



Timber and Taxes

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Figuring the Tax On Timberland Income

Forest landowners whose timber-related activities are considered to be a business may be liable for the self-employment tax.

This tax applies to sole proprietors, independent contractors, members of a partnership, and owners of limited liability companies. Its purpose is to provide Social Security and Medicare coverage to self-employed taxpayers.

Basic Provisions

The self-employment tax is imposed on net receipts from self employment. These are earnings derived by an individual from a trade or business, minus all business deductions allowed for federal income tax purposes. The tax must be paid on net earnings of \$400 or more per year. It is composed of two parts which total 15.3 percent. The Social Security rate is 12.4 percent and the Medicare rate is 2.9 percent.

Net earnings from self-employment to a maximum of \$68,400 in 1998 are subject to the Social Security portion of the tax. If an individual also earned wages as an employee in 1998 from which Social Security taxes were withheld, only the first \$68,400 of the combined wages and self-employment net earnings are subject to the Social Security tax.

However, the 2.9 percent Medicare tax must be paid on all net earnings from self-employment-regardless of the total amount of such earnings and of the total amount of wages received.

There is no exemption from the self-employment tax for those already receiving Social Security benefits, those who are fully insured under Social Security, or persons who are otherwise not required to file an income tax return. Finally, no one is exempt because of age.

Exclusions From The Tax

Several types of timber-related receipts are excludable from the self employment tax even if associated with a timber-related business. They are still subject to the income tax, however.

Rental Payments

Rent received for the use of real estate, and for personal property leased with real estate, are exempt if the taxpayer is not a real estate dealer and does not provide substantial services in the rental activity. Most hunting lease income, for example, would fall into this category.

Capital Gains

Income that qualifies as capital gain is also excludable. Receipts from the sale or other types of disposal of standing timber generally do not qualify for capital gains treatment even if the owner is in the business of selling stumpage as opposed to holding the woodland as an investment. Also, for taxpayers who cut their own timber, and elect to treat the cutting as a sale under the provisions of Section 631 (a) of the Internal Revenue Code, the gain is not included in the net amount for self-employment tax purposes. The profit on the sale of the logs or manufactured products, however, may be subject to the tax.

It is obviously extremely important that woodland owners make certain that their timber sales qualify for capital gain treatment. If the qualifying rules are not met, an IRS audit could result in the self-employment tax being levied against the sale proceeds. This subject has been discussed in detail in previous issues of *National Woodlands*.

Income Subject To The Tax

The sale of forest products other than standing timber, and cutting by an owner who has not made a Section 631(a) election, will produce ordinary income. Receipts from these sources are thus included in self-employment income even if the transactions are infrequent and the woodland owner is primarily engaged in some other business, trade or profession. For example, a person may be employed in the city but own timber property several counties away. If he or she occasionally cuts and sells firewood, the income received will be subject to the self-employment tax.

Treatment Of Spouses

If you are the sole proprietor of a trade or business, and your spouse works for you, he or she may be your employee. The treatment of employees for employment tax purposes is explained shortly.

Alternatively, both spouses may be jointly engaged in a business. In that case, each individual's self-employment net earnings are subject to the self employment tax. If, however, spouses join together in the conduct of a business and share in its profits and losses, a partnership may have been created even if no formal partnership agreement has been executed. The business income should then be reported on a partnership return, Form 1065. Schedules K-1 should be attached to show each partner's portion of the net income, and each spouse then calculates the self-employment tax on his or her share.

Christmas Tree Growers

Growers and sellers of Christmas trees are subject to the same tax rules applicable to timber producers in general. The selfemployment tax applies to ordinary income received from the sale of Christmas trees, and decorative material made from the foliage, such as wreaths. At least part of the gain realized from the tree sales, themselves, however, usually qualifies as capital gain and therefore will not be subject to the self-employment tax.

Cost-Share Payments

Net payments received under the Agricultural Conservation Program (ACP), the Forestry Incentives Program (FIP), and the Stewardship Incentive Program (SIP), as well as those from state cost-share programs, are included in self-employment income if the timber activity is considered a business-unless the payments are specifically excluded from income for federal income tax purposes.

All or some of such receipts may qualify for exclusion, as discussed previously in *National Woodlands*. Only the portion actually excluded from gross

income, however, is not included in self employment income.

Net Conservation Reserve Program (CRP) payments—both costshare and rental—are also generally included in self-employment income. CRP cost-share payments do not currently qualify for income tax exclusion. If, however, they are treated as a conservation expense under Section 175 of the Internal Revenue Code, they become a deduction in determining net earnings from self-employment.

Bypassing Capital Gains To Generate Benefits

Qualification for Social Security benefits depends on how much Social Security and/or self-employment tax a person has paid. Generally, forty quarters of credit are required.

Those who are not certain that they will qualify for full benefits on retirement should check on their status by contacting the Social Security Administration office listed in the telephone book under "United States Government, Social Security Administration." For example, many state and local government employees, and school teachers, among others, are not under the Social Security System.

Woodland owners who cut their own

trees, and who need to make additional contributions, may prefer not to make an election under Section 631(a) to treat the cutting as a sale. If so, the timber income and expenses, and the basis of the timber harvested, would be reported on either Schedule C or Schedule F of Form 1040 as ordinary income on which the self-employment tax is paid.

It must be remembered, however, that if the Section 631 (a) election has been made in prior years, it may not be foregone in any following year without IRS permission. There is a one-time exception to this rule for elections made prior to 1987.

Those who sell standing timber, and whose woodland holdings are treated as a business, can only qualify the sale receipts as a capital gain by selling under the provisions of Section 631 (b) of the Internal Revenue Code—i.e., under a pay-as-cut contract.

Taxpayers in this position, who need additional credits to qualify for Social Security benefits, may wish to sell under another method—such as by lump-sum sale—and report the income as ordinary income on either Schedule C or Schedule F.

Employment Status

If woodland owners hire individuals to

perform work on their forest property, those persons are either employees or independent contractors. If they are employees, the employer has several tax responsibilities. Most employers must withhold, deposit, report and pay the following federal employment taxes:

- (1) Income tax withheld from the employee's wages.
- (2) Social Security and Medicare taxes (both employer and employee portions).
- (3) The Federal Unemployment Tax (FUTA). This tax is not withheld.

An IRS Form W-2, which shows wages paid and taxes withheld, must be prepared at the end of the year for every employee. Copies are sent to the Social Security Administration and to the employee. In addition, woodland owners should check with their state taxing authorities concerning state tax requirements for employees.

An individual is an employee, for federal employment tax purposes, if he or she has the status of an employee under the common law rules applicable in determining an employer/employee relationship. Generally, this relationship exists when the person for whom the services are being performed has the right to control and direct the individual who



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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. In other words, an employee is subject to the will and control of the employer not only as to what work is to be done, but also as to how it is to be done. It is not necessary that the employer actually direct or control the manner in which work is done; it is sufficient if he or she has the right to do so.

Independent contractors, on the other hand, are not subject to the right of control and direction. However, if the tests for defining an employee are met, it doesn't matter that the individual is called an independent contractor or agent.

How the payments are measured or paid, or what they are called, is also irrelevant. If a worker is determined to be an independent contractor, and payments to him or her aggregate \$600 or more in a calendar year, the person for whom the work is performed must file an information return (IRS Form 1099-MISC) reporting the total paid. The return must be filed with the IRS by February 28 of the following year, with a copy to the payee by January 31.

Conclusion

Woodland owners need to be aware of how the self-employment and Social Security taxes impact their timber operations. For more information on the self-employment tax, see IRS Publication 533, "Self-Employment Tax." Farmers can also refer to Publication 225, "Farmer's Tax Guide."

IRS Publication 15, Circular E, "Employer's Tax Guide," provides information concerning an employer's Social Security responsibilities for employees. If you pay a worker for services on your forest property and are not certain whether that person is an employee or not, you can obtain an IRS ruling by filing Form SS-8.

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.

AND THEN SOME.....



Profiles of woodland owners throughout the U.S. who have made significant personal commitments to private forest stewardship "and then some...."



Beginning his "life in the woods" at age 14 working summer vacation in a local sawmill, **Michael C. Greason** received a B.S. in Forestry from the University of Massachusetts in 1964. After five years as a public and private forester in New England, he began his long public service career with the New York State Department of Environmental Conservation, retiring as Chief of the Bureau of Private Land Service in August 1998.

Active in the NY Society of American Foresters (serving as Chair for two years) Greason has always been a strong supporter of the many organizations and associations in New York's forest community. It could be argued that he was simply doing his job, as NYSDEC Section Chief for Private/Urban Forestry, but everyone knew his dedication came from the heart. In recognition of this, the New York Forest Owners Association (NYFOA, a NWOA Affiliate) awarded Greason its coveted Heiberg Memorial Award in 1993 for his "...outstanding contributions in the fields of forestry and conservation in New York State."

Greason's support for private forest owners and their woodlot improvement efforts is not exceeded by anyone else in the state. He has contributed 18 articles to the *New York Forest Owner*, the bi-monthly publication of NYFOA and other articles to *National Woodlands*, the *New York Conservationist*, *The American Tree Farmer* and *Journal of forestry*. A statewide meeting of forest owners would find Mike Greason in attendance. Even if he was not on the agenda, he would be contributing a personable professionalism that inspired, informed and entertained.

"Mike has been a wonderful resource for forest landowners over the years!" says Jill Cornell, president of the NY Forest Owners Association. "He succeeded in making forest owners feel welcome and comfortable when they called DEC for information, and he encouraged DEC foresters to work with NYFOA members to develop chapters and to participate in NYFOA's landowner education programs. For many years he has talked at NYFOA state, chapter programs and woodwalks, Cooperative Extension Master Forest Owner/COVERTS training sessions, written articles, and helped to get Capital District Chapter and other chapters up and running. He edited the CDC Newsletter. He is a man who loves and lives good forestry, and who communicates his enthusiasm to landowners."

Dick Fox, Editor, *New York forest Owner* magazine

** "And Then Some" is a tribute to the memory of W. Pat Jennings, Sr. The southwest Virginia native distinguished himself as a county sheriff, member of Congress and Clerk of the House of Representatives-but he always remained an active farmer and an advocate of the best of rural America. He was a valued counsel to several U.S. Presidents as well as the National Woodland Owners Association. A truly motivational speaker, one of his finest addresses was to the graduating class of Smyth County High School (which included one of his grandsons). The message: the secret of success is dedication to an ideal, giving it your very best... and then some.*