

# Tax Tips for Forest Landowners for the 2018 Tax Year

by Dr. Linda Wang, National Timber Tax Specialist, USDA Forest Service

The Federal income tax provisions that apply to timber have changed for the 2018 tax year from the December 2017 new tax legislation. To help family timber owners, foresters, and their tax preparers in filing their 2018 tax returns, this bulletin provides income tax guidance that is current as of September 30, 2018.

## Timber Property Types

It's important to recognize that the tax treatments vary significantly for different types of properties. You must make a determination on your property type each year. Your timber may be classified under one of the following three types: (1) *personal-use* property (mainly for personal enjoyment vs. for profit); (2) an *investment* property (mainly for generating profit from growing timber or asset appreciation); or (3) a *business* property (with regular, active, and continuous profit-making timber activities to qualify). Businesses are subject to passive loss rules (i.e., losses from a passive business cannot be used to offset nonpassive income such as wages). In other words, deductions from a passive business may be denied for the year (when there's no income of the passive source). A passive activity is one in which you do not materially participate, mainly based on the number of hours you participate in the business. Also, your timber may be considered a *hobby* if it is not engaged for profit. Losses from hobby activities are generally not deductible.

**Example 1:** Mr. Henderson owns a 57-acre tree farm where he manages timber primarily for profit. He reports his timber as an investment.

## Deductions of Timber Expenses and Taxes

For timber owned as a business, if you are "materially participating" in the business, the timber expenses are fully deductible on Schedule C of Form 1040. These expenses may include fees paid for forester, attorney, or accountant, precommercial thinning, firebreak maintenance, overnight travel, vegetation-competition control, insects, disease, and fire control, and depreciation from equipment used. For timber held as an investment, timber expenses (along with certain other "miscellaneous itemized deductions") are no longer deductible, starting in 2018 through 2025 (Public Law 115-97).

**Example 2:** Ms. Smith owns a 50-acre property as an investment. Her 2018 timber expenses of \$1,000 is not deductible.

State and local property taxes on timber investment property are deductible on Schedule A. Alternatively, you may elect to treat these taxes as part of the timber costs (i.e., as "carrying charges") and deduct them upon timber sales. Property taxes paid in a trade or business are deductible on Schedule C. Severance and yield

taxes paid are deductible from the timber harvests.

## Timber Sales and Reporting

To be eligible for the beneficial long-term capital gains, you must own the standing timber held as an investment for more than 1 year before the sale (inherited timber is automatically considered long-term). Timber sale expenses are deductible from the sale proceeds. Report the sale of standing investment timber on Form 8949 and Schedule D.

**Example 3:** Ms. Johnson sold hardwood standing timber she inherited 10 years ago for \$12,000. The timber is an investment for her. Assuming the selling expense was \$500 and the timber depletion (see topic below) was \$4,000, she will report \$7,500 (\$12,000 - \$4,000 - \$500) as a long-term capital gain on Form 8949 and Schedule D.

**Example 4:** Assuming the same facts as above in Example 3, except that the taxpayer is classified as timber business. In this case, the gain of \$7,500 would qualify as a capital gain.

However, if the business taxpayer cut his timber (or had "a contract right to cut" the timber) to sell or to use in his trade or business, different rules apply. Under this sales method, capital gain treatments (Sec. 1231 gain) are available when the taxpayer has owned such timber for more than 1 year and elects to treat the cutting as a sale. The election is made on Form T, Part II.

**Example 5:** Mr. Jones is a logger and manages his Douglas fir timber as a business. He cut his timber himself and delivered and sold the logs to a mill for \$20,000. Assuming the fair market value (FMV) of the standing timber on January 1, 2018, was \$15,000, and his timber depletion (see below) was \$2,000, under Sec. 631(a) election, gains of \$13,000 (\$15,000 - \$2,000) from standing timber are capital gains, and the \$1,000 (\$20,000 - \$15,000 - \$4,000 cut-n-haul cost) from the sale of felled timber is ordinary income.

## Timber Basis and Depletion Deduction

Generally your timber basis is the amount you paid for it (if you purchased the property). For inherited property, it is the timber's fair market value on the decedent's date of death.

**Example 6 (a):** Six years ago, Mr. Forrest inherited a tract of timberland. A professional appraisal had retroactively established the timber basis as of the date of death, which consisted of \$16,000 for 80 thousand board feet (MBF) of pine sawtimber and \$5,000 for 250 cords of pine pulpwood.

Timber depletion is a deduction against the timber basis upon timber sale.



**Example 6(b):** Mr. Forrest sold 50 MBF of sawtimber. His depletion was \$10,000 ( $\$16,000$  of total timber basis  $\div$  80 MBF of total volume  $\times$  50 MBF of timber sold).

### Timber and Landscape Tree Casualty Loss

Depending on the type of properties affected, loss of timber and landscape trees due to a casualty event such as hurricane, fire, earthquake, tornado, or hail or ice storms may be tax deductible. For timber held as an investment or a business, the loss deduction is the smaller of the adjusted basis of timber and the difference of the FMV of the timber immediately before and after the casualty in the block. Report salvage sale of timber separately. A taxable gain may result if the salvage sale exceeds the adjusted basis of the timber and related selling expenses.

**Example 7:** Mr. Brown owned a woodland as an investment. A professional appraisal documented a \$5,000 timber loss from hurricane damage. Assuming his timber basis was \$1,000, the amount of casualty loss deduction would be limited to \$1,000.

For 2018 landscape tree loss at a private residence, the deductible casualty loss would be limited to federally declared disasters.

### Installment Sales

Using Form 6252, a taxpayer may defer taxes by spreading the gain from the property sale over 2 or more years.

**Example 8:** Mr. Davis sold \$10,000 of timber (\$7,500 after deducting timber depletion and sale expenses). His *gross profit percentage* was 75 percent ( $\$7,500 \div \$10,000$ ). The buyer paid him \$6,000 in 2018, and he took a note payable in 2019. Report a \$4,500 gain ( $\$6,000 \times 75\%$ ) for 2018. Interest charged on deferred payments is ordinary income.

### Reforestation Costs

Reforestation costs are tax deductible. Taxpayers may deduct up to \$10,000 (\$5,000 for married couples filing separately) per year per qualified timber property (QTP). Any amount over \$10,000 per year per QTP may be deducted over 84 months (*amortized*). Trusts are eligible for amortization only.

**Example 9:** Mr. and Mrs. Lee incurred \$17,000 to replant their property in 2018. They deduct \$10,000, plus 1/14th (\$500) of the remaining \$7,000 in 2018 for a total deduction of \$10,500. For 2019–2024, they will deduct 1/7th (or \$1,000) of the \$7,000. In 2025, they will deduct the last 1/14th (or \$500). Report the deduction as an adjustment to gross income on the front of Form 1040 for investment, or Schedule C for business. Elect to amortize on Form 4562. Also, attach a statement to the return showing the date, location, and amount of the expenditure.

### Depreciation, Sec. 179 Expensing and Bonus Depreciation

For timber held as an investment or a business, you may take depreciation on the assets used (for example, tractor, logging equipment, bridge, culvert, fence, or temporary road). Land is not depreciable. Also, business taxpayers may elect to deduct up to \$1,000,000 for qualifying property in 2018, subject to

\$2,500,000 annual phase-out and business taxable income limitations (Sec. 179 expensing). Also, eligible taxpayers may take a bonus depreciation equal to 100 percent of the cost of qualifying property.

### Net Investment Income Tax

Timber sales from an investment or passive business may be subject to a 3.8-percent net investment income tax for single taxpayers with adjusted gross income (AGI) over \$200,000 (or \$250,000 for couples).

**Example 10:** Mr. and Mrs. McDonald sold investment timber at a \$40,000 gain. Assuming their AGI was \$270,000, the lesser of the timber gain or \$20,000 ( $\$270,000 - \$250,000$  threshold) are subject to the 3.8-percent tax (\$760 tax).

### Cost-Share Payments

You may exclude part or all of a qualified cost-share payment you received from your income if it was used for capital expenditure. Otherwise, report it as ordinary income. Qualified Federal programs for income exclusion include the Forest Health Protection Program, Conservation Reserve Program (CRP), Conservation Security Program, and Environmental Quality Incentives Program. Several State programs also qualify for exclusion. The excludable amount is the *present value* of the greater of \$2.50 per acre or 10 percent of the average annual income from the affected acres over the last 3 years.

**Example 11:** Mr. Hill received \$6,000 from CRP cost share for qualified capital expenditure in his timberland. If he had no income from the property in the last 3 years, he could exclude up to \$4,912 ( $(\$2.50 \times 100 \text{ acres}) \div 5.09\%$ ) from his income. The interest rate is from the Farm Credit System Bank. If he had \$9,600 of income from the property in the last 3 years, he could exclude up to \$6,287 ( $(10\% \times (\$9,600 \div 3)) \div 5.09\%$ ). Attach a statement to the tax return describing the cost-share program and the exclusion calculations.

### Filing Form T (Timber)

Form T (Timber), Forest Activities Schedule, is required if you claim a timber-depletion deduction, sell cut products in a business (under Sec. 631(a)), or sell outright business timber. However, you are not required to file if you only have occasional timber sales (one or two sales every 3 or 4 years).

### Conservation Easement

Donation of a qualified conservation easement are tax deductible. The deduction is up to 50 percent (or 100 percent for qualified farmers and ranchers, including forest landowners) of the taxpayer's AGI in a year. Any excess amount of donation over the 50- or 100-percent limit may be carried forward for 15 years.

### Like-Kind Exchanges

The tax deferral rules for like-kind exchanges after December 31, 2017, apply only to exchanges of real property not held primarily for sale. It no longer applies to personal property.