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Minimizing Federal Income Tax for Forest Landowners

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This bulletin provides a general guide to federal income tax for forest landowners. It discusses only income tax items specific to timber growers or with which timber growers generally have problems in preparing their income tax returns. It specifically includes changes that have occurred as a result of the American Jobs Creation Act of 2004 (AJCA, H.R. 4520). Landowners should use this material in consultation with their tax preparer or accountant to plan their forest management to maximize after-tax income and minimize after-tax costs. It is not intended to substitute for legal counsel.

The American Jobs Creation Act of 2004 (AJCA 2004) affected forest landowners who manage timber in several ways. These areas of tax reform are discussed below, along with some of the basic provisions for deductibility of expenses and depreciation allowances.

Timber Sales and Long-term Capital Gains

Capital gains are net income from the sale of assets, which usually include timber. The advantage of declaring net timber sale income as a capital gain is that, because it is not "earned income," self-employment tax (Social Security and Medicare) is not charged on it. Capital gains may be long- or short-term, depending on whether the asset was held for more than one year. Although neither short-term nor long-term capital gains are subject to the self-employment tax, the income tax rate does differ.

Tax rates

For timber sold after May 5, 2003, and before 2009 and held for more than 12 months, the capital gains tax rate is 5 percent for income that would otherwise be taxed at the 15 percent or lower ordinary income tax rates, and 15 percent for that which would be taxed at the 25 percent or higher rates (Table 1).

Qualifications

To qualify as long-term capital gains (LTCG), income from timber sales must also be from trees that are at least 6 years old from seed and be sold as standing timber, not cut. Section 631(a) of the Internal Revenue Code (IRC), however, provides for an equivalent capital gain for standing timber cut for use in the taxpayer's trade or business. Prior to AJCA 2004, timber held by a business received capital gains only if it was sold with a pay-as-cut contract — that is, if the timber owner is paid per unit of timber that is actually harvested. This is no longer the case.

Table 1. Capital gains tax rates.

Holding Period	Date Sold	Ordinary Income Tax Bracket	Capital Gains Tax Rate
0-12 months	Anytime	10 to 35%	Same after netting
More than 12 months	On or after May 6, 2003	less than or equal to 15% greater than 15%	5% 15%

Section 631(a) sales are generally for taxpayers who cut their own trees and sell cut products such as logs, firewood or Christmas trees. To receive capital gains treatment on the standing timber, the taxpayer is required to elect to "consider the cutting as a sale or exchange" under this section of the Internal Revenue Code. This election is made by making the following statement on IRS Form 4797: “I elect to consider the cutting of timber as a sale or exchange in accordance with Section 631(a)," and by making a computation of the fair market value of the timber. The fair market value is determined by multiplying the value per unit (board feet, cords, etc.) as of the first day of the taxpayer's tax year times the number of units cut. Once the grower has made an election, it is not necessary to do it again in future years for Section 631(a) sales.

Section 631(b) sales are for sales of timber on the stump. Timber growers may do this by selling timber on a per unit basis or by a lump sum. If timber growers contract to receive so many dollars per unit of timber and the amount of timber sold is measured as it is cut or removed, these are referred to as "sale-by-scale" or "pay-as-cut" contracts. Selling timber for a fixed amount, agreed upon in advance, is known as a “lump sum” contract. The AJCA of 2004 amended the tax code such that both sale-by-scale and lump sum sales qualify under Section 631(b) for capital gains treatment of the sale income. The sale income is reported on Form 4797 as "Section 1231 gains and losses".

Regardless of whether their timber sale income qualifies as a long-term capital gain, timber growers should report capital gains separately from ordinary income. For sole proprietors of a business, capital gains are still not subject to the self-employment (Social Security) tax, unlike ordinary income. In addition, capital losses are offset against capital gains up to the amount of the gain, but only up to $3,000 per year of personal capital losses may be deducted from ordinary income. Losses from the sale of business assets, reported on Form 4797, however, are fully deductible.

Taxable Sale Income

A timber owner's capital cost of establishing or acquiring his or her timber asset is recovered as the timber is sold or when the timberland itself is sold. Timber sellers pay tax not on the gross income from the timber sale but on the net income. The net income is calculated by subtracting the timber "depletion allowance" and the sale expenses from the gross timber sale income.

Timber basis and depletion allowance

The timber depletion allowance is the method used to account for the seller's cost of the timber as the timber is sold or "depleted." The depletion allowance is based on the owner's timber basis, which is the cost of buying or establishing the timber, or the value when acquired, if it was an inheritance. If the timber was purchased at a price equal to its fair market value, then the basis is the fair market value of the timber, separate from the land, on the day of purchase. If the timber was established by the taxpayer, the basis is the actual cost of site preparation, planting labor and stock, seeding labor and seed unless these costs were deducted or amortized at the time of establishment. If the timber was inherited, the timber basis is the fair market value of the timber on the day of the death of the decedent. If the timber was a gift, the basis is equal to the donor's basis (not the donor's fair market value) plus that portion of the gift tax paid by the donor on the increase in value since acquisition (see Potter-Witter and Ramm, 1999, p. 7, for detailed information). The donor is liable for any gift tax.

If all the timber is cut at one time, then the entire basis is subtracted from the sale income. If, however, only part of the timber is sold, then the timber owner must determine how much the timber was depleted. This is done by calculating the depletion unit — i.e., how much of the basis is allocated to each unit of timber. The timber units may be in cords, thousand board feet, cubic feet or any appropriate measure of volume. The entire depletion allowance for the sale is equal to the depletion unit multiplied by the number of units cut and sold (Figure 1).

An owner's timber basis does not increase with time unless additional investments are made in the timber — for example, through expenditures for reforestation. The basis does not

Figure 1. Calculation of depletion allowance.

1. **basis** = cost of planting stock and other costs of stand establishment, or value of standing timber when purchased, inherited or otherwise acquired.
2. **adjustments to basis:** add any additional capital expenses or subtract any capital losses.
3. **depletion unit:** basis divided by total volume in current inventory.
4. **depletion allowance:** depletion unit times volume sold.
5. **taxable timber sale income:** gross income minus depletion allowance minus sale expenses.

increase even if the value of the timber increases through market prices or inflation. The depletion unit may decrease through time as the timber volume grows or some of the basis is subtracted though timber sales (Figure 2).

Form 1099 MISC and 1099-S

Many timber growers are under the impression that timber sales, often paid for in cash, do not have to be reported by the buyer to the IRS. This is the case for lump-sum sales of standing timber and the sale of cut products. However, buyers are required to report if the sale was for more than $10 and the timber was sold on a pay-as-cut contract, also known as sale-by-scale. The timber purchaser should report these payments on Form 1099-S, Proceeds from Real Estate Transactions. Both the timber seller and the IRS should receive a copy of the form. The IRS will consider the payment reported as part of the timber seller's income. More information on 1099-S is available on page 1 of the IRS instructions for Form 1099-S available at **http://www.irs.gov/pub/irs-pdf/i1099s_04.pdf**.

Recovering Costs

Basic rule

All the ordinary and necessary expenditures associated with growing timber held with the intention and reasonable expectation of producing income can be recovered in one of three basic ways:

Capitalize — Expenditure is recovered over a period of years through depreciation, amortization, depletion, or by sale or disposal of the property.

Expense — Deduct from gross income for the tax year in which the expenditure occurs, or carry over for recovery in a later tax year in the case of passive losses or a net operating loss.

Deduct from sale proceeds — Expenditures associated with a timber sale or other form of disposal are deducted from any income received.

Types of costs

Capital expenses are costs associated with the acquisition of property or property rights or permanent improvements that increase the value of property already owned. They include establishment or acquisition of timber or real estate and improvements to them. Durable equipment such as trucks, tractors, power saws and buildings are also capital expenses.

Operating expenses include those costs that aren't capital costs and aren't associated with the disposal of an asset. Items such as tools of short life (generally those costing less than $100), interest on mortgages, equipment operation and maintenance, property taxes, salaries and fees for services, and business travel fall under the category of operating expenses.

Carrying charges are property taxes, loan interest and insurance premiums that timber growers and landowners pay to own and care for or develop their property.

Ways of recovery

Land and timber acquisition costs are recovered when these assets are sold or otherwise disposed of in whole or in part. Property taxes paid on timberland are always deductible as an

Figure 2. Example of depletion allowance calculations over time.

Year	Event	Timber basis	Volume in inventory (cords)	Volume removed (cords)	Depletion unit (per cord)	Depletion allowance
1995	timber purchase	$ 5,000	750		$ 6.67	
2005	before timber sale	$ 5,000	1,000		$ 5.00	
	timber sale			200	$ 5.00	$ 1,000
	after timber sale	$ 4,000	800		$ 5.00	
2006	before timber sale	$ 4,000	800		$ 5.00	
	timber sale			400	$ 5.00	$ 2,000
	after timber sale	$ 2,000	400		$ 5.00	
2016	before timber sale	$ 2,000	1,000[a]		$ 2.00	
	timber sale			200	$ 2.00	$ 400
	after timber sale	$ 1,600	800		$ 2.00	

[a] *includes 10 years' timber growth of 600 cords.*

itemized deduction for investors and as a business expense for businesses. Deduction of operating expenses other than property taxes, however, requires that the timber be held for the production of income as part of a "for profit" business or investment. Taxpayers who are not holding their timber for profit as a business or investment may be able to deduct some of their operating expenses under the provisions of the "hobby loss rule." The deduction is limited to the amount of income from the property during the current year. Carrying charges can be expensed or capitalized at the taxpayer's discretion, except timber stand improvement (TSI) expenses. These need to be treated the same way every year — i.e. capitalize or expense.

Operating Expense Recovery

How you recover operating expenses depends on whether your activity is a hobby, an investment or a business. Operating expenses of a business are deducted from business income on a business tax schedule such as Schedule C or Schedule F, or the corporate or partnership forms. Investment and hobby expenses, except property taxes, are reported as miscellaneous itemized deductions on Schedule A of Form 1040. Miscellaneous itemized deductions increase total itemized deductions only to the extent that they exceed 2 percent of adjusted gross income.

Hobby: If a taxpayer does not engage in the activity primarily for the production of income, his or her timber activity is a hobby.

Investment: Timber growers with a profit motive but infrequent timber harvests and management activities are likely to be considered to have held their timber as an investment.

Business: For his or her forestry activity to qualify as a trade or business, the taxpayer must have a profit motive rather than a hobby interest in the activity. The hobby loss rule says that if an activity (business or investment) generates a profit in three out of five consecutive years, the IRS will assume that the taxpayer is engaged in the activity with the intent to make a profit. Not making a profit in three out of five consecutive years, however, does not mean that the IRS presumes that the activity is not engaged in with the intent to make a profit. Without profits, the taxpayer must prove by a showing of the facts that, in his or her particular circumstances, he or she intends to make a profit and has a reasonable expectation of being able to do so. If a taxpayer reports that he or she has a reasonable expectation of making a profit, this expectation must later be met. Appreciation in the value of assets — i.e., increase in timber volume and total value, and land — are considered profit for the purpose of this test.

Recovery restrictions for businesses

Deduction of business expenses is subject to restrictions which depend on whether the taxpayer materially participates in the activity (business) for the current year. The restrictions affect whether the taxpayer may deduct the timber activity expenses against any of his or her income or only against other passive activity income. The restrictions fall under the passive loss rules, which established three categories into which all income or losses fall:

Active income: Salary, wages and bonuses, or income from a trade or business in which the taxpayer materially participates (see definition of material participation below). This would include timber sales income from a timber operation in which the owner actively participates.

Portfolio: Interest, annuities, dividends, royalties (unless earned in the ordinary course of a trade or business), dividends on S or C corporation stock, and gain or loss on the sale of property generating portfolio income.

Passive income: Income from a trade or business in which the taxpayer does not materially participate in the current year, income from limited partnership interests and any rental income except for a $25,000 exclusion. This would include timber sales income from a timber operation in which the owner does not materially participate.

Investment activities are not currently subject to the passive loss restrictions. The Tax Reform Act of 1986, however, did make provisions for the Secretary of the Treasury to determine under what circumstances investment activities might constitute a passive activity.

Material participation

To materially participate in an activity, a taxpayer must have "regular, continuous and substantial" participation in the activity. Several tests are used to judge material participation. The taxpayer must meet the tests each year, and his or her classification may change from year to year. In the case of a jointly owned business, other than spouses, material participation must be determined separately for each owner. Taxpayers materially participate in the activity for a particular year if they pass any one of the following tests:

1. The taxpayer and spouse participate in the activity 500 hours, or more, during the year.
2. The taxpayer and spouse contribute "substantially all of the participation" in the activity during the year. ("All of the participation" includes time put in by a consulting forester or others working for the taxpayer.)

3. The taxpayer and spouse participate for 100 or more hours and put in as many hours or more than anyone else.
4. The taxpayer and spouse materially participated in the activity for 5 of the years during the preceding 10 tax years.
5. When summed, the taxpayer and spouse contributed at least 500 hours in all of their "significant participation activities." These activities are those in which there are more than 100 hours per year.
6. Based on the "facts and circumstances," the taxpayer and spouse participated in the activity (a) on a regular, continuous and substantial basis, (b) at least 100 hours, and (c) at least as many hours as anyone else and did not use a paid manager.

For test number 6 above, time spent "managing" the activity doesn't count as participation unless the taxpayer spends more hours in managing than anyone else does and no one else receives compensation for "management services." Work that is customary for owners of an activity counts; "investment work" does not. Examples of investment work are analyzing the finances or operations of the activity for the taxpayer's use, studying financial statements and keeping track of the performance of the operation in a non-managerial capacity. Activity by the taxpayer's spouse counts even if they are not both owners in the activity or do not file a joint return.

Controversy over the definition of material participation for timber growers is likely to continue. Taxpayers should keep in mind that the IRS will not classify their income or expenses in one of the above categories — taxpayers must do this themselves and be able to defend their judgment if they are audited. Taxpayers are not required to have daily time reports, but they need to have a record of time spent in various activities. The record should include the type of activity and the number of hours spent. Taxpayers can document these by appointment books, calendars or written summaries.

Operating expense deduction limits

Hobby: Property taxes can be fully deducted. Other expenses may be deducted only to the extent that hobby income exceeds the property taxes deducted. Other expenses that exceed the limit cannot be carried to a future year. Instead, the other deductible expenses must be combined with other miscellaneous itemized deductions and the total deducted only to the extent that it exceeds 2 percent of adjusted gross income.

Active participation in a trade or business: Forest management expenses are fully deductible, even if they cause a tax loss for the year. They are reported on Schedule C for businesses or Schedule F for farms. If a farmer logs his or her own timber, the IRS recommends that the income be reported on Schedule C rather than F.

Passive trade or business: Forest management expenses are deductible from income earned from any passive activity, not just from the forestry operation. If income from passive activities is not sufficient to deduct all of these expenses or losses in the year in which they occur, they may be deducted when passive income occurs or be recovered when the entire passive activity is sold. For an S corporation, if the owner is not a material participant, losses may be deducted only from passive income. A closely held C corporation, however, may deduct passive losses from active business income but not from portfolio income. Taxpayers involved in passive activities or who have passive losses carried over from previous years are required to file Form 8582, "Passive Activity Loss Limitations."

Investment: Property taxes are deductible from any income. Interest charges attributable to the investment activity are deductible from net investment income only and may be carried forward if no investment income occurs the year in which the charges occur. Expenses are added to the taxpayer's miscellaneous itemized deductions, and the amount of that total that exceeds 2 percent of adjusted gross income may be deducted from income. One strategy is to schedule the payment of expenses such as timber stand improvement, forestry consultations, tool purchases and possibly property taxes so that the payments are concentrated in a particular tax year. In this way, expenses are accumulated in a year that, if spread over several years, would not exceed 2 percent of adjusted gross income in any year.

Capital Costs Recovery

Capital expenses are usually recovered when the asset is sold, as was discussed above under depletion allowance, or depreciated, in the case of capital equipment. The tax code also allows for special treatment of reforestation expenses.

Depreciation

Certain costs incurred by timber growers may be depreciated — that is, deducted over time as an investment or business expense. These costs include machinery, vehicles, office equipment, fences and other land improvements, and buildings. How the cost may be depreciated depends on the type of depreciable cost, when the cost was incurred and how the grower has chosen to deal with preproductive expenses. Taxpayers should consult IRS Publication 946 and make sure that they use the most recent schedules when filing. Under Section 179, a business can elect to expense instead of depreciate a certain amount of the cost of depreciable expense. For 2004 the maximum amount allowed was $102,000. Taxpayers should check with their tax preparers or the IRS for the allowable amount for the tax year for which they are filing. The Section 179 deduction is taken the year in which the asset is purchased and put in service. The amount, however, cannot exceed taxable business income for that year, and any unused portion may be carried forward to the next year. Other changes to depreciation rules are that salvage value is no longer considered and no distinction is made between new and used equipment.

Expenses of sale

All costs associated with a timber sale or other form of disposal of timber are sale expenses. These expenses include timber cruising, marking, scaling, consultant's fees and travel. Sale expenses are added to the depletion allowance of the stumpage sold or disposed of, and the total is subtracted from the sale proceeds to determine the net gain.

Reforestation amortization

The AJCA of 2004 amended the IRS regulations such that tree farmers may now expense up to $10,000 of qualified reforestation expenses incurred after October 22, 2004. Qualified reforestation expenses over this amount may be amortized over 8 tax years (84 months). Since planting does not begin until partway through the tax year, 1/14 of the expenses may be deducted from income in the year the trees are planted. For the next six years, 1/7 is allowed. Finally, another 1/14 is deducted in the eighth year. Expenses that qualify for amortization are those for site preparation, seed or seedlings, labor and tools.

Figure 3. Example of reforestation amortization.

One hundred acres were planted in 2005 at a cost of $200 per acre for a total cost of $20,000.

Year	Item	Amount
2005	Expensing of first $10,000	$10,000
	Amortization of remaining cost	
2005	Deductions from income	$ 714 (1/14 x $10,000)
2006 to 2011	Deductions from income	$ 1,429 per year (1/7 x $10,000)
2012	Deduction from income	$ 714 (1/14 x $10,000)

For taxpayers filing their timber operations as investors, qualified reforestation expenses are reported as adjustments to gross income, even though there is no line for doing so on Form 1040.

Taxpayers may also choose to capitalize all of their reforestation costs, by creating a plantation account for each project. The timber represented by each account is added to the merchantable timber account when the timber reaches merchantable size, thereby contributing to the depletion allowance for timber sales or other disposals.

Summary of Implications for Forest Landowners

Forest landowners should keep several things in mind as they plan to minimize their federal income taxes. Capital gains from timber sales should be reported separately for several reasons. The tax rates for long-term capital gains are substantially lower than those for ordinary income. In addition, for taxpayers who are sole proprietors or partnerships, it is important to remember that, unlike earned income, capital gains are not subject to the self-employment tax. The more income these tax-payers can report as capital gains, the smaller their tax burden. Taxpayers filing as investors should also be aware that if they have capital losses, these are first and fully deductible from capital gains, up to the magnitude of the gain. But only $3,000 of a net capital loss is deductible from ordinary income in any one year (joint return). Previous tax law changes in the Tax Reform Act of 1986 made it more difficult for many forest landowners to gain any reductions in their taxes by writing off expenses. This has not changed. Taxpayers need to keep good accounts of their activities and costs to maintain or establish their status as material participants in the business of growing timber. Those who do so should experience no change in which costs they may recover. Extension will continue to be a source of information on this and other tax matters. Timber growers are also advised to consult their tax preparers or attorneys.

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www.irs *The IRS Web site provides access to all forms, subject guides and many sets of instructions needed for filing taxes on capital gains from timber, including the hard-to-find Form T, Timber Industries Schedule*.

www.timbertax.org *This is a comprehensive site devoted to timber taxes. It includes programs to record your timber accounts and calculate depletion allowances, installment sales of timber and other transactions. A comprehensive index and list of cases and rulings are also included, as well as current developments*.

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