it.

There are good reasons to set up your timber sale to qualify for capital gains treatment. Tax rates on ordinary income (including income from the sale of capital assets held less than 12 months) for noncorporate taxpayers vary across five income brackets, but the corresponding tax rates on long term capital gains (from the sale of capital assets held more than 12 months) are substantially lower. Also there is a limit to how much capital loss can be deducted from ordinary income, but no limit on how much capital loss can be deducted from capital gains. In addition, if you are a sole proprietor or partner whose timber holdings are considered a business, your ordinary income is subject to self-employment tax, but capital gains income is not subject to this tax.

Capital gains are categorized as long-term or short-term. To qualify for long-term capital gains, you must have owned timber (or the contract right to harvest timber) for more than one year prior to sale. If you sell timber acquired by gift the holding period starts on the same day the donor's holding



period started. For inherited timber, no holding period is required to qualify for long-term capital gains status.

Whether your timber sale income is a capital gain depends on your primary purpose for holding timber and your sale method. Sale methods are: (1) a lump-sum sale, (2) a pay-as-cut sale, or (3) harvesting the timber yourself and selling cut products, such as logs.

Lump Sum Sale: When you hold timber for at least 12 months and sell it for a fixed amount agreed upon in advance of the harvest (i.e., a lump sum sale), you may treat the income as a capital gain. This rule applies whether you manage timber as a business, investment, or for personal use.

Pay-As-Cut Sale: Timber harvested under a contract that requires payment at a specified amount for each unit of timber harvested (such as \$18 per cord), is a disposal with an economic interest retained. Advance payments are permitted, but the contract must clearly state that adjustments will be made so that the total amount paid will be determined by multiplying the volume actually cut by the specified unit price. The income is considered a capital gain under IR Code Section 631(b) whether the timber was held primarily for personal use, investment, use in a business, or sale to customers in the ordinary course of a business so long as it meets the minimum holding period requirement.

Harvest Timber, Then Sell Products: If you harvest standing timber and then sell the logs or other timber products, report the income as ordinary income, unless you make a Section 631(a) election. You may make a Section 631(a) election only if you held the timber primarily for investment or for sale or use in your business (not for personal use), you met the minimum holding period requirement for a long-term capital gain (more than 1 year), and you owned the timber (or the contract right to harvest timber) on the first day of the tax year. Report a Section 631(a) transaction in two parts:

(1) Net income from harvesting timber: For the timber that was cut, determine its fair market value as standing timber on the first day of the tax year in

which it was cut. Value the timber as it existed on that date regardless of any changes to it between that date and the harvest date. Subtract from this fair market value, the allowable basis for the timber that was cut. The difference qualifies as a long-term capital gain (or loss) under Section 631(a) and is reported as a Section 1231 transaction.

(2) Net income from selling sawlogs: From the gross log sale income, deduct the fair market value of standing timber on the first day of the tax year in which it was cut and the logging expenses. The difference is ordinary income (Example 6).

Example 6. You held timber for more than one year, then personally harvested timber and then sold the cut logs to a sawmill. Your depletion allowance for the standing timber was \$3,000. Based on sales of comparable timber in the area, a forester estimated the fair market value of the standing timber on the first day of the tax year in which it was harvested as \$11,000. Your logging expenses were \$2,000. The sawmill paid you \$14,000 for the logs. Since you had owned the timber longer than the one-year minimum holding period, you may report part of your earnings as a long-term capital gain. Determine the income from harvesting timber separately from the income from selling sawlogs as follows:

Transactions	\$ Amount
Net Income From Harvesting Timber:	
Fair market value of standing timber on first day of tax year	11,000
Allowable basis	-3,000
Long-term capital gain (Section 1231)	8,000
Net Income From Selling Sawlogs:	
Gross log sale income	14,000
Fair market value of standing timber on first day of tax year	11,000
Logging expenses	-2,000
Ordinary income	1,000

Report \$8,000 as a long term capital gain. Then report ordinary income of \$14,000 and ordinary expenses of \$13,000.

Installment Sale: Installment sale provisions apply when you sell timber either:

- for a lump sum agreed upon in advance of the harvest, and receive payments in more than one year (such as down payment and final payment), or
- on a pay-as-cut basis and held the timber for less than one year, and receive payments in more than one year.

You may elect out of the installment sale provisions by reporting the full fair market value of the contract in the year of the sale. Refer to IRS Publication 537 to report an installment sale. Installment provisions do not apply toward a loss. A loss must be reported in full in the year incurred.

Other Timber-Related Income

Report the sale of products derived from trees as ordinary gains or losses. This rule applies to all wood products derived from harvested trees, such as logs, lumber, pulpwood, poles, fence posts, crossties, fuelwood, and chips. It also applies to maple syrup, fruit, nuts, bark, and nursery stock. Income from sale of limbs and tops left after logging is ordinary income, even if the timber was subject to a 631(a) election and subsequently eligible for capital gains treatment.

Form 1099, Information Return

When you sell timber, the purchaser may file Form 1099 with the IRS showing the payment made to you. Whether you receive a Form 1099 or not, you still are obligated to report timber sale and cost-share income to the IRS.

Cost-Share Payments

How you treat cost-share payments depends on whether they were received for timber stand improvement or for reforestation.

Timber Stand Improvement

Timber stand improvement (TSI) includes such practices as weed or brush control after stand es-

tablishment, pruning, culling, and pre-commercial thinning. If you received a government cost share payment for TSI, you must report it as income. Then deduct or capitalize the full cost of the practice as you would other operating expenses.

Reforestation

Reforestation means to seed or plant trees on forest or open land or to perform site preparation work that stimulates natural tree regeneration. A government cost-share payment for reforestation may be partially or totally excluded from taxable income if two provisions are met: (1) the Secretary of Agriculture determines that the reforestation practice is primarily for conserving soil and water, protecting or restoring the environment, improving forests, or providing wildlife habitat; and (2) the Secretary of the Treasury determines that payment does not substantially increase your annual income from the property. Ask the agency that provides the cost-share payment whether it has been approved for the exclusion or check with the IRS.

Include Cost-Share Payment: Report the cost-share payment that you choose or are required to include in your gross income as ordinary income. When you receive cost-sharing to plant trees for timber production you may be qualified to currently deduct up to \$10,000 in reforestation expenses, including the cost-share amount, plus you may amortize any remainder above \$10,000.

Exclude Cost-Share Payment: You may exclude from income your cost-share payment for reforestation, subject to limits set by the Secretary of the Treasury. According to Treasury rules, the maximum cost-share payment that may be excluded is the present fair market value of the right to receive annual income from the affected acreage equal to the greater of: (1) 10 percent of the prior average annual income from the affected acreage or (2) \$2.50 times the number of affected acres (Example 7).

IRS regulations do not describe how to determine the present fair market value of the right to receive annual income. A common method for determining the value of annual income over an indefinitely



long period is to divide the current annual income by the interest rate that you could expect to earn in your next best investment alternative over a time period similar to the timber investment. IRS regulations do not specify an appropriate interest rate to use, however, a procedure is described in IR Code Section 2032A (e)(7)(A) for valuing farm and forest lands for estate tax special-use valuation purposes, which specifies the Farm Credit Bank interest rate. Technically the Farm Credit Bank interest rate does not apply to calculating the exclusion for reforestation cost-share payments, but it has been informally accepted by the IRS.

Prior average annual income is defined as the average gross receipts from the reforested acreage for the three tax years immediately preceding reforestation.

Example 7. You harvested \$12,000 worth of timber from 20 acres and then within three years you reforested that same 20 acres at a cost of \$3,800. You received 50% government cost-sharing, or \$1,900, for reforestation from a program approved for exclusion. To calculate your cost-share exclusion:

- (1) Calculate average annual income from the three previous years:
 $\$12,000 \div 3 = \$4,000$
- (2) Calculate 10% of average annual income from the three previous years:
 $\$4,000 \times 0.10 = \400
- (3) Calculate \$2.50 times the number of reforested acres.
 $\$2.50 \times 20 = \50
- (4) Select the larger amount (\$400) from steps 2 and 3, and calculate its present value over an indefinitely long time period:
 $\$400 \div 0.0736 = \$5,435$

[Note: 0.0736 was the average annual effective interest rate on Farm Credit Bank loans at the time of this writing.]

- (5) Compare the cost-share payment to the value from step 4 and determine which is larger:

\$5,435 exclusion is larger than \$1,900 cost-share payment.

- (6) Since the cost-share payment is less than the exclusion limit, you may exclude the entire cost-share payment.

Note: If you had no income from the reforested acres within the previous three years, then the maximum exclusion would have been \$2.50 times the number of reforested acres, divided by the Farm Credit Bank interest rate:

$$(\$2.50 \times 20) \div 0.0736 = \$679$$

\$679 qualifies for exclusion; the remaining \$1,221 portion of your cost-share payment must be included in income.

If you exclude any portion of your cost-share payment, attach a statement to your tax return showing the amount of the cost-share payment you received, date you received it, amount of cost-share payment that qualifies for exclusion, amount you choose to exclude, and how you determined that amount.

Payments excluded from taxable income may be subject to taxation as ordinary income if trees are disposed of within 20 years of establishment.

Casualty Loss

You may be able to claim a deduction for a casualty loss to timber if you have determined a basis in the timber. A casualty results from a natural or other external force acting in a sudden, unexpected, and unusual manner. Examples include fire, windstorm, tornado, hail, sleet, and airplane crash. Losses from insects, disease and drought usually do not qualify as a casualty loss because the damage is not sudden and such losses are expected over the life of a timber stand, but there are exceptions among Revenue Rulings.

Your deductible loss is the reduction in value of the timber damaged or destroyed, up to its allowable basis, less any insurance, salvage, or other compensation received. Every reasonable effort must be made to salvage timber, such as by offering it

for sale. If a gain results from the salvage activity, there is no casualty loss. The identifiable property for purposes of claiming a casualty loss is any unit of property containing the damaged timber that has an identifiable adjusted basis.

Example 8.

A wildfire damaged or destroyed 15 acres of timber on your 40 acre tract. The fair market value of timber on this 15 acres immediately before the fire was \$7,000, but your adjusted basis in the 15 acres destroyed was just \$5,000. You offered the timber for sale and received \$3,500 for trees that could be salvaged. Your reportable casualty loss is your adjusted basis, minus the salvage value:

$$\$5,000 - \$3,500 = \$1,500 \text{ casualty loss}$$

Property Taxes

Property taxes may be deducted from taxable income on your federal income tax return if you itemize deductions. This deduction is available to all taxpayers whether you hold timber for personal use, for an investment or for a business. But, property taxes still must be paid and constitute a substantial annual cost of forest land ownership. To reduce property taxes get information from your state or local taxing authority or from a forester about special property tax programs in which you may enroll your woodland. In some states forest land may be eligible for more than one classification, depending on its use, and each classification may carry a different tax rate. Discuss your use of the land with your taxing authority and ask about any special tax breaks for managed forest land. If any tax breaks exist, they may require you to follow a forest management plan prepared by a forester with your input, and approved by a government agency.

Financial Analysis of Woodland Investments

Whether its stocks, bonds, mutual funds, or savings accounts, as an investor you are interested in getting the greatest return on each dollar invested. Forest land is no exception. Many landowners,

however, overlook the potential opportunity to increase the return on their forest land investment. In addition to providing important wildlife, recreation, and aesthetic values, investing in forest management can add to your financial bottom line. Because management is a long-term proposition, the investments you make need to be carefully considered. When properly applied, modest investments in management early in a life of a forest stand can have a substantial impact on financial returns through increased forest growth, improved wood quality, and greater economic yields in the future. In addition, investing in forest management often compliments many other reasons individuals own forests such as improving wildlife habitat.

Forestry investments generally require a long-range commitment of money, land, time, and other resources. Because such resources are limited, you should identify and evaluate various investment alternatives to determine how these resources can best be used to meet your demands. This process, called financial analysis, is described in this chapter. Keep in mind, however, that a financial analysis offers one input toward deciding which alternative is best. Your decisions also may depend on other factors that are not easily quantified or profit-motivated.

There are a number of factors to consider when investing in forest management. These include:

Tolerance for risk– Future rates of return can't be predicted with certainty. Investments that pay higher rates of return are generally subject to higher risk and volatility. The actual rate of return on investments can vary widely over time, especially for long-term investments such as forest management, as there is often a large degree of uncertainty that anticipated returns will be fully realized. This includes uncertainty about future prices for your products (“What markets will exist when my products are ready for sale?”), management costs (“What will be my annual property tax liability for the property?”), and future forest conditions (“Will forest growth increase in response to management as expected?” “Will the forest be affected by insect or disease infestation or wildfire?”).



Investment timelines— Landowners need to consider the timeframe associated with their forest management investments. The income or benefits from these investments may not be realized for years or even decades. In some cases, it may be your heirs that realize the investments you make today in your forests.

Portfolio diversification— For many individuals, investing in forest management provides added diversification that complements an existing investment portfolio.

Stand suitability for potential practices— The existing condition of your forest (such as tree types, sizes, ages) will often dictate the opportunities to invest in forest management, as well as the specific practices that can be applied.

Financing— Depending on your access to capital to fund investments in forest management, you may need to secure outside funding. The terms of outside financing (that is, the interest rate charged by the lending institution, repayment period, the amount of financing obtained) can vary considerably and have a substantial impact on the financial feasibility of an investment.

When to sell your products— How will you know when your timber and other forest products are ready for harvest? What criteria will you use to make this determination? From a strictly financial perspective, you will want to sell your products when they no longer increase in value at a rate that exceeds your next best investment opportunity (such as your opportunity cost). For example, if you could invest the proceeds from the sale of your forest products into an account earning an eight percent annual return, you would want to let your forest grow until its value increases at a rate that is less than eight percent per year. The timing of any income-generating activities can also be affected by other factors such as the immediate need for money, anticipation of an insect attack, or cleanup following a windstorm.

Marketing— When your forest products are ready for sale, there will likely be costs associated with preparing your stand for sale and finding a market

for the products. Many landowners use a consulting forester to oversee the sale of forest products. They will typically collect a fee that represents a percent of the gross sale value.

Importance of benefits which are difficult to quantify— Forest management may involve selling timber or other forest products to markets which pay for delivered material. It can also provide other benefits that may not have a well-defined market (such as aesthetics, bird-watching). As the significance of these non-market benefits varies from one landowner to another, it may be important to weigh them in any management decisions.

Taxes— Property taxes are usually the single largest recurring annual cost of forest management. What are the expectations about the future level of property taxes? Additionally, how will federal and state income tax provisions (such as treatment of timber income and management expenses) affect the performance of my investment?

Record keeping— Important, but often overlooked is keeping complete and detailed records of your forest management activities. These records are not only important for tax purposes, but they also enable you to better document the timing and types of treatments applied to your stand.

Government and other support or incentive programs— There are several government-sponsored programs that provide technical and/or financial assistance to landowners interested in managing their forest. This includes cost-share funds to help with certain management practices such as tree planting or other silvicultural activities. A consulting forester or your local department of natural resources office can help you identify the programs applicable for your situation.

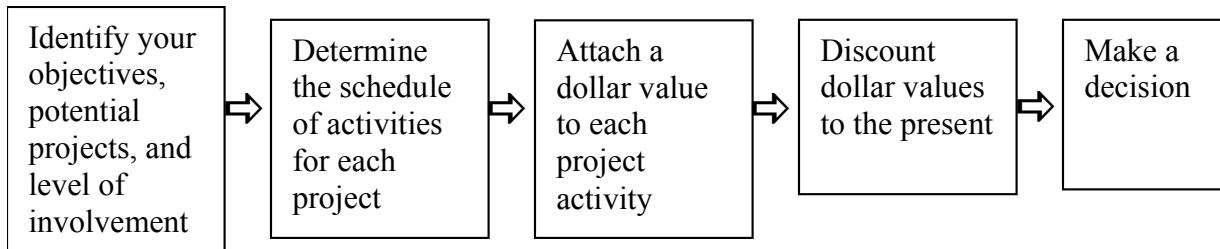
Steps in a Financial Analysis

Investments require costs and produce benefits or income at various points over time. The timing and amounts of these cash flows determine the profitability of an investment alternative.

A financial analysis requires identifying objectives, potential projects and your level of involvement;

determining the schedule of activities for each objective; attaching a dollar value to each activity; and discounting those dollar values to the present (Figure 14-1). Your consulting forester can help you with many parts of this process.

Figure 14-1. Flow chart of financial analysis steps.



1. Identify your objectives, potential projects, and level of involvement

Sound planning begins with determining your objectives, identifying potential projects which might help you achieve those objectives, and deciding the level of involvement you want to have with on-the-ground management of your forest. When identifying your objectives, it may be useful to write a short description of the situation or to describe the desired outcome in a clear, concise statement.

Develop a list of potential solutions or investment alternatives which might help achieve your objectives. To reduce the number of alternatives to a manageable few, start by considering your resources such as:

- Technical-equipment, species, etc.
- Economic-relationship between benefits and costs (timing, amount, etc.).
- Commercial-availability of markets.
- Financial-amount of available funds and other financial obligations.
- Personnel-adequacy of staffing (number, capabilities, etc.).
- Legal/Ethical-relationship with accepted standards and expectations.

You probably lack data to predict outcomes for many alternatives. Many otherwise promising options may be discarded because there is little or no information regarding benefits.

While being actively involved in the on-the-ground management activities, can save you money, it

takes time. Do you anticipate doing those activities as a hobby when time permits or do you plan to make it a major line of your work? Because the amount of involvement often depends on the perceived returns, leave room for flexibility. You can rerun your analysis to evaluate how different levels of personal involvement or hired services will impact your profitability.

2. Determine the schedule of activities for each project

Each project that you might undertake has an associated schedule of activities during its life. The events should be placed in the appropriate year(s) on a time line to help you track these activities over time. A sample time line for a Christmas tree farm is shown in Figure 14-2.

Figure 14-2. Sample time line.

Years in the Future	Activity
0	Site preparation, tree planting, weed control, spraying, taxes
1	Spraying, fertilize, weed control, taxes
2	Spraying, fertilize, shearing, taxes
3	Spraying, shearing, taxes
4	Spraying, shearing, taxes
5	Spraying, fertilize, shearing, taxes
6	Spraying, shearing, tree sales, taxes
7	Spraying, shearing, tree sales, taxes



In this case, site preparation, planting, weed control, spraying, fertilizing, shearing, payment of property taxes, site cleaning, and marketing are needed during various years. While site preparation and tree planting would occur now according to the timeline (Figure 14-2), the marketing of trees (sale) would occur six and seven years in the future. Make sure your timeline include all activities, including your own investment of time that the project will require.

3. Attach dollar values to each project activity

Identify those activities from your time line that involve a cash transaction where you are either receiving income (a benefit) or paying someone (a cost). For each of those activities, determine the associated dollar value. Do not include the cash flow from an existing or completed project as an initial benefit in an analysis. However, that income may be used as available funds to cover investment costs.

As the economic environment is constantly changing and your financial analysis is heavily influenced by your assumptions about the timing and dollar amount of financial transactions, it is very important to have the best and most current information available. Some products have grower associations such as a Christmas tree grower's association or a maple syrup producers association. These associations may be of some assistance in determining dollar values, growth rates, insurance costs, etc. Some products however do not yet have well-defined markets and prices. In these cases, foresters and extension educators may be of some assistance. When defining dollar values, make sure that they are all expressed in the same units (such as \$/acre, \$/year).

4. Discount values to the present

If you deposit funds into a saving account, you expect your investment to grow over time through a process called compounding. Compounding occurs when interest is paid on the original principal and on the accumulated past interest. Assuming a 5 percent interest rate and compounding once a year, a \$100 investment would grow to \$105 (\$100 X 1.05) at the end of the first year and \$110.25 (\$105

X 1.05) at the end of the second year.

Before you can compare your alternatives and make a decision (Step 5), you must convert the cash flows on your time line into comparable values. This is done through a process called discounting, which is just the opposite of compounding; it starts with a future value and finds its worth today. The formula for calculating the present value of a future value is:

$$PV = \frac{FV}{(1 + i)^n}$$

Where:

PV = Present value

FV = Future value

i = Alternative rate of return or interest rate (expressed in decimal form)

n = Number of years in the future when the transaction occurs.

Fortunately, computer spreadsheet programs contain built in functions for determining the present value of future financial transactions. The key factor when discounting values to the present is determining the discount rate or alternative rate of return (i). This is the cost of borrowing money or the best rate of return available in other investments. These other investments may be alternative land uses, what you can earn through financial markets, or the rate of return available in a savings account or money market fund.

Using the formula above, the present value of \$110.25 in two years is \$100 using a discount rate of 5 percent.

$$\$100 = \frac{\$110.25}{(1 + .05)^2}$$

Or, suppose that a future transaction will provide \$250 in 10 years. If your savings account pays 7 percent interest, then FV = \$250, i = .07 (for 7 percent), and n = 10. The calculated present value is \$127.09. You would do the same for all financial transactions which occur in the future, discounting them to the present.

Depending on an individual's financial resources, tolerance for risk, and investment preferences (such as stock market vs. savings account) the discount rate applied may vary from one individual to another. As a result, the present value for a future transaction can vary considerably among individuals. For example, the present value of the same \$250 transaction in 10 years is \$139.60 using a 6 percent interest rate.

5. Make a decision

There are many economic decision rules that can analyze the financial feasibility of investment opportunities. One of the more common is net present value (NPV), the difference between a project's discounted benefits and discounted costs. A positive NPV indicates that a project is a better use of your resources when compared to the rate of return you could get from your next best investment opportunity (i.e., your discount rate).

The investment alternative with the highest positive NPV is generally the preferred alternative. You need to consider additional factors such as the amount of risk, investment timelines, the amount of uncertainty associated with future cash flows, tax implications, non-market benefits provided or affected (such as aesthetics, bird-watching), your labor, etc. before making a final decision.

As an example, suppose you identified the two investment options shown below with an alternative rate of return of 7 percent. Neither option provides net income until the third year. The NPV for Option A is \$16.61 and \$17.62 for Option B. Because both options have a positive NPV, we know that they will each return more than the alternative rate of return (7 percent). Based solely on financial criteria, Option B would be preferred because it has the largest NPV. But, because a financial analysis only incorporates project costs and benefits that can be quantified, consideration of other factors may result in Option A being preferred.

Option	Net benefit (\$) by year				Net present value (\$)
	0	1	2	3	
A	-100	-10	-10	165	16.61
B	-250	-10	-10	350	17.62

Example

The farm you grew up on is now being sold by your parents who are retiring. Your siblings and you decide to purchase the farm to keep it in the family. While your brothers and sisters decide to keep their part of the farm in production, you are going to establish pheasant habitat on the 100 acres you purchased, with the intent of leasing the hunting rights once the habitat is suitable. Your estimated costs and returns are as follows:

- \$750/acre purchase price of land, paid back annually in equal installments over 5 years at 9% annual interest.
- \$200/acre wildlife habitat establishment costs incurred one year after purchase.
- \$50/acre habitat maintenance costs in years 2-3.
- \$10/acre habitat maintenance costs in years 4-10.
- Annual recreation leases of \$140/acre beginning in years 4-9.
- \$5/acre/year in property taxes and liability insurance, beginning immediately.
- You plan to sell the land in year 10 for \$1,300 per acre.
- Your alternative rate of return is 7%.



Cash Flow Table (\$/acre)

	0	1	2	3	4	5	6	7	8	9	10
Costs											
Purchase		193	193	193	193	193					
Wildlife Est.		200									
Habitat Maint.			50	50	10	10	10	10	10	10	10
Prop. Taxes	5	5	5	5	5	5	5	5	5	5	5
<i>Total Costs</i>	5	398	248	248	208	208	15	15	15	15	15
Returns					140	140	140	140	140	140	
Rec. Lease											1,300
Total Return					140	140	140	140	140	140	1,300
Net Return	-5	-398	-248	-248	-68	-68	125	125	125	125	1,285

Discounted Cash Flow Table (\$/acre)

	0	1	2	3	4	5	6	7	8	9	10
Costs											
Purchase	0	180	169	157	147	137	0	0	0	0	0
Wildlife Est.	0	187	0	0	0	0	0	0	0	0	0
Habitat Maint.	0	0	44	41	8	7	7	6	6	5	5
Prop. Taxes	5	5	4	4	4	4	3	3	3	3	3
<i>Total Costs</i>	5	372	217	202	159	148	10	9	9	8	8
Returns	0	0	0	0	107	100	93	87	81	76	0
Rec. Lease	0	0	0	0	0	0	0	0	0	0	661
Total Return					107	100	93	87	81	76	661
Net Return	(\$5)	(\$372)	(\$217)	(\$202)	(\$52)	(\$48)	\$83	\$78	\$73	\$68	\$653

Adding numbers in the Net Return row of the Discounted Cash Flow table above, we find, the net present value is \$59/acre (rounded to the nearest dollar). Because that value is positive, this alternative will provide a 7 percent rate of return plus an additional \$59 acre. Assuming that the level of risk, investment timelines, the amount of uncertainty associated with future cash flows, tax implications, non-market benefits provided or affected (such as aesthetics, bird-watching), your labor requirements, etc. are acceptable, you would prefer this alternative to the one which yields a 7 percent rate of return.

Carbon Credits for Forestry

Global climate change may result in severe changes in temperature, precipitation, and melting polar ice caps. In the Lake States climate change may lead to changes in vegetation, wildlife habitat and habitat ranges, and even economic opportunities.

More than 40 years ago scientists around the world recognized that global climate change may be related to increased concentrations of “greenhouse gases” such as carbon dioxide (CO₂) that enters and circulates in the atmosphere. Human-induced activities contributing to greenhouse gas concentrations include deforestation, urbanization, emissions from burning fossil fuels, and industrial agriculture.

Carbon sequestration (extracting and storing carbon from the atmosphere) has been proposed as one means among many to help mitigate climate change. Growing plants extract CO₂ from the atmosphere and convert it to biomass—a process referred to as “terrestrial carbon sequestration.” New tree plantings provide a net gain in carbon sequestered. A managed forest both maintains a stock of carbon and continuously sequesters more carbon. If trees are harvested and converted to long-lived forest products, the carbon is stored in those products until they are discarded and decay, releasing the stored carbon.

Market for Forest-based Carbon Credits

Since trees sequester carbon over a relatively long time period, the scientific community recognizes the role of forests in mitigating climate change. Farmers and landowners who use practices that sequester carbon from the atmosphere may be eligible for carbon credit payments for this ecological service. Carbon credits for forestry aim to 1) prevent or reduce carbon emissions produced by human activities from reaching the atmosphere, and 2) remove carbon from the atmosphere by planting trees and securely storing it in tree biomass and the soil.

The carbon credits, also called offsets, are being traded on greenhouse gas markets and exchanges, much like a stock exchange. Current United States markets are voluntary, member-based organiza-

tions comprised of large companies, municipalities, and institutions that allow greenhouse gas sequestration benefits from conservation practices to be quantified, credited and sold. The greenhouse gas exchanges purchase carbon sequestration credits from landowners who have implemented carbon sequestering practices on their lands, and in turn, sell those credits to carbon emitting companies and industries, thereby allowing the carbon emitters to reduce their net carbon emissions. The greenhouse gas exchanges offer carbon credits for the following forestry practices: managed reforestation, new plantings on afforested lands, existing sustainably managed forests, substitution of renewable fuels for fossil fuels, and long-lived forest products.

Landowner Enrollment Procedures

The amounts of carbon sequestered per acre are determined either by rate tables organized by species or species groups or by direct measurement of biomass. In the Lake States those values range between one and two metric tons of CO₂ equivalent per acre. The greenhouse gas exchanges currently require that credits be sold in increments much larger than what the average landowner might be able to offer. For example, one exchange requires that at least 12,500 metric tons of CO₂ equivalent be available to trade. That equates to around 4,000 acres of land.

In order for most forest landowners to sell their credits to the carbon exchange, they need to work with an aggregator. An aggregator is a company that will combine a landowner’s carbon credits with those of other landowners to create a large enough bundle to sell to the greenhouse gas exchange.

Before enrolling in the program, the landowner must demonstrate that the land is or was degraded before the restoration or sequestration project began, and demonstrate a long-term commitment to maintain the land in trees. The landowner must also demonstrate that they would not have undertaken the forestry activity without the credit. This is called “additionality,” meaning that any credits must support activities that are “in addition” to what the landowner would have done without the



credit. The current greenhouse gas exchange stipulates that to receive credits for managed forests, the forest must be certified through an organization (see Forest Certification, page 120), or through a conservation easement, letter of intent, or U. S. Department of Agriculture Conservation Reserve Program contract. The aggregator is responsible for preparing all documents required for the landowner to get started in the program. The landowner must provide to the aggregator a legal description of the acreage and practice(s) employed on the land.

Verification

A third party verification of sequestration levels is generally required for projects that sequester large amounts of carbon (for example, more than 2,000 metric tons of carbon annually). This verification guarantees transparency, rigor, and integrity, and provides members with standardized procedures for managing greenhouse gases. Verifiers use information provided by the landowner or aggregator, combined with potential site visits, to accurately assess a project's actual, annual greenhouse gas sequestration or loss. A carbon offset project is subject to initial verification, as well as annual verification for the duration of its enrollment.

Trading Carbon Credits

Once the carbon offset is verified, the aggregator will trade the carbon to the greenhouse gas exchange. The aggregator usually conducts trading when the price is favorable to the aggregator and landowner. A landowner participating in the program usually receives payment once or twice a year. The amount of money received depends on the amount of credits being enrolled or sold through the aggregator, the price of carbon at the time of trading, the fees deducted by the aggregator (usually 8 to 10 percent of the gross amount) and other fees, such as insurance, that will protect the participant in case of events might affect the enrolled credits (such as fire and drought).

Estate Planning

After managing a woodland for many years, you want to preserve its financial and other values for the benefit of future generations. Discuss your goals for the property with family members and others that have a stake in it. Listen to their concerns and expectations. Then fine-tune your goals and work with professional advisors (attorney, accountant, and forester) to find the right mechanism for passing on this legacy.

Get an accurate appraisal of your woodland and other assets. State and/or federal estate taxes may be due upon the death of an owner. Property owned in different states is subject to estate laws in those states. If there is not enough cash available from liquid assets to pay estate taxes, it may be necessary to sell land to pay those taxes.

Wills and Trusts

Prepare a will to insure that taxes and creditors are paid and assets are transferred to heirs as you wish. A will does not control distribution of some assets, such as property held in joint tenancy, life insurance, and retirement plans. Designate beneficiaries on financial accounts (such as retirement accounts, bank accounts, life insurance) to keep them out of probate.

A trust can be written to specify how assets will be managed and distributed after death. Assets can be transferred to the trust during the lifetime of the trustor or at death. The trustee is obligated to manage the trust's assets for the benefit of beneficiaries. A trust can be written to last a specified number of years, a lifetime, or multiple generations. The trustee must file income tax returns and pay taxes on income retained in the trust while beneficiaries pay income taxes on funds distributed to them.

A revocable living trust enables the creator to become both the trustee and beneficiary. This trust may be amended or revoked at any time. The trust is not subject to income tax. By designating an alternate trustee, it provides financial protection in case of disability and assets transferred to the trust during the trustor's lifetime avoid probate at death. Estate taxes cannot be avoided by this trust.

Types of Business Ownership

To keep your woodland intact and managed as a business after your death, discuss these forms of business ownership with your professional advisors.

Sole Proprietorship

This business has one owner. Startup costs are low, income and taxes are reported on the owner's tax return, one person makes all decisions, and no documents are required to describe the business or its management. The owner is not protected from liability and the business ends when the owner dies. Upon death of the owner, the business's value is its fair market value at the date of death.

Joint Tenancy and Tenants-in-Common

More than one individual owns the business. The business pays no tax, but does file a tax return to report income or loss. Partners report their share of the income on individual tax returns. Partners are not employees so no payroll tax is reported. Partners can pool finances and share management with few legal restrictions. Every partner shares liability for his or her own actions, for actions of other partners, and for actions of employees. The joint ownership terminates at the death or bankruptcy of any partner. Written buy-sell agreements are important to determine what happens to the business and land when an owner dies. Individual owners in the land can demand their share of the fair value of the property at any time, and force the sale of the property to get their value out. This creates an unpredictable situation for remaining owners. When the death of a partner occurs,

- Under joint tenancy, ownership passes automatically to the remaining partners.
- Under tenants-in-common, ownership passes to the heirs of the partner that died if there is no buy-sell agreement between partners.

Family Limited Partnership

The partnership is composed of family members. One or more general partners manage the business for the benefit of all partners and have general liability for the business. Limited partners are treated as investors with no active role in management and

no liability. The business pays no tax, but does file a tax return to report income or loss. Partners report their share of the income on individual tax returns. Partners are not employees so no payroll tax is reported. This arrangement allows selected family members that are most interested and competent to manage the business to the benefit of all while allowing other family members to transition into management over time. This partnership may be required to terminate at the death of a general partner or at a specified time. At the death of a partner, buy-sell agreements control how partner interests are valued and transferred. Valuation is based on the business's assets and cash flow, reduced by any restrictions in the partnership agreement.

Limited Liability Company

This entity combines features of a partnership and corporation. Owners are called members. The business pays no tax, but does file a tax return to report income or loss. Members report their share of the income on individual tax returns. Members are not employees so no payroll tax is reported. One or more general members manage the business for the benefit of all members. General members have limited liability for business actions and debts. Limited members are treated as investors with no active role in management and no liability. Profit distribution is flexible. LLCs can be created with unlimited life. At the death of a member, buy-sell agreements control how member interests are valued and transferred. Valuation is based on the business's assets and cash flow, reduced by any restrictions in the membership agreement. Each state has different laws and regulations concerning LLCs. This is a popular business entity for ownership and transfer of land between generations.

S Corporation

This is an Internal Revenue Service designation for a small corporation. The business itself pays no tax, but does file a tax return to report income or loss. Shareholders report their share of the income on individual tax returns. Shareholders who manage the corporation are employees and payroll reporting is required for their salaries. All shareholders have liability protection. Self-employment tax may be lower than under a partnership. Only



one class of stock is permitted and distributions to stockholders must be equal. Corporate structure is defined by state law. All appreciation in the value of assets, including land, is taxed if land is sold or the corporation is dissolved, making the S Corporation less suitable for small woodlands.

C Corporation

This entity may have one or more shareholders that pool capital and resources to conduct business. The corporation pays taxes on its income at corporate tax rates. Money comes out of the corporation through salaries or dividends. Dividends are not deductible to the corporation, but are taxable to shareholders, creating a double tax burden. Corporate tax rates vary, but may be lower than rates for a sole proprietor or partnership. Both common and preferred shares can be issued with different rights for each class. Shareholders are protected from liability. Corporate structure is defined by state law. C Corporations are less suitable for small woodlands because 1) all appreciation in the value of assets, including land, is taxed if land is sold or the corporation is dissolved, and 2) C corporations do not qualify for reduced capital gains tax rates. Transfer of stock is controlled by corporate statute and limited by any buy-sell agreements between shareholders.

Land Protection Options

Many woodland owners invest a great deal of time and money into managing their woodland and wish to preserve the features they value about their land for future generations. But pressure to develop that woodland for residential or business use may lead a future landowner to sell the property for such development. Woodland can be protected from development by a conservation easement or donation to a conservation organization.

Conservation Easement

A conservation easement is a legally enforceable land preservation agreement between a landowner and a land protection organization, such as a nonprofit land trust or public agency. The owner typically gives up the right to develop the land while retaining other rights, such as the right to sell

the property, live on the property, manage timber, recreate, and mine subsurface minerals. All rights are negotiable between the landowner and the entity holding the easement. The receiving organization is obligated to prevent future development of the property and may have other rights to use it for conservation purposes stipulated in the agreement.

There are several benefits of a conservation easement to the landowner, foremost of which is that the land will continue to be managed and used as the current owner specifies. If the fair market value of the land declines as a consequence of the easement, the landowner may deduct this “loss” as a charitable contribution on federal income taxes [Internal Revenue Code Section 170(h)]. The reduced land value also may result in lower property taxes. Lowering the property value also lowers the estate value, thus reducing estate taxes when the property owner dies. A conservation easement does not always result in a lower property value since the property’s value as “green space” in a rapidly developing area may sustain or raise the property value.

Search for natural resources-oriented state and federal agencies and nonprofit land trusts that may offer conservation easements. Some easements are for fixed-time periods while others are perpetual. Work with an attorney experienced in such easements to help you write the agreement.

Land Donation

Another means to protect your land is to donate it to a public agency, nonprofit organization, or college that shares your values. Such organizations may accept land for natural areas, parks, forestry, hunting and fishing, research or other uses that you value.

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Potter-Witter, K. and C.W. Ramm. 1999. *Depletion Accounts: Guide for Consulting Foresters and Landowners*. North Central Region Extension Bulletin NCR 609.

Web Sites:

Internal Revenue Service: www.irs.gov

Small Business Administration: www.sba.gov

National Timber Tax Website:
<http://www.timbertax.org/>

For details on how to incorporate family discussion and succession planning into your land transfer plans, visit the Ties to the Land website at <http://www.familybusinessonline.org/resources/ttl/home.htm>

