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INCOME TAX MANAGEMENT AND REPORTING FOR CHRISTMAS TREE GROWERS

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ABSTRACT

Christmas tree growers should report and manage income taxes very similar to farm taxpayers. Costs associated with establishing, growing, harvesting, and selling trees are classified as "basis", depreciation, depletion, and annual deductible expenses to determine when they are recovered. Receipts from harvesting and selling Christmas trees may be reported in different ways depending upon the grower's harvesting methods and intent. Managing sales to qualify under certain tax reporting elections can save tax dollars.

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Keeping track of all deductible expenses and knowing how to claim them on the income tax return is an important part of good business management. Christmas tree growers need a well-organized record system to keep track of production and marketing costs. Knowing which expenses qualify as deductible operating costs versus those that must be capitalized is required to file correct tax returns and perform wise tax management.

Capital Expenditures

The purchase of equipment, machinery, buildings, bridges or other structures used in the business are capital expenditures. Trees or seedlings and their planting costs are capital expenditures and cannot be deducted as annual expenses in the year they occur. Site development costs also must be capitalized.

The total cost of many capital purchases used in the business are recovered through depreciation over a period of years determined by depreciation rules and guidelines. Depreciable expenditures include: tractors, business vehicles, tree planting machines, power saws, harvest equipment, office equipment, sheds, shops, bridges, culverts, and improved roadways.

The cost of seedling trees is recovered as basis when the trees are cut. A Christmas tree cost basis account should be established to include the following expenses in addition to new tree seedlings:

-- site preparation costs including brush and stump removal

-- hired labor employed in tree planting and site preparation

-- the value attributed to standing trees when a Christmas plantation is purchased

-- costs of replacing trees that die

All of these capital expenditures are accumulated in the account as they occur and are recovered or claimed when the trees are harvested. Here is an example:

Sam Scotchpine planted 8,000 trees on 50 acres six years ago and capitalized the following costs:

Brush clearing and land preparation, $100/acre =		$5,000
Scotchpine seedlings @ 8 cents =		640
Planting costs @ $15.20/acre		760
	Total	$6,400

Sam's cost basis account for this 50 acre block is $6,400 or 80 cents per tree planted. Sam has claimed all annual growing costs such as shearing and weed control as operating expenses on Schedule F. This year Sam cuts and markets 1,000 trees from this block. He will claim a cost basis or depletion allowance of 80 cents per tree or $800 on Form 4797. See how he reports the income from this sale under Tax Reporting.

Land purchased for tree production is a nondepreciable capital expenditure. The cost of the land is recovered when the land is sold by deducting it from the sale amount.

If land is purchased with trees already growing on it, the purchase price must be divided between land and trees. This allocation should be made immediately and recorded in the recordkeeping system.

Operating Expenses

Operating expenses are those costs that are usually incurred year after year and do not extend the life of the Christmas tree stand or other capital assets. Common operating expenses include labor, small tools, herbicides, fertilizer, pesticides and supplies, services purchased, equipment hired, repairs, costs of operating equipment, management fees, advertising, business travel, and marketing expenses. Most of these operating expenses may be claimed in the year they are paid. But marketing expenses, advertising, and other costs associated with selling Christmas trees must be deducted from the sale proceeds.

Wages paid family members are deductible if they are paid for services actually performed and payments are made on a regular basis. Salaries paid to the sole proprietor or partners of a business are not deductible.

A new roof or an addition on the storage shed is a capital improvement, but replacing the door and repairing the roof are operating expenditures.

Carrying Charges or Development Costs

Property taxes, interest payments, costs of thinning, pest control, shaping (pruning, shearing), and other costs of developing a stand are called carrying charges or development expenses. These costs may be claimed either as annual operating expenses or capitalized and recovered when the trees are harvested.

Most growers elect to claim these costs in the year they occur to offset current income. Growers with little or no taxable income during the development stage may save tax dollars by accumulating carrying charges to claim them when income is generated. In either case, the grower must follow a consistent practice year after year.

Tax Reporting

Growing Christmas trees is a farming operation and the operating costs are reported on Schedule F. Christmas tree enterprises that are a part of an individual's timber operations may be reported on Schedule C. Corporations and partnerships must use the appropriate business tax returns. The income from tree sales may be reported on Schedule F or C, or on Form 4797 if the grower elects to treat the cutting of trees as a sale in accordance with IRS Section 631(A). Christmas trees must be six years old when cut in order to qualify. Electing Section 631(A) keeps most of the tree income off from Schedule F or C where it is ordinary income subject to self-employment tax.

It also makes this income eligible for favorable capital gains treatment if enacted.

Reporting the cutting of Christmas trees as a sale under Section 631(A) is a two step process.

Step 1: Establish the January 1st market value of the trees that were cut. Non-calendar year taxpayers use the market value on the first day of their tax year. Subtract the cost or other basis of the trees harvested. The difference is the gain attributed to growing and cutting the trees and it is reported on Part I of Form 4797.

Step 2: Determine the income from selling the trees by subtracting the January 1st market value plus all the costs of harvesting and selling, from the price received for the trees. The January 1st market value divided by the trees sold is referred to as the depletion allowance.

Here is how Sam Scotchpine will report his tree sales and expenses:

1. Sam elects Section 631(A) and reports the sale of his 1,000 trees on Part I of Form 4797. He must show his calculation of the value of the standing trees as of the first day of his tax year; <u>1,000 trees x $4.00 per tree under Section 631(A)</u>.

Gross sales price	$4,000
Cost or other basis	- 800
Gain	$3,200

Sam calculates the value of standing trees as the appropriate market price less cutting and marketing costs. The calculated value becomes the stumpage cost or depletion allowance on Schedule F. If this is the first year in which Sam has elected Section 631(A) he must include on his return:

"I elect to treat the cutting of timber as a sale or exchange in accordance with Section 631(A)."

The $3,200 gain is entered on Schedule D so it can be reduced by long term capital losses if Sam has any.

2. Sam sells the trees for $6,500. His deductible harvesting and marketing costs, excluding his own time and management, are $1,800.

Sam reports the following transactions on Schedule F:

Part I; line 4, Christmas tree sales	$6,500
Part II; line 17, Depreciation on equipment & shed	435
line 22, Gasoline, fuel, oil	360
line 23, Insurance	125
line 25, Labor hired	1,200
line 28, Repairs	310
line 31, Supplies	600
line 32, Taxes	250
line 35a, Advertising	40
line 35b, Stumpage or depletion allowance for Sec. 631(A) trees	4,000
line 38, Total deductions	$7,320
line 39, Net Farm (loss)	$(820)

Depreciation is computed on Form 4562. Insurance is fire insurance on Sam's shed and tractor. Taxes are the real estate taxes on the 50 acres.

Annual operating expenses plus Sam's harvesting and marketing costs are $820 more than the income from tree sales. This net loss plus the $3,200 gain from Form 4797 gives Sam a $2,380 taxable gain from his Christmas tree enterprise.

3. Sam reports his capital gains and farm loss on Form 1040 along with other taxable income.

Line 13, Capital gain (net of capital losses)	$3,200
Line 19, Farm income (loss)	$(820)

Sam will pay income tax on his $2,380 taxable gain from Christmas tree farming providing he has other income to the extent of personal exemptions and allowable deductions. He will pay no self-employment tax because Schedule F shows a loss.

Currently the only advantage of electing Section 631(A) is to reduce self-employment taxes. A Section 631(A) election is binding with respect to all eligible timber or Christmas trees in the year of the election and all subsequent years. The Commissioner's consent must be obtained to revoke the election.

Christmas tree plantation owners that sell trees "on the stump" under a lump sum contract may be able to qualify for capital gains under IRC Section 631(B). Taxpayers in the business of growing, harvesting, and selling Christmas trees on a regular and continuing basis do not qualify under Section 631(B).

"You cut" or "choose and cut" Christmas tree sales can be reported under Section 631(A) but not Section 631(B).

<u>The Profit Motive</u>

Christmas tree enterprises cannot be managed to generate continuous annual losses to offset other taxable income. A grower must be in the business of producing trees to make a profit to be allowed annual expense deductions that exceed income from tree sales. A grower who is not trying to make a profit on the Christmas tree enterprise will be allowed to claim expenses only to the extent of income from the enterprise. Here are factors considered in deciding whether there is a profit motive:

1. The extent that good business management is practiced.
2. The knowledge and expertise of the taxpayer and his advisers about the enterprise.
3. The time and effort expended by the taxpayer.
4. The success of the taxpayer in carrying on other activities.
5. The expectation that business assets may appreciate in value.
6. The taxpayer's history of profits and losses from the business.
7. The size of profits/losses from the business.
8. The causes attributed to losses including start-up costs.

IRS will presume the tree growing enterprise is carried on for profit if it shows a profit in three out of five years. A taxpayer can rely on this presumption and not be required to show proof of the profit motive unless IRS shows it is not valid. The presence of profit or loss is determined by including tree enterprise income and deductions reported on Form 4797 as well as that on Schedule F or C.

For more information on tax reporting and management of Christmas tree and timber sales refer to: Forest Owners' Guide to Timber Investment, The Federal Income Tax and Tax Recordkeeping Agricultural Handbook No. 681, available from Superintendent of Documents, Washington, DC.

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