



Tax Tips for Forest Landowners for the 2007 Tax Year

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This guide is designed to assist owners of forest land with timber tax information. It is current as of October 1, 2007, and supercedes Management Bulletin R8-MB 128. It is strictly for educational purposes; consult your legal and tax professionals for advice on a specific tax situation.

Purpose for Owning Timber

Forest owners must classify their timber management activities into one of three categories for tax purposes:

- Trade or business
- Income-producing (or "investment")
- Personal use

The distinction is important in terms of how income, expenses and losses are treated and reported for tax purposes.

For example, owners who are active participants in a timber business can fully deduct ordinary and necessary management expenses on Schedule C or F of Form 1040. In contrast, owners who hold timber for investment purposes must report these expenses as miscellaneous itemized deductions on Form 1040, Schedule A, where they are subject to income limitations. There is no tax advantage to holding timber for personal use.

Tax Basis of Timber

Basis is a tax concept of the *cost* of your forest land and timber. If properly documented, timber basis can lower your taxes by reducing the taxable proceeds from timber sales, enabling reforestation cost recovery or allowing timber loss deductions. *Setting up your basis helps avoid missing deductions.* The tax law specifies how to determine the basis of property acquired by purchase, inheritance, gift, tax-deferred exchange, replacement in an involuntary conversion or through reforestation. The records necessary typically include:

- Purchase price
- Survey, legal and accounting fees solely for acquisition
- Separate value of land, timber and other capital assets such as bridges or roads (i.e., their individual fair market value) on the date of acquisition, by purchase or inheritance
- Timber volume and value (or the per-acre value of pre-merchantable timber)
- For timber received as a gift, the basis in the hands of the person making the gift, plus any gift taxes paid
- Costs of planting, such as site preparation, seedlings, hired labor, fertilization and depreciation on equipment used.

Gathering these data in a timely manner (preferably when the

property is acquired) can prevent problems down the road. Setting up timber basis retroactively is acceptable, but typically needs the help of a professional forester. An excellent way to keep track of timber basis is to use IRS Form T (Timber) "Forest Activities Schedule," Part II (see "Form T," below).

Timber Management Expenses

Generally when there is a profit motive, ordinary and necessary expenses incurred for managing forest land as a business or an investment are deductible even if there is no current income from the property. Property tax and interest are currently deductible, but you may elect to capitalize them if doing so provides a tax benefit. For example, owners who hold timber as an investment and take the standard deduction may elect to capitalize property tax and interest since they are itemized deductions.

Ordinary and necessary expenses associated with timber management generally include the costs of post-establishment timber cruises, fees paid consulting foresters and brush control, the cost of protection from fire, insects and disease, precommercial thinning, timber stand improvement, tools of short useful life, travel directly related to timber activities, and the cost of hired labor and mid-rotation fertilization (Revenue Ruling 2004-62). Costs associated with a timber sale, including a pre-sale timber cruise, should be deducted from the sale proceeds. Costs associated with establishing a timber stand, including supervision by a consulting forester and brush control, are part of the timber basis and can be deducted and amortized accordingly (see "Timber Planting Costs," below).

Timber Planting Costs

Under IRC section 194 a taxpayer may *elect to deduct outright up to \$10,000 per year of qualifying timber establishment costs, and amortize any additional amount over 84 months* (8 tax years, due to the half-year convention), rather than capitalizing and recovering them at the time of a timber sale.

Example 1: Mrs. Smith plants 40 acres of timber in 2007 at a cost of \$6,000. She can elect to deduct all \$6,000 of the cost on her 2007 income tax return because it is less than \$10,000.

Example 2: If Mrs. Smith's planting cost was \$14,000, her total deduction for 2007 would be the \$10,000 limit on deductions, plus 1/14 of the amount over \$10,000, or \$287 ($\$4,000 \div 14$, due to the half-year convention). She can deduct \$571 ($\$4,000 \div 7$) on her returns for 2008 through 2013, and the final \$287 on her return for 2014. *Note:* Once Mrs. Smith has filed her income tax return for 2014, the contribution to her timber basis from the

planting will be \$0. Elect to use this provision on Form 4562 (Part VI) on a timely filed return (including extensions).

If your timber property is located in a special hurricane zone (i.e., Gulf Opportunity Zone or the Rita or Wilma GO Zone) and you own no more than 500 acres of forest land altogether, **the \$10,000 deduction is increased to a maximum of \$20,000 per tax year for planting costs incurred through the end of 2007** (IRC section 1400N(i)(1)). The hurricane zone provisions are not available to publicly traded corporations or real estate investment trusts.

Cost-share Payments

Cost-share payments generally must be included in income unless a section 126 election is in effect. Under this election, cost-share payments from qualified government programs may be **wholly or partially excluded from income**. Federal cost-share programs that qualify for exclusion include the Conservation Reserve Program (CRP), Environmental Quality Incentives Program (EQIP), Forest Land Enhancement Program (FLEP), Wildlife Habitat Incentives Program (WHIP) and Wetlands Reserve Program (WRP). Various state programs also qualify.

The process of calculating the maximum excludable amount of a qualifying cost-share payment is shown here by example:

Example: Mr. Drew, a Texas landowner, sells \$21,000 worth of timber in 2007 and reforests his 30-acre tract at a cost of \$6,000, including a \$2,000 cost-share. He uses the 6.08% interest rate under Farm Credit System for the Texas region in 2007 to calculate how much of the cost share he can exclude.

Answer: The maximum excludable amount of the cost-share payment is the present value of \$2.50 per acre or 10% of the average annual income from the tract over the last 3 years, whichever is larger: $\$2.50 \times 30 = \75 ; $10\% \times (\$21,000 \div 3) = \700 ; the present value of \$700, the larger of the two amounts, is $\$700 \div 6.08\%$, or \$11,513; Mr. Drew can exclude the entire cost-share payment.

Without the harvest, the maximum excludable amount of the cost-share would be only \$1,234 ($\$75 \div 6.08\%$). Mr. Drew would have to include the remaining \$766 ($\$2,000 - \$1,234$) in his income, but he could then deduct it using the reforestation deduction and amortization provisions.

Timber Income

In almost every situation, it benefits you to have your timber sale income qualify as a **long-term capital gain**. Among the reasons are that long-term capital gains are taxed at lower rates than ordinary income, and are not subject to self-employment taxes.

To qualify for long-term capital gain treatment, you must hold your timber for **more than 12 months**. Timber held as an **investment** qualifies under IRC section 1221. Report a sale on Form 1040, Schedule D, Part II. Timber held as part of a **trade or business** qualifies under IRC section 631(b). Report a sale on Form 4797, Part I, whether it was outright (lump-sum) or pay-as-cut.

If you as the owner **cut standing timber yourself** and sell cut products to a mill, all the proceeds are ordinary income unless you **elect on Form T, Part II, to treat it as an IRC section 631(a) transaction**. If you have a section 631(a) election in effect, the income from holding the standing timber is a capital gain and only the additional amount from converting the timber and transporting it to the mill is ordinary income.

When you sell or dispose of timber you can take a **timber depletion deduction** against the proceeds. The deduction allows you to recover a part of your adjusted timber basis that is proportional to the volume of timber harvested.

Timber Losses

In general, loss deductions are permitted to property held for business or investment purposes. It is important to note that your deduction for a loss is limited to your adjusted basis in the asset lost, minus any insurance or other compensation received.

A **casualty loss** is caused by natural or outside forces that are sudden, unexpected, and unusual – e.g., by fire, ice storm or hurricane. A loss that is unexpected and unusual but occurs over time – e.g., by disease or insect attack – is a **non-casualty loss**. Other kinds of loss, **timber theft** and **condemnation**, result from human activity. A timber theft loss is deductible in the year you discover it.

To calculate a loss deduction, start with the adjusted basis in the account you use to keep track of the “block” that includes the damaged area. If you keep track of all your timber in one account, use the adjusted basis in that account. Next, determine the difference in the fair market value of the property in the block immediately before and immediately after the loss. Court cases have established that a salvage sale is a separate event from a loss, so the “after” figure should include the value of any salvageable timber in the block. Your loss deduction is the lesser of your basis in the block or the decrease in value. Keep in mind that basis verification and reasonableness of valuation are two of the main audit areas by the IRS.

Form T

You are required to file a Form T (Timber) “Forest Activities Schedule” if you claim a timber depletion deduction, make a Section 631(a) election or sell timber outright under section 631(b). Owners with occasional sales may be excepted from this requirement, but it is considered prudent to file. Even if you are not required to file Form T in a given year, it is an excellent way to keep your timber tax records. An electronic version of the form can be found at: <http://www.irs.gov/pub/irs-pdf/ft.pdf>.

References:

Haney, H. L., Jr.; Hoover, W. L.; Siegel, W. C.; and Greene, J. L. 2001. *Forest Landowners Guide to the Federal Income Tax*. Agric. Handb. 718. Washington, DC: U.S. Department of Agriculture. This book may be downloaded free: <http://www.timbertax.org/publications/aghandbook/aghandbook.asp>.

National Timber Tax Website: www.timbertax.org

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