



William C. Siegel, J.D.

## Tax Implications Of Forest Ownership

Woodland owners derive many benefits from their property. They may have special interests in providing wildlife habitat, conserving soil and water, protecting endangered plants or animals, or other activities not related to the production of income. Such forest stewardship activities—although not income-producing per se—may nevertheless increase the market value of the property. Forest stewardship simply refers to the management of forest land for the protection, restoration and enhancement of all of its resources. Tax law may be of benefit in some of these efforts. Woodland owners need to be aware, however, that current tax provisions may not support all stewardship endeavors. In this article I will discuss the basic stewardship-related tax incentives for forest land.

### Management Expenses

Even though a woodland owner may expect to sell timber sometime during his or her lifetime, timber production may not be the primary motivating factor for owning and managing the property. Tax law, however, is keyed to the production of income. Expenses incurred for an activity carried out to produce a profit, as either a business or an investment, generally can be deducted currently or over a period of years. A critical factor, however, is that such expenditures must be directly related to the property's income potential. There is one major exception to this rule. Whether or not woodland is managed for the production of income, property taxes paid on it can always be deducted as an itemized deduction on Schedule A of Form 1040.

### Wildlife-Related Costs

A forest owner may have a special interest in wildlife and manage the property to attract and retain certain species. In some cases, wildlife management activities—such as planting food plots and cover shrubs, or maintaining a timber species and stocking mix to favor certain animals and/or birds—may be related to the production of income

if the land is leased for hunting. In other instances, however, this type of expenditure may be made strictly to increase enjoyment of the property. In order to claim such costs as deductible expenses for income tax purposes, the property should be managed so there is no question that the intention of the owner is to eventually realize income from it.

### Combined Wildlife And Timber Programs

In many instances, it may be possible to carry out wildlife habitat management activities as part of a timber management program and receive income from both. The wildlife expenses may be incidental to timber production. In that case, they could be treated as timber management costs. If, however, the wildlife program dominates overall forest management, and no income related to wildlife is received, the expenditures probably would not qualify as deductible business or investment expenses. In some cases, though, the costs may qualify to be added to the basis of the property if they increase its value.

### Capital Costs

Whether or not woodland is being managed to produce income, it will be to the owner's advantage to keep records of amounts spent for capital improvements. The original basis of both the land and the timber should be recorded, as well as future adjustments to basis. If permanent improvements are made to the land—such as construction of roads and ponds—their costs will increase the land basis. This is important because both the land basis and the timber basis can be recovered (deducted) from the sale price to determine the taxable gain if the property were to be sold in whole or in part, even if not being held for the production of income. Additionally, in the event of a casualty loss, the basis governs the amount of the deduction. You cannot, however, take depreciation deductions on depreciable land improvements—such as drainage structures and fences—unless the

woodland is being managed for profit.

### Capital Gains Treatment

Income from the sale of woodland, if the property has been held for more than one year, will qualify as a long-term capital gain whether or not it is being managed for the production of income. The one year rule does not apply to inherited woodland for which there is no maximum holding period. If the sale proceeds do qualify, the long-term capital gain rate (currently a maximum of 15 percent for non-corporate taxpayers) will apply.

### Estate Planning

Many of the best opportunities to promote stewardship with forest land are associated with woodland estate planning. It is beyond the scope of this article to cover all of these. One of the more significant, however—conservation easements—will be discussed.

### Conservation Easements

If a woodland owner is highly motivated to engage in activities that improve the conservation and ecological value of the property, and wants to guarantee that it will remain as forest land in perpetuity, it may be in his or her best interest to sell, donate or otherwise transfer all or part of the ownership interest to an organization specializing in the management of forest and other lands for conservation purposes. In addition, tax advantages may be realized. The options are not limited to the outright divestiture of the entire ownership interest. For example, the owner can transfer a restriction on the use of the woodland for purposes other than remaining in forest—such as for housing, commercial or industrial development. The restriction can be transferred with the transferor retaining the right to live on, produce timber from, and otherwise continue enjoyment of the property. These types of agreements are generally referred to as conservation easements and provide a way for the owner to control the use of the land during and after his or her lifetime.

### Sale of a Conservation Easement

By selling a conservation easement on woodland, the owner in effect will realize some income from the development rights without having to sell the property as a whole. Although this will be taxable income, the low non-corporate long-term capital gain rates will usually apply. In addition, the value of the development rights is removed from the seller's estate and therefore will not be subject to estate or inheritance tax.

### Donation of a Conservation Easement

Under some circumstances, a donation of a conservation easement on woodland may qualify as a charitable contribution. The charitable contribution

deduction can apply to income, estate and gift tax liability. Three basic criteria need to be met.

### Qualified Organization

The contribution must be made to one of the following types of organizations: (1) a unit of local, state or federal government; (2) a publicly supported charitable, religious, scientific, educational, or similar organization; or (3) an organization that is controlled by, and operated for, the exclusive benefit of a governmental unit or a publicly supported charity.

### Conservation Purpose

The contribution must be made only for one of the following purposes: (1)

preservation of land areas for outdoor recreation by, or for the education of, the general public; (2) protection of a relatively natural habitat for fish, wildlife, plants, or a similar ecosystem; (3) preservation of open space, including farm and forestland, which yields a significant public benefit — and must also be either for the scenic enjoyment of the general public or under a clearly defined federal, state, or local government conservation policy; or (4) preservation of a historically important land area or a certified historic structure.

### Qualified Real Property Interest

One of the following interests in real property (forest land and timber are real property) must be donated: (1) An entire interest in real estate other than a mineral interest; (2) a remainder interest — i.e., the interest that remains after an interest that has been held for some designated time period, or for a time fixed by an identifiable event, such as death, expires; or (3) A restriction on how the property may be used if the restriction is perpetual.

### Valuation of a Conservation Easement

The value of a conservation easement, whether sold or donated, generally is equal to the fair market value of the entire property before the sale or donation minus its fair market value afterwards. The best evidence of this difference in value often lies with sales of similar properties in the area that were bought and sold, some with and some without restrictions similar to those being considered.

Because of the need for accuracy, a professional appraisal should be used to determine the value of the donation. If a deduction of more than \$5,000 for donated property is claimed, a qualified written appraisal made by a qualified appraiser is required.

### Estate Tax Exclusion

A percentage of the value of land subject to a qualified conservation easement before a decedent's death may be excluded from the decedent's gross estate. The applicable percentage that can be excluded is limited to 40 percent of the value of the property subject to the easement. However, this is reduced by two percentage points for each percentage point that the value of the qualified easement is less than 30 percent of the value of the property before the easement. This means that if the value of the easement is less than 10 percent of the pre-easement value, the applicable exclusion percentage is zero. The maximum amount that can be excluded is \$500,000. The decedent's



## FLTC Tax Report by Frank Stewart, RF



**Death Tax:** On January 7, President Bush gave a major address in Chicago on the economy. In the course of it, he talked about the death tax. He's still president, so we can expect that he can still have a lot to say about how a tax bill is written. Here's what he had to say:

"...And so I will strongly urge that the Congress keep taxes low. One way to do it is to make sure that all the tax cuts we passed are made permanent. If you're interested in taking uncertainty — (applause) — One of the other taxes that's going to return will be the death tax, which is being phased out, and in 2011 it kicks back in, which means it's going to be hard on estate planning. Let me put it to you that way: I hope a lot of people don't decide to move on just because of the tax cut. (Laughter) I'm absolutely convinced we can do a better job of having the estate tax put on the road to extinction and then let it pop back up. It makes no sense.

Listen, the estate tax is a lousy deal, particularly for farmers and small business owners. I mean, you get taxed twice: You get taxed when you build your business, and then they tax you when you die. I'm absolutely convinced that there is a deal to be done, and get rid of the estate tax once and for all, for the sake of economic vitality and growth and fairness."

**Alternative Minimum Tax:** Almost immediately after we submitted our last article, which included an update on the Alternative Minimum tax, Congress passed a one-year patch for the AMT. The measure will "protect" 23 million middle-income American workers from a tax increase. Unfortunately, after months of delaying this bill, it will now force the IRS to reprogram computers and reprint essential collection forms, slowing the process of mailing refund checks.

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The organization that I'vel (IRC Section 6018) for non-industrial private forest landowners?

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basis in land for which the exclusion is used carries over to the heirs and legatees. Thus there is no step-up in basis.

#### **Exclusion Qualifications**

To qualify, the land must be located in the United States or in a U.S. possession. It must have been owned by the decedent or a member of the decedent's family during the three years ending with the decedent's date of death. The property must be subject to a qualified conservation easement granted by the decedent, a member of the decedent's family, or the trustee of a trust that holds the property. The exclusion also applies to land that becomes subject to a qualified easement granted after the death of the decedent by the executor of the estate.

#### **Conclusion**

Some woodland owners, particularly those with small properties, may manage their forest land for stewardship purposes rather than for profit. Even so, however, there are provisions in the tax law—if taken advantage of—that may provide financial benefits. These should not be overlooked.

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**William C. Siegel** is an attorney and consultant in private practice specializing in timber tax law and forestry estate planning. He is retired from the US Forest Service where he served as Project Leader for Forest Resource Law and Economics Research with the Southern Forest Experiment Station, where he still serves as a volunteer. He provides this column as a regular service to National Woodlands readers. Mr. Siegel welcomes comments and questions. They may be directed to him at: 9110 Hermitage Place, River Ridge, LA 70123; tel. (504) 737-0583; email: [wcslog@aol.com](mailto:wcslog@aol.com). 