

Tax Issues for Christmas Tree Growers Following a Freeze

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October 8, 2002

Introduction

Cold temperatures in the Christmas tree growing area of some states caused freeze damage to Christmas trees in the spring of 2002. The damage forces producers to make management decisions such as whether to harvest the trees in their damaged condition or reshape the trees and let them grow another year to increase their value at harvest. The income tax consequences of harvesting the damaged trees rather than letting them grow could be a significant factor in the management decision. No matter what management decisions are made, the income tax consequences of the damage, if any, must be reported on the producer's income tax return.

This issue discusses the income tax consequences of freeze damage to Christmas trees. It also discusses the income tax consequences of subsequent expenses to repair the damage and sale proceeds from the sale of damaged crops. These income tax principles also apply to weather damage to other crops such as fruits and nuts or ornamental trees and plants.

Background: Income tax rules for Christmas trees

The age of Christmas trees at the time they are severed from the roots affects the tax treatment of the cost of raising the trees as well as the tax rules that apply when calculating the income or loss from the sale of trees.

If Christmas trees are more than six years of age at the time they are severed from the roots, they are defined as timber under I.R.C. §631 and therefore, the timber tax rules apply. If the trees are six years old or younger at the time they are severed from the roots, they are not treated as timber under I.R.C. §631 and they are subject to the I.R.C. §263A uniform capitalization rules.

Note.

The age of a tree is measured from the date the seed is planted. Therefore, if a producer buys two-year-old seedlings, the two years are included in the age of the tree. If the tree is grown in the field seven years prior to harvest, its age is nine when it is severed from the roots.

Observation.

Christmas trees grown in the Southern United States are often cut at six years of age or less. Christmas trees grown in the Northern United States or at higher elevations in the Southeast US are generally cut at more than six years of age.

Treatment of Gains from Sale of Christmas Trees Older than Six Years

If the owner of the Christmas trees is in the business of raising and selling trees, then the gain from the sale of trees is reported in one of three ways.

1. All of the gain is ordinary income unless the sales contract qualifies under I.R.C. §631(b) or the taxpayer elects to report the sale under I.R.C. §631(a).
2. If the owner retains an economic interest in the trees, then all of the gain is capital gain under I.R.C. §631(b).
3. If the Christmas tree owner elects to report the gain under I.R.C. §631(a), then the difference between the value of the trees at the beginning of the tax year and the basis in the trees is I.R.C. §1231 gain and the difference between the sale price and the value at the beginning of the tax year is ordinary income.

The third method may be beneficial to taxpayers in the business of raising Christmas trees that have suffered freeze damage in a late spring freeze.

Example 1. *Frazier Firr raises Christmas trees for sale in both retail and wholesale markets. Frazier harvests (severs from the root) the trees when they are seven years old or older. He uses the cash method of accounting, which allows him to deduct his operating expenses in the year they are incurred. Under I.R.C. §263A Frazier must capitalize the cost of establishing the trees and recover those costs when the trees are sold.*

In 2002, Frazier sold 10,000 trees for \$150,000. His basis (cost of establishing the trees) is \$20,000. Frazier computes his gain as follows.

Amount realized	\$150,000
Less Basis	(20,000)
Less Cost of Sale	(20,000)
Gain on Sale	\$110,000

Example 2. *Lucy Spruce also raises Christmas trees and sells them in a “cut-your-own” operation. Customers to Lucy’s tree plantation have an implicit contract with Lucy under which the act of cutting the tree of their choice obligates them to pay for the tree. This transaction is a present sale of a cut Christmas tree, not a sale of standing timber. If Lucy does not make the I.R.C. §631(a) election, income from the sale of the Christmas tree is ordinary income to Lucy.*

Note.

It is difficult for the owner of Christmas trees to qualify for I.R.C. §631(b) because there is no contract between the parties by virtue of which the customer had both a right and an obligation to cut timber. *Ah Pah Redwood Co. v. Commissioner*, 251 F.2d 163 (9th Cir. 1957); *Jantzer v. Commissioner*, 284 F.2d 348 (9th Cir. 1960, and *Patterson v. Belcher*, 302 F.2d 289 (5th Cir. 1962), opinion amended and reh.den.,371 U.S. 921 (1962).

Example 3. *If Frazier Firr in Example 1 elected to report his gain under I.R.C. §631(a), part of the gain is treated as I.R.C. §1231 gain. To allocate the gain between ordinary income and §1231 gain, Frazier must determine the value of the trees at the beginning of the tax year in which they are cut.*

Assume Frazier can show the value of the trees to be \$11 per tree on January 1, 2002. The \$110,000 gain is then allocated as follows.

Calculation of I.R.C. § 1231 Gain	
Value on 1-1-02: 10,000 trees x \$11 per tree	\$110,000
Less basis	\$(20,000)
I.R.C. § 1231 gain	\$90,000
Calculation of Ordinary Income (Loss)	
Amount realized from sale	\$150,000
Less adjusted basis (value on 1-1-02)	\$(110,000)
Less cost of cutting	\$(20,000)
Ordinary income	\$20,000

Observation. Examples 1 and 3 illustrate that Christmas tree growers can dramatically reduce their ordinary income by making the I.R.C. §631(a) election. The election reduced the ordinary income from \$100,000 in Example 1 to \$20,000 in Example 3.

Treatment of Losses due to Freeze Damage

When taxpayers suffer economic losses, they want to take advantage of all the aid and benefits that are available to them. One potential benefit is the casualty loss deduction found in the Internal Revenue Code. However, there is no casualty loss deduction in some cases.

For purposes of calculating a casualty loss, losses are limited to the **lesser** of

1. the adjusted basis of the property, or
2. the decrease in fair-market-value of the property [Treas. Reg. §1.165-7(b)].

However, if the property is business property, such as Christmas trees, and the property is totally destroyed, the amount of the loss is the property's adjusted basis [Treas. Reg. §1.165-7(b)(1)(ii)].

Single identifiable property. For casualty losses incurred in a trade or business or in any transaction entered into for profit, taxpayers must calculate the basis and fair market value of each single identifiable property [Treas. Reg. §1.165-7(b)(2)(i)]. In

Weyerhaeuser Co. v United States, 92 F.3d 1148 (Fed. Cir. 1996), the court held that the single identifiable property for timber is the depletion block when that block serves for commercial, forest management and depletion purposes. In light of *Westvaco Corp. v. United States*, 639 F.2d 700 (Ct. Cl. 1980) and *Weyerhaeuser*, supra, the IRS issued Rev. Rul. 99-56, 1999-2 CB 676, which revoked Rev. Rul. 66-9, 1966-1 CB 39. Rev. Rul. 66-9 defined single identifiable property as the quantity of timber destroyed by the casualty. Therefore, the single identifiable property for Christmas trees is likely to be a group of trees that are planted at the same time, in the same plot and will be ready for harvest at the same time.

Basis. As noted above, the adjusted basis of Christmas trees is either the accumulation of capitalized pre-productive expenses or, if there is an I.R.C. §631(a) election, the value of the timber at the beginning of the tax year.

Decrease in Value. The decrease in fair market value is determined by an informed disinterested third party who compares the value of the timber before the loss with the value after the loss.

Observation. If taxpayers, in error, have deducted pre-productive expenses or the costs of establishing Christmas trees along with annual operating expenses, the basis of those trees is zero. Since casualty losses are limited to the lesser of adjusted basis or the decrease in FMV the taxpayer will have no deductible casualty loss.

Business losses are not subject to the personal casualty loss limitations of \$100 per event and 10% AGI floor as found in I.R.C. §165(h).

Example 4. *Frazier Firr from Example 3 has suffered losses due to a late spring freeze. Frazier's trees were at a very tender growth stage when the freeze occurred. The freeze killed the growing point and set back the marketability of the trees. The trees lost a size class, shape and form, and declined from a grade 1 tree to a grade 2 tree. The trees had an average value of \$11 per tree on January 1 for the purposes of the I.R.C. §631(a) election, but following the freeze in early May, have an average value of \$7 per tree. Frazier estimates that it will take an additional trimming to reshape and reform the trees to be marketable next year; that trimming will cost \$2.25 per tree. Frazier's newly planted seedlings were also killed by the freeze.*

Question 1. Does Frazier have a deductible casualty loss due to the late spring freeze?

Answer 1. Arguably yes. I.R.C. §165(c)(1) allows taxpayers to deduct losses incurred in a trade or business. Since the Christmas trees are treated as timber for income tax purposes, Frazier can arguably follow the rules that allow a casualty loss of timber to be deducted. In *Westvaco Corporation v. United States*, 639 F.2d 700 (Ct. Cl. 1980), the court explained those rules as follows:

“Therefore, as a matter of law, there is no bar to recognition of a partial loss of timber as a legitimate casualty loss. In this respect we agree with plaintiff and hold that plaintiff's allowable loss for casualty damage to or destruction of its timber is not limited to merchantable units of timber totally destroyed. However, plaintiff's calculation of the loss can only represent the change in fair market

value attributable to the damage or destruction; it cannot deduct future profits, nor can it deduct paper losses.”

The loss is limited to the lesser of:

- | | |
|---|-----------|
| 1. Adjusted basis: | \$ 20,000 |
| or | |
| 2. The decrease in FMV: | |
| FMV before casualty (10,000 trees x \$11) | \$110,000 |
| FMV after casualty (10,000 trees x \$7) | 70,000 |
| Decreases in FMV | \$ 40,000 |

Therefore, Frazier’s deductible loss is \$20,000. The loss is reported on Form 4684 and is carried to Form 4797.

The casualty loss reduces the basis of the Christmas trees from \$20,000 to zero.

Alternative Argument

The IRS may argue that although the Christmas trees are treated as timber for income tax purposes, the loss is not deductible because it the grower has only suffered a loss of future profits. This argument is based on the fact that unlike trees that are harvested for their wood content, the Christmas trees had value only as a potential crop when the freeze occurred. Therefore, the only loss that the Christmas tree owner suffered is the loss of future profits, which is not deductible as a casualty loss.

Question 2. If Frazier cuts and sells his trees in 2002 at lower grade and size class how are gains and losses calculated if he makes the I.R.C. §631(a) election?

Answer 2. If Frazier sells his trees in 2002, he will not report a separate casualty loss since the decrease in value of the trees is included in the loss he reports for the sale. If he makes the I.R.C. §631(a) election he has \$90,000 of I.R.C. §1231 gain.

Calculation of I.R.C. §1231 Gain	
Value on 1-1-02: 10,000 trees x \$11 per tree	\$110,000
Less basis	(20,000)
I.R.C. § 1231 gain	\$ 90,000

His ordinary loss on the sale is \$60,000.

Calculation of Ordinary Income (Loss)	
Amount Realized from Sale	\$ 70,000
Less adjusted basis (value on 1-1-2002)	(110,000)
Less Cost of Cutting	(20,000)
Ordinary Income (Loss)	\$ (60,000)

Note that Frazier’s \$30,000 (\$90,000 §1231 gain - \$60,000 ordinary loss) net income in Example 4 is \$80,000 less than his \$110,000 income in Example 3.

That is the \$80,000 difference between the \$70,000 sale price in Example 4 and the \$150,000 sale price in Example 3.

Observation. Frazier would make more money on the trees by spending \$2.25 per tree to reshape and reform the trees and waiting until 2003 to sell them when they are again worth \$11 per tree. However, since his business plan is to sell 10,000 trees each year, he may be forced to sell trees in 2002 to meet his cash flow needs.

Question 3. Does Frazier have any other losses that he may deduct?

Answer 3. Yes. Frazier can claim a deduction for the loss of the seedlings that were killed in the freeze. His basis in the seedlings is the cost of purchasing and planting them. The FMV of the seedlings would be about the same as the basis.

Question 4. If Frazier does not sell his trees in 2002, can he increase his loss by making the I.R.C. §631(a) election? The election would increase his basis, thereby increasing his deductible loss to the decrease in FMV, which would be the lesser of his basis or the decrease in FMV.

Answer 4. No, Frazier cannot make the I.R.C. §631(a) election if he does not sell the trees. For the purposes of qualifying for I.R.C. §631(a) election the timber (Christmas trees) **must be cut and sold** in the same year. Frazier has decided to carry over his Christmas trees and therefore cannot benefit from the I.R.C. §631(a) election to recognize I.R.C. §1231 gain based on the FMV at the beginning of the year thereby increasing his basis and his deductible loss.

Question 5. Can Frazier deduct his loss in the preceding year under I.R.C. §165(i)?

Answer 5. No, I.R.C. §165(i) allows taxpayers to deduct a loss in the year immediately preceding the year of a disaster only if the loss is in an area that is declared a disaster area by the President. There were no disaster area declarations as a result of the late spring 2002 freeze.

Gains and Losses from Christmas trees six years old or less when cut

Treatment of Gain on Sale

If Christmas trees are six years old or less when they are cut; they are not treated as timber under I.R.C. §631. Therefore, neither §631(a) nor §631(b) reporting of income can be used. Consequently, if the producer is in the business of raising and selling Christmas trees, all of the gain from the sales of Christmas trees is ordinary income and subject to SE tax.

Example 5. *If the trees Frazier Firr sold in Example 3 were 6 years old or less when they are harvested (severed from the roots), he would not be allowed to make the §631(a) election. Therefore, all of his gain must be reported as ordinary income as it was in Example 1.*

Example 6. *The trees Frazier Firr owned in Example 5 suffered freeze damage in early spring and sustained damage and death loss.*

Question 6. Does Frazier have a deductible casualty loss?

Answer 6. No. Since Frazier's trees are not treated as timber, he is subject to the rules for reporting losses for crops raised in a farming business. Treas. Reg. §1.165-6(c) says, "The total loss by frost, storm, flood or fire of a prospective crop being grown in the business of farming shall not be allowed as a deduction under I.R.C. §165(a)." Therefore, Frazier will realize his loss from the freeze in the form of less income when he sells the trees.

Question 7. Can Frazier deduct the loss of seedlings that were killed by the frost as a casualty loss?

Answer 7. No, he cannot deduct the loss as a casualty loss because the seedlings are also a prospective crop. However, since the seedlings were completely destroyed and will not produce income in a future year, Frazier can include the costs that were capitalized into the basis of the trees on line 2 of his 2002 Schedule F (Form 1040) as a cost of assets that were held for sale in the ordinary course of his farming business and disposed of during the current year. (The basis of the seedlings is treated the same as the basis of livestock that was purchased for resale and died during the tax year.) By reporting the basis on line 2 of Schedule F (Form 1040) Frazier will reduce his farm income for 2002 by the basis in the seedlings.

Practitioner Note. Practitioners are cautioned to obtain correct information relative to the prior reporting of establishment costs and pre-productive expenses. Frequently, these expenses are (incorrectly) deducted for the tax year they are incurred. If this is the case, then basis of the Christmas trees is zero and there is no casualty loss deduction for the business.

Uniform Capitalization Rules

If the Christmas trees are six years old or less when they are harvested, they are subject to the capitalization or pre-productive expense rules. I.R.C. §263A(c)(5)(A) and (e)(4)(B). Under those rules, all costs of raising the trees must be added to the basis of the trees rather than deducted as they are incurred, unless the taxpayer elects out of the rules.

If the taxpayer elects out of the rules, there are two consequences.

1. When the trees are sold, an amount equal to the costs that would have been capitalized is subject to the I.R.C. §1245 recapture rules.

Observation. This rule is of no consequence for a taxpayer who is in the business of raising trees since all of the gain from the sale of trees is ordinary income before

recapture rules are applied. The recapture rules do not convert ordinary income subject to self-employment tax into ordinary income not subject to the self-employment tax.

2. The taxpayer is required to use the alternative depreciation (ADS) method (straight line over the class life) for depreciated all assets used in the farm business and related businesses.

Example 7. *Frazier Firr, from example 3 cut and sold his trees when they were five years old. His cost of raising his trees was \$3 per tree and he did not elect out of the uniform capitalization rules. Frazier calculates his income from this sale as illustrated below.*

Amount Realized On Sale	
10,000 x \$15	\$150,000
Less basis	
Establishment costs	\$(20,000)
Annual costs 10,000 x \$3	\$(30,000)
Less cost of cutting	\$(20,000)
Ordinary income	\$80,000

Treatment of Casualty Losses

As previously discussed, there is no casualty loss deduction for trees harvested at six years of age or less. However, the basis would be higher since it would include the annual capitalized costs as well as the cost of establishing the trees.

Summary and Conclusion

Christmas tree growers suffering losses and damage to their Christmas tree plantings due to a late spring freeze must deal with many issues. Those issues include loss of income from delayed sales of product due to freeze damage and decreased sales revenue due to loss of quality and size. These producers may have a deductible business casualty loss. The losses are limited to the lesser of basis or the decrease of fair market value of the trees. If producers have deducted establishment and capitalized costs in previous years; there will be no casualty loss since basis is zero. Producers of fruit or nut tree crops or horticultural crops that have suffered weather damage may also use the casualty loss rules to their benefit. However, I.R.C. §631 is applicable only to timber. Christmas trees older than 6 years of age when cut qualify as timber.

Disclaimer:

Information provided is for educational purposes only: nothing herein constitutes the provision of legal advice or accounting services. Taxpayers should contact their tax practitioner relative to their circumstances in regards to these issues. The above discussion is based on information currently available.