William C. Siegel, J.D.

Installment Sales:
How They Relate to Timberland

If certain conditions are met, the gain recognized on the sale of real property—such as forest land and/or standing timber—can be spread over more than one year for income tax purposes. Such sales are referred to as "installment" or "deferred payment" contracts. An outright sale, on the other hand, triggers immediate recognition of all gain in the year of sale for income tax purposes. Although the 1967 Revenue Act repealed the installment sale method of reporting for dealers in real and personal property, it specifically exempted sales of property used or produced in the trade or business of farming as defined in Section 2032A of the Internal Revenue Code. This definition of farming includes timber growing.

In addition to the income tax advantages, installment sale contracts can also be a good estate planning tool. Their use has become much more prevalent in recent years for facilitating the lifetime transfers of farm and forest property to succeeding generations while deferring recognition of taxable gain to future years.

Basic Requirements and Restrictions

The former requirements that an installment obligation must have two or more payments spread out over at least two tax years and that the payment(s) in the year of sale not exceed 30 percent of the selling price were repealed in 1960. Now the installment method of reporting income is available when at least one payment is to be received after the close of the taxable year in which the sale occurs. No payment is required in the year of sale, although one of more can be made.

The receipt of timber payments in more than one year could arise from either a lump-sum sale or from a "pay-as-cut" contract. A typical lump-sum transaction might require an initial down payment, a minimum actual payment, and payment in full before cutting starts. A typical pay-as-cut contract might require an initial down payment and monthly payments based on the volume cut and scaled during the previous month. If a pay-as-cut disposal qualifies for treatment under Section 631(b), however, the contract is not treated as an installment sale and the Section 631(b) rules apply as discussed in earlier columns.

Payments in the year of sale include down payments made in a prior year as well as payments received in the year that the benefits and burdens of ownership pass to the buyer. This is usually the year of transfer of possession, or the year of title passage, whichever occurs first. For example, suppose a woodland owner agreed to sell his tree farm for $150,000 and received a down payment of $5,000 on September 20, 2003. The first installment payment of $25,000 is received on June 10, 2004, and possession is given to the buyer at that time. A total payment of $30,000 would be reportable as income by the seller in 2004.

Certain restrictions on the use of installment sales should be kept in mind. For example, a sale of depreciable property between related persons cannot be reported by the installment method unless it can be established that the transaction was not made in avoidance of taxes.

Another restriction governs the sale of non-depreciable property between related persons and then a resale by the purchaser. If the purchaser in such a situation sells the property before the installment payments are made in full, the amount realized by the related party second seller from the second disposition is treated as being received by the initial seller at that time.

The first seller's gain, in other words, is accelerated to the extent of the payment received by the second seller. In many cases, however, depending on the facts involved, the restrictions do not apply if the second sale takes place more than two years after the first. A related person includes a spouse, child, grandchild, parent, grandparent, brother, sister, and corporations, partnerships and estates 80 percent or more owned by such persons.

Making the Election And Computing the Gain

If the eligibility requirements are met, the installment method of reporting income is automatic for sales of real property unless the taxpayer "elects out" of it. This negative election recognizes that almost all taxpayers prefer the installment method when possible. An election not to use the installment method must be made on or before the due date, including extensions, for filing the taxpayer's return for the tax year in which the installment sale occurs.

If interest is stipulated in the contract, any portion of it that is included in a payment is reported separately as ordinary income. If the contract provides for no interest on the deferred payments, or provides for inadequate interest as defined by the IRS, the taxpayer must impute interest and report it in the same manner as stated interest. The remainder of each payment is treated as if made in two parts. The first is a return of investment (basis) in the timber or other property sold plus the costs of sale if any. The second is the gain from the sale. If timber has been sold, the gain will be a capital gain if the trees were a capital asset and had been held for more than one year. The two parts are calculated using what is called the "gross profit percentage." The method of computing gross profit percentage is shown in the following example:

EXAMPLE

Timber is sold at a contract price of $30,000 and the adjusted basis in the timber is $4,000. The costs associated with selling the trees totaled $2,000. The gain on the sale is $24,000 ($30,000 minus $4,000 minus $2,000) and the gross profit percentage is 80 percent ($24,000 divided by $30,000). After subtracting out interest, 80 percent of each payment should be reported as gain

dren and avoid the gift tax by keeping annual gifts to each child within the $22,000 split gift tax exclusion amount. If the parents wish to stay within the $22,000 limit, they will have to convey the property a few acres at a time or give small fractional interests, neither of which are very suitable alternatives. An installment sale, however, can provide a vehicle for immediate transfer of the woodland to the children while making it possible for the parents to stay within the exclusion amount for each child.

For example, the property may be conveyed in exchange for $11,000 principle amount, interest bearing notes, payable semiannually. If the parents wish to make a gift to the acquiring child, they may forgive the notes as they become due.

Caution should be exercised, however, so that the IRS will not contend that a gift of the entire value of the property occurred in the year of sale. There should be no problem if the notes are legally enforceable and subject to assignment or sale to third parties, if the property is subject to foreclosure in the event of default, and if the parents have no legal obligation to make annual gifts to the children.

from the sale in the tax year in which the payment was received.

Estate Planning Considerations

An installment sale contract may be an ideal tool for parents to use to begin lifetime transfers of forest land to their children. Such contracts are particularly attractive to those surviving spouses wishing to avoid particularly heavy involvement in management of a tree farm. The major advantages are as follows:

- An interest in the property as security can be retained by keeping the title (in most states);
- A steady, annual income can be received for the duration of the contract, with the income not subject to Social Security tax or not reducing Social Security benefits;
- Management responsibility can be transferred to the children or other family members;
- An opportunity for the children or others to acquire an interest in the property with a low down payment can be provided;
- The size of the estate can be reduced by consuming or making gifts of the installment payments received; and
- Because the contract value is fixed, further increases in value after the contract is signed will not increase the size of the estate.

There may also be certain disadvantages associated with an installment sale from parents to children that should be considered. For example, the parents may outlive the terms of the contract and then have to depend on other sources of income to live on, because inflation may elevate their cost of living to a point where they will have difficulty maintaining their standard of living on the fixed income payments.

Interactions with Gifting

If the sellers are concerned that the family members purchasing the tree farm will have difficulty in generating a sufficient cash flow to finance the purchase, they may wish to establish a selling price below market value. The danger of this, however, is that if the price is too low the transaction may be characterized as part sale and part gift, making the sale subject to gift tax as well as income tax. Because transfers of property between family members will be carefully scrutinized by the IRS to determine whether a gift has occurred, unless a gift is intended the parties must structure the sale to insure that it has the characteristics of a bona fide business transaction.

On the other hand, an installment sale may facilitate the gifting of forest property by making it possible for parents to convey the woodland to a child or chil-

Installment Obligation Dispositions at Death

Generally, upon the death of a property owner, the property receives a new income tax basis (the so-called "stepped up" basis), and the potential gain or loss is eliminated. But on the death of a seller within the term of an installment sale, the installment obligation as an asset of the estate does not receive a new basis.

Payments received after death are reported in the same manner, for income tax purposes, as the seller would have done if he or she were still alive. This feature may represent an income tax disadvantage compared with retention of the property until death. The disadvantage, obviously, is greatest for property that has appreciated substantially in value.

Previously unreported gain from an installment sale will be immediately recognized by (become part of) a deceased seller's estate, if the installment obligation is transferred by bequest or inheritance from the decedent to the obligor (purchaser) or is cancelled by the seller's executor.

For example, suppose a father sold 25 acres of timber property to his only son for $100,000, using an installment sale contract. After receiving the first two payments, the father died with the contract passing to the son by inheritance. All unreported gain in the installment obligation would be taxable in the father's estate.

In order to avoid this result, installment obligations could be bequeathed to family members other than the obligor. This would mean that family members would own each other's installment obligations but not their own and that payments would have to continue to be made.

Installment Sales By the Estate

A different rule applies if the estate is the seller under an installment obligation. In that case, distribution of the obligation to the heirs causes immediate taxation of the gain in the obligation under all circumstances.

For some assets with a new income tax bases received at death, the amount of gain may be little or none. But if the sale involves timber property that had been valued under special use valuation, the amount of gain could be substantial. The new basis at death would only be up to the value set for federal estate tax purposes—in this case, special use value, and not up to fair market value.

Conclusion

Installment sales are reported on IRS Form 6252. This form is used to report the original sale in the year it takes place, and also to report payments received in later years. If timber is involved, the sale should additionally be reported on Form T in the year it takes place.

If an installment sale is being considered for estate planning purposes, the advantages and disadvantages should be carefully weighed and the final decision made only with expert professional advice. Because of timber's unique nature, and the interactions between installment sales and the gifting laws, careful planning is essential in structuring installment sales of woodland as part of an estate plan.

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.

PLEASE NOTIFY NWOA OF YOUR ADDRESS CHANGE!!!
The covers of 14 member's copies of the Special 20th Anniversary Issue of *National Woodlands* were returned to NWOA (and the magazine junked—Postal Regulation 3579) because of a change of address with no forwarding service. Although we usually do get your new address, the magazine is dumped. Please let us know so this does not happen to your copy!

FOREST LANDOWNERS TAX COUNCIL

NATIONAL NWOA WOODLAND OWNERS

FLTC Tax Report

by **Frank Stewart, RF**

Welcome to a new "21st Century Feature" from NWOA. This report will come to you quarterly, and we hope you believe, as we do, that the taxation of your timber/timberland is of the highest consequence. We look forward to bringing you the latest quarterly federal timber tax information.

<u>Congressional Tax Seminar</u>: On November 14, the Association of Consulting Foresters of America, Inc. was joined by the Forest Landowners Tax Council to sponsor a seminar for congressional staff entitled, the "Forest Tax Impact on Non-Industrial Forestland Owners." This event was hosted by the United States House of Representatives Subcommittee on Forests and Forest Health, at the Longworth House Office Building on Capitol Hill in Washington, D.C. Congressional staffers who have significant responsibilities affecting the ten million non-industrial forestland ownerships in the U.S. attended the seminar. The event was for educational purposes only.

<u>Sec. 631(b) Issue</u>: The U.S. House of Representatives has reported out of Committee the JOBS Act (H.R. 2896-FSC/ETI Repeal Bill), which replaces a tax regime that is very important to U.S. exporters and is similar to the Senate bill reported here last issue. This legislation cuts taxes for U.S. manufacturers, sole proprietors, partnerships, farmers, small businesses, <u>forest landowners</u> and simplifies international taxes for U.S. companies operating overseas. The legislation is meant to head off trade sanctions from Europe that likely would force U.S. manufacturers and agricultural producers to slice jobs.

<u>Death Tax</u>: FLTC's Executive Director was the only forest-based representative at the Department of the Treasury Roundtable on death tax on November 6. Treasury Secretary John Snow signaled that the Bush administration's push for tax changes in 2004 will focus on making permanent the tax cuts passed in the past three years--with a particular emphasis on repealing the death tax--and reviving a proposal from early this year to encourage individual savings.

<u>Passive Loss</u>: Rep. Wally Herger (R-CA) has introduced a "free standing" bill that provides an exception to the passive loss rules for small timber owners (H.R. 3346) "The Timber Tax Fairness Act of 2003." FLTC plans to work with the Herger office to find suitable opportunities for this much needed correction to an unintended consequence of the Tax Reform Act of 1986.

Frank Stewart is the executive director of the Forest Landowners Tax Council (FLTC), which is an independent non-profit organization dedicated to providing an effective and unified voice for non-industrial, private forest landowners on federal tax issues. The Council seeks to provide technical research to identify opportunities for timber tax improvements. FLTC is also a source of education for those who wish to learn more about timber and timberland taxation, as well as the business aspects of forestry. Membership is open nationwide. Visit the official website at "http://www.FLTC.net" or contact Stewart directly via email: Director@FLTC.net, tel: 703-549-0747, fax: 703-549-1579.