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Gifting of Timberland As An Estate Planning Tool

Estate planning and associated tax considerations frequently focus on the transfer of property at death. Lifetime gifts, however, are also a valuable planning tool. The "ability to afford the gift" should be the first consideration in a giving program. Timberland and other property that someday might be needed should not be given away.

Many times people give things to others for personal reasons that do not involve tax savings. To the donor, these objectives are just as important—or perhaps more so—than tax and financial considerations. Nevertheless, careful attention to the tax rules will permit the property owner to maximize the benefits of the gift. In this article I will discuss the role of gifts in timberland ownership.

The Federal Gift Tax

Significant changes have been made to the federal gift tax in recent years. It is now a stand-alone tax, separate from the federal estate tax.

Nontaxable Gifts

Three types of gifts are not taxable at the federal level. These are gifts to spouses, charitable gifts, and gifts to which the annual exclusion applies. Each will be discussed in turn.

Unlimited Marital Deduction. Gifts made from one spouse to another are not taxed, regardless of amount. This is referred to as the unlimited marital deduction. Although an effective planning tool in the right situation, the question remains as to what extent it should be used. A lifetime transfer saves estate administrative expenses and probate costs for the donor spouse who dies first and it could permit full utilization of the estate tax credit if the other spouse were to die first. On the other hand, the prospective donor might wish to consider alternatives if he or she feels that it is necessary to insure that the children ultimately receive the property.

Charitable Gifts. Lifetime gifts to qualified charities and other non-profit organizations are not taxed, regardless of amount. In addition to removing the gifted assets from the donor's estate with possible estate tax savings, there may also be income tax savings associated with the gift.

Annual Exclusion. The annual exclusion also permits tax-free gifts to be made. The first $11,000 in qualified gifts, based on fair market value, to each recipient (other than the donor's spouse or to charity) during each calendar year may be transferred without tax. Such gifts must be of a present interest. This means that they cannot comprise property or consist of a right that cannot be utilized until some future date by the person who is receiving the gift.

Example: *Mr. and Mrs. Woodland Owner have three adult married children. Mr. Woodland Owner owns 1,200 acres of timberland which he inherited from his father and which is valued (both land and timber) at $1,500 per acre. Mr. Woodland Owner (the donor) can give each child (donee) $11,000 in value each year. That is, he could give each child either 7.33 acres or a fractional, undivided joint interest in the entire property worth $11,000 each, for a total of $33,000 per year for the family. He could also give each child's spouse the same $11,000 property interest each year. This could be transferred as 14.66 acres or $22,000 in joint family ownership to each child and his/her spouse for a total annual family transfer of $66,000.*

In the example above, the timberland could also be placed into a limited liability company (LLC) or family limited partnership. The gifts then would be of LLC or partnership ownership units rather than outright gifts of land and timber. As long as the donor makes the gifts outright, qualifying for the annual exclusion should not present a problem. However, with timberland, a qualified appraisal is necessary in order to verify the fair market value of the transfer.

Split Gifts. A married person who makes a gift to a child or any other person can treat that transfer as though one-half had been made by him/her and one-half by the spouse, if the spouse agrees. The gift is said to be "split" for gift tax purposes. In such cases, the $11,000 annual exclusion per donee can be expanded to $22,000. A gift tax return is required to be filed for split gifts even though no tax is due.

Example: *Assume the same facts as in the previous example, but now Mrs. Woodland Owner agrees to make a tax-free split gift to the children. Each child will now receive a split gift of either $22,000 in woodland value or 14.66 acres. This can be increased to $44,000 or 29.33 acres per year by making split gifts to the child and his/her spouse. In that case, the total transfer per year for the three children and their spouses would be $132,000.*

The Type of Property to Give

Choosing the right property to give is an important part of the gift plan. There are certain basic considerations to bear in mind.

Low Gift Value

For lifetime gifts, it makes sense to give property that has a low gift tax cost but a high potential estate tax cost. Rapidly appreciating assets, such as pre-merchantable and young merchantable timber, fit this category. Timberland with high growth potential is a good candidate for gifts because it is likely to become an estate tax problem for the donor if held.

Appreciated Property

Timber often fits into the appreciated property category. Assume that a donor is in the 28 percent federal marginal income tax bracket. If he/she sells the property for a $50,000 net gain, the capital gain tax (15 percent) will be $7,500. However, if the property is given to a son or daughter older than 14 who is in the 15 percent marginal bracket, the capital gain tax on the sale (5 percent) will only be $2,500.

High Yield Assets

Senior family members in the higher federal income tax brackets may wish to consider transferring high-income producing assets to children over age 14 who are just getting started in their careers and who currently are in low marginal income tax brackets. Alternatively, a retired person in a low federal income tax bracket should consider gifts to children of low income producing assets with good growth potential such as rapidly appreciating young timber stands.

Keeper Assets

Woodland is often low basis property that will remain in the family. Many times senior family members who worry about control of their timberland will consider taking the timber income and parting with the land. If the timber will cause future estate problems, the owner could harvest the mature timber and transfer the cutover bare land to the children. This type of transaction can be coupled with gifts of some of the liquid assets to cover the cost of reforestation. In such cases, the donor should be certain that the person receiving the gift can afford the management costs and carrying charges that will be associated with the property while it is unproductive.

Incomplete Gifts

A complete gift requires a competent donor and donee, a clear intent to make a gift, an irrevocable transfer of legal title, delivery of the gift to the recipient, and the recipient's acceptance. If the donor retains an interest or power over the property gifted, it results in the gift being incomplete.

The Internal Revenue Service will treat the gift of underlying land with retention of the timber rights by the donor as an incomplete gift. This means that the value of the land will revert to and be included in the donor's estate. IRS Revenue Ruling 78-26 addresses this point, holding that the entire value of forest land given to an individual by a donor who reserved for ten years all timber rights, with the donor dying during the ten year period without having removed any timber, was included in the donor's estate. It did not make any difference that two separate property ownerships legally existed under state law. In an unrelated case, the U.S. Fourth Circuit Court of Appeals upheld the IRS position.

Gifts Within Three Years of Death

The value of gifts made within three years of the donor's death is generally no longer includable in his/her gross estate as once was the case. Such gifts are valued on the effective date of the transfer, and the appreciation in value after that date is not subject to the estate tax.

There are certain exceptions to this rule, however. The value of a life insurance policy transferred by the decedent within three years of death will be included in the gross estate. In addition, all gifts within three years of death will be included in the calculation of estate value for purposes of determining the timberland's qualification for federal estate tax special use valuation. Property eligible for special use valuation

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must comprise at least 50 percent of the value of the decedent's adjusted gross estate. Gifts of property not eligible for special use valuation are often made in order to increase the percentage of qualifying property, such as timberland, in the estate—but such transfers, in order to accomplish the tax goal, must he made prior to three years before the decedent's death.

A similar rule applies to transfers within three years of death in order to qualify for the payment of estate taxes over 14 years at a low rate of interest under Section 6166 of the Internal Revenue Code. To qualify for this provision, potentially eligible property (such as woodland) must comprise at least 35 percent of the decedent's adjusted gross estate.

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.

Sec. 631(b) Issue: Language to allow capital gains treatment for revenues from the sale of timber by non-industrial private forest landowners passed the Senate on May 11 and the House on June 17, attached to each house version of the Corporate Tax Bill (S.1637& H.R. 4520, aka: JOBS Bill, FSC/ETI Bill, International Trade Bill). The next step is the appointment of conferees for the joint Senate/House Conference Committee. After the Committee negotiates a compromise bill (traditionally, identical language--as is the case with our Sec.631(b) language—is not at issue in Conference), the bill goes back to each chamber for an up or down vote. Some believe this process may not be completed until September.

Background: The corporate tax bill replaces an existing export tax break with new tax structure for manufacturers. The World Trade Organization (WTO) has ruled that the current export tax is an illegal subsidy. And so, the European Union—as of March 1—has imposed a five percent retaliatory tariff on some U.S. products. The EU will increase the tariff by one percent each month that the illegal U.S. tax break continues.

Reforestation: Language to allow reforestation costs to be expensed in the year of occurrence—with an accelerated amortization schedule—by non-industrial private forest landowners passed the Senate on May 11, also attached to the Corporate Tax Bill (S.1637). Neither this provision, nor one similar, was attached to the House version of the Corporate Tax Bill.

Death Tax: Permanent, immediate repeal of the death tax has passed the House as the Death Tax Repeal Permanency Act (H.R. 8), last year. The Senate version, the Death Tax Fairness Act (S. 13), hasn't passed. Sen. Jon Kyl (R-AZ) says S. 13 won't pass in this election year: The Kyl Proposal is to extend elimination of the death tax from the only year that allows it (2010) to the year 2009, as well. Sen. Don Nickles (R-OK) agrees that S. 13 will not pass in 2004: So, Nickles has a proposal is to lower the tax rate across the board to 15 percent (same as capital gains rate), and to raise the threshold for the tax to $15 million.

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.

Gifts Associated With Installment Sales

A strategy of selling timberland to a child or other related person, coupled with periodic forgiveness of all or part of the payments as they become due, should be used with considerable caution. It runs the risk of having the entire sale re-characterized as a gift. Because the payments under the installment contract are classed as income to the seller, a possible solution is to treat the payment as income and make gifts of cash to the donees who then make the payments from a totally separate account.

Income Tax Considerations

The gift recipient's income tax basis in property given to him/her is the donor's basis (which often will be quite low) plus any gift tax paid on the net appreciated value of the gift while in the donor's hands. For this reason, highly appreciated property should often be held rather than gifted in order to secure a stepped-up income tax basis on the death of the owner. This strategy, however, must be balanced with the further appreciation potential of the property and a comparison of potential income tax rates (both state and federal) with potential death tax rates (again, both state and federal).

Conclusion

Because of the power of gifting to reshape the donor's estate, a program of gifts should be pursued carefully. The advantages and disadvantages of each gift situation must be seriously weighed and the final decision made only with expert professional advice. Another consideration is a possible state gift tax. At last count six states had a gift tax.

A major point to remember is that a valid gift—once made—is irrevocable and the loss of control over the property is permanent. Because of its unique nature, and sometimes unusual interactions with the gifting laws, careful planning is particularly essential in making gifts of woodland.

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.

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On the Cover: *Timber harvesting is an essential part of intelligent forest management. This well-equipped and certified Pennsylvania logger, Joe Zehr of Christiana, PA, is one of the best in the business. The job was a light thinning on private land marked by a consultant forester in southeastern PA.*
Photo by Eric Johnson