COLLEGE OF AGRICULTURE & LIFE SCIENCES

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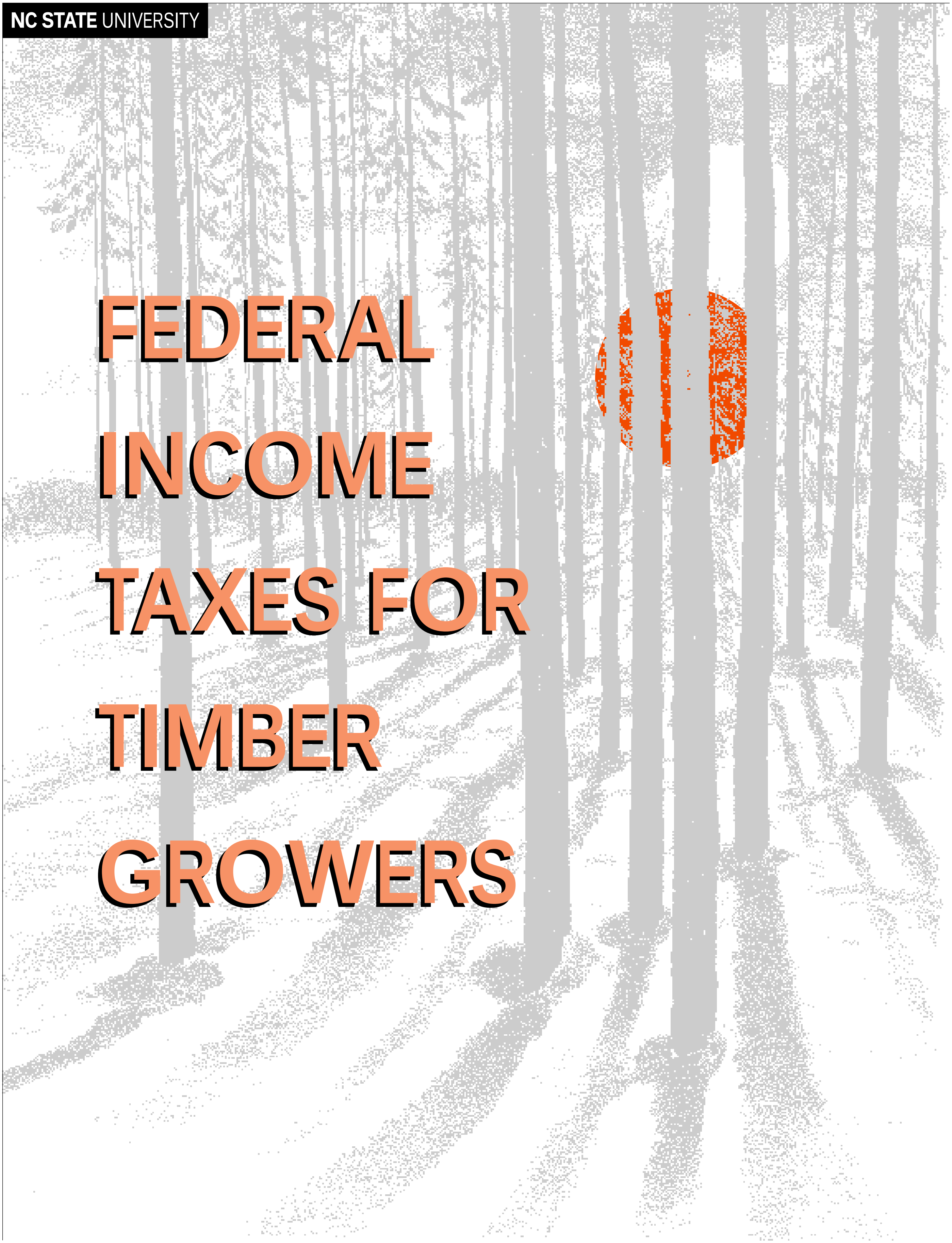

FEDERAL INCOME TAXES FOR TIMBER GROWERS

Contents

Introduction

Three fourths of North Carolina's commercial timber is owned by individuals with little expertise in tax law accounting. Every year at income tax time, these growers face an extra challenge—the task of dealing with a complex set of federal tax laws governing timber ownership, which underwent a major overhaul via the federal Taxpayer Relief Act of 1997 and amendments to the 1998 IRS Restructuring and Reform Act.

Understanding some of the intricacies of tax law can help timber owners minimize their tax liability. They can learn how to establish complete records for each tract of timber, how to choose the best method of selling their timber, and how to take advantage of all deductions and tax incentives permitted by law.

The following information, which aims to be easy to read and understand, is based on an interpretation of the present Internal Revenue Code (IRC) as it pertains to timber ownership and on analyses provided by various tax advisory services. It is believed to be accurate. However, action taken as a result of this information is solely the responsibility of the user.

Definition of timber

"Timber" is defined by the IRC as the wood in *standing* trees that is recovered when the trees are cut and processed. It includes the parts of standing trees that are used or usable for lumber, pulpwood, veneer, poles, crossties, piling, and other wood products. Timber, as defined by the IRC, has the same meaning as the word **stumpage**[1] when used by professional foresters.

Once trees are cut, they cease to be timber for income tax purposes. The simple act of cutting standing trees converts timber from real property into wood products, which are personal property. Consequently, any gain from the sale of standing timber should qualify as a **capital gain**, whereas any gain from the sale of wood products qualifies as **ordinary income**.

Gain or loss from sale of timber

You can calculate gain or loss by subtracting the **selling costs** and the "adjusted **basis**" in the timber from the total receipts of the sale. Qualifying sales expenses include tree marketing costs, appraisal fees, scaling costs, survey fees, cruising costs (see pages 5 and 9), temporary road costs, consulting fees, and legal fees. "Basis" and "adjusted basis" in timber are explained in the next section. Compute the gain or loss in a timber sale as follows:

	Gross sales receipts
Minus:	Sales expenses
Minus:	Timber adjusted basis
Equal:	Net gain or loss

Timber basis

"Basis" is a broad term used to determine, for tax purposes, the amount of capital invested in property. The basis of property is usually its cost when first acquired, except when acquired by inheritance or gift. The basis a landowner has in timber is determined by the method of acquiring the timber, the length of time the timber has been held, and the timber management and tax accounting practices employed by the owner.

You can increase basis by adding the cost of improvements or decrease it by deducting for **depletion**, **amortization**, or casualty losses. The increased or decreased basis is called the "adjusted basis." The adjusted basis of property is used to determine gain or loss on sales or exchanges and for computing amortization, cost recovery, depletion, and casualty loss deductions.

Purchase of land and timber

When a tract of land is acquired, the basis (cost) should be allocated among land, timber, buildings, fences, wells, and other items of value. In this case, the basis includes the purchase price of the land plus closing costs, such as attorney fees, surveys, and title searches. Separate **capital accounts** should be established for each type of property—for

[1]Forestry or accounting terms presented in **boldface** are explained in the GLOSSARY at the end of this publication.

example, one for the land, one for the timber, and a third for the property eligible for depreciation (cost recovery). Each account represents the basis (capital investment) in that specific type of property.

Example 1: John buys timberland for $200,000. At the time of purchase, an appraiser allocates $100,000 of the total cost to land, $75,000 as the fair market value of merchantable timber, and $25,000 as the fair market value of buildings, fences, wells, and other improvements. John then establishes separate accounts for each type of property—land, timber, and buildings.

However, if a person buys land at less than fair market value, the purchase price should be allocated among land, timber, and property eligible for basis in proportion to the actual fair market value of each category.

Example 2: Paul buys land, timber, and buildings for $200,000. An appraiser values the land, timber, and buildings at $125,000, $75,000, and $50,000, respectively. The appraisal indicates that the land represents 50 percent of the market value, the timber 30 percent, and the buildings 20 percent. Therefore, the basis assigned to the land, timber, and buildings is as follows:

Land:	$100,000 ($200,000 times 50 percent)
Timber:	$60,000 ($200,000 times 30 percent)
Buildings:	$40,000 ($200,000 times 20 percent)

Young growth

When a taxpayer acquires land that contains both **merchantable timber** and **young growth**, he or she should subdivide it so that each tract includes only merchantable timber or young growth. Separate accounts should be established for each tract. The basis of the merchantable timber is generally the fair market value of the standing sawtimber, pulpwood, or other wood products at the time of acquisition (see Example 2 above). The basis of the young growth is the difference between the purchase price for that tract and the bare land value. Cutover woodland lacking merchantable timber or young growth has no original timber basis.

Exchange of real property for timberland

If timberland is acquired by exchanging other investment property, the basis in the timberland is the basis of the real property exchanged. If additional payment is made, the basis of the timberland is the basis of the real property exchanged plus the additional payment. Conversely, if payment is received in the exchange, the basis must be reduced by that amount.

Example: George exchanges an apartment building, held as an investment with an adjusted basis of $100,000, for a tract of timberland. He pays an additional $20,000. George's basis in the timberland becomes $120,000 ($100,000 plus $20,000).

Timberland acquired by inheritance

The basis of timberland acquired by inheritance is generally the fair market value as appraised for the decedent's estate at the date of death. Factors considered in arriving at this value include the species, age, size, and quality of timber; the quantity of timber per acre; and the location and accessibility of the land, which affect common carrier freight rates to important markets.

Example: Dean inherits timberland valued for the decedent's estate at $75,000, based on land valued at $50,000 and timber valued at $25,000. Although the decedent's basis was $15,000, the basis to his heir becomes the stepped-up revaluation of $50,000 for the land and $25,000 for the timber.

Timberland acquired by gift

The basis of property received by gift is generally the adjusted basis of the property in the hands of the donor. Exceptions include property acquired by gift before 1921, property on which a taxpayer pays a gift tax, property on which the fair market value is less than the donor's basis and a loss must be determined, and gifts of property that must be included in a decedent's estate. These and other exceptions may result in a basis other than the adjusted basis of the donor.

Example: Jerry gives his son a tract of timberland with a fair market value of $75,000. Jerry's basis of $15,000 remains the son's basis for the timberland.

Reforestation

Cash outlays by a landowner to reforest cutover woodland or to plant bare land are **capital expenditures**. All direct expenditures in reforestation, up to the time a stand is established, are capital expenditures and must be put into a timber account. This includes the costs of brush removal, piling, tree planting, seedlings, wages, small tools, and depreciation on equipment used to establish the **timber stand**. The total of these expenditures is the basis of reforested timber.

If a landowner allows land to reforest naturally with no cash outlay, no costs are incurred. In this case, the reforested timber stand has no basis.

Example 1: *Mary spends $3,000 to reforest 30 acres of cutover woodland. The cash outlay of $3,000 becomes the basis in the tract.*

Example 2: *Ellen spends $8,000 to reforest 80 acres of cutover woodland. She receives reimbursement of $4,800 under the Forestry Incentives Program (FIP) and elects not to report the $4,800 as income. Therefore, she must reduce her costs of $8,000 by the $4,800 reimbursement not reported as income. Ellen's basis here is $3,200 ($8,000 minus $4,800).*

Example 3: *If Ellen, the taxpayer in Example 2, elects to report the reimbursement as income, her basis becomes $8,000. This amount now is eligible for recovery by amortization under the reforestation incentive or by depletion when the timber is sold. (See the discussion on page 11 for further details on cost-sharing.)*

Back cruising

In situations where a landowner acquires a parcel of land at some time in the past and never allocates costs among timber, land, and other assets, an estimate of the volume and value of the timber at the time of purchase must be made to establish a basis. The procedure for arriving at this estimate is called **back cruising**.

In back cruising, the present timber volume is reduced by the estimated amount of growth since the purchase. Growth-rate estimates are made by evaluating growth rings on core samples taken from standing trees. Once the growth rate has been established, the past volume can be estimated. The basis is calculated by multiplying the estimated past timber volume by the prevailing timber prices in the year the property was acquired.

Back cruising is permissible in determining basis only while trees are standing. Once trees are cut, back cruising is prohibited by law, and the trees cease to be timber for income tax purposes.

Basis recovery

A taxpayer may recover all or part of the timber basis when standing timber is sold, destroyed, stolen, or disposed of. The taxpayer may deduct an allowable amount of the basis from the gross sale by claiming the allowable basis. If all the standing timber is sold, all of the basis is recovered. However, if only some of the standing timber is sold, only a portion of the basis may be recovered—through depletion. Allowable depletion is calculated in two steps:

First, calculate the depletion unit. The depletion unit is the total adjusted basis in the timber account divided by the number of units of timber volume immediately preceding the sale or other disposition. Second, multiply the depletion unit by the number of units of standing timber actually sold (or otherwise disposed of) to calculate the allowable depletion.

Example: *Harry plans to thin (partially harvest) 80 acres of his woodland next month. The Merchantable Timber Account for the stand to be partially harvested shows an adjusted basis of $15,000. Before thinning, Harry calculates that there are 20 cords per acre of pulpwood. Multiplying 20 cords by the 80 acres produces a total of 1,600 cords. To figure the depletion unit, Harry divides the adjusted basis ($15,000) by the total volume (1,600 cords), which equals $9.38 per cord. Harry thins the stand and sells 400 cords of standing timber for $6,000 ($15.00 per cord). To determine his net taxable income from this sale, he must calculate his allowable depletion by multiplying the number of units sold (400 cords) by the depletion unit ($9.38), which comes to $3,752. He subtracts this figure from his sale income ($6,000 minus $3,752), and assuming there are no costs of sale, Harry's net taxable income from the thinning is $2,248.*

A forest often contains multiple products (sawtimber, pulpwood, poles, etc.), making calculation of depletion units more difficult. A professional forester should assist with the process.

Timber stand management expenses

You can increase the original basis for a timber stand by capitalizing certain annual expenses incurred during the growing period. The growing period is the time after a stand has been established and up to the final cutting or harvesting. It is also the time during which little cash is realized, but visible value is produced as the timber volume increases.

Carrying charges

Certain annual expenses incurred during the growing period are defined as **carrying charges**. They include:

1. Interest payments on loans for establishing and/or maintaining a timber stand. But interest payments for land mortgages cannot be included as a timber cost.
2. Premiums paid for fire, windstorm, theft, and general liability insurance.
3. Road and fireline maintenance expenses, including annual road grading, fireline clearing, and ditch cleaning.
4. Insect and disease protection costs.
5. Expenses for prescribed burning (for brush control and fireline maintenance).
6. Administrative costs, including annual accounting fees, legal fees, and professional forest management fees.
7. Cost of hired labor, tools, and materials used in maintaining a timber stand.

Each year the timber owner may choose between treating the carrying charges as annual expense deductions or capitalizing them by adding them to the timber basis. Annual carrying charges may be deductible, in full or in part, even if no timber income is received in the year the expenses are incurred. The Tax Reform Act of 1986 instituted passive-loss rules that dictate how a forest landowner may deduct expenses. These rules vary, depending on how much an owner participates in the forest activity:

1. **Material participants in a trade or business.** Material participation requires active, regular, continuous, and substantial involvement. In this category, all timber carrying charges are fully deductible from income from any source, not just from timber income.
2. **Passive participants in a trade or business.** Timber carrying charges may be deducted each year only up to the amount of passive income from all sources for that year. If deductions from passive activities exceed income from passive activities in a particular tax year, the excess may be carried forward and used in future years when there is additional passive income.
3. **Investment.** Property taxes are fully deductible from income from any source. Interest on loans related to the timber is deductible only up to the amount of net investment income. All other timber carrying charges are deductible as "miscellaneous itemized deductions." Only the portion of these deductions that exceeds 2 percent of the Adjusted Gross Income (AGI) may be deducted, however.

Taxpayers will be considered to "materially participate" in a timber activity (item 1 above) if they meet at least one of the following tests:

1. Participation for more than 500 hours in the taxable year.
2. The sole participant in the activity for the year.
3. Participation for more than 100 hours, and no other individual spends more time on the activity.
4. "Significant participation" that exceeds 500 hours in all business activities, including timber, for the tax year.
5. "Material participation" in a timber activity for five of the past ten years.

Normally, timber carrying charges are taken as annual expense deductions, reducing the owner's current tax liability. If the timber owner does not claim these deductions in any year, the carrying charges should be capitalized (added to basis). Otherwise, the tax advantages of these timber expenses will be lost. If the timber owner elects to capitalize carrying charges, he or she should attach to the annual tax return a statement listing the capitalized items.

Carrying charges incurred on a harvested tract must be deducted in the year in which the timber is sold. No capitalization is allowed in the year that timber is sold.

Improvements

You may deduct annually as expenses most of the costs of improving an established timber stand.

These costs include pre-commercial thinning, pruning, girdling, and cull-tree removal. If you elect to capitalize these **timber stand improvement** expenditures, you must do so consistently every year. Deduction of improvement expenses is subject to the passive-loss rules above.

Fertilization increases the growth and yield of managed forests and may be applied when a timber stand is established or throughout its life. However, the Internal Revenue Service (IRS) has concluded that fertilizer costs must be amortized over the expected useful life of the fertilizer, and, thus, these costs are not fully, currently deductible. Each IRS district may establish guidelines. Generally, the useful life of the fertilizers is determined and the annualized amortization is deducted as a timber management expense. Consult your nearest regional IRS office for specific information.

Forest roads with a determinable use life may be depreciated. Temporary roads, culverts, bridges, and canals are depreciable land improvements subject to 15-year depreciation under the Modified Accelerated Cost Recovery System (MACRS). A temporary road built specifically for a timber harvest over a short number of years may be depreciated by the unit of production method, assuming the road will be closed after the harvest. Forest road maintenance expenses may be deducted annually or capitalized (added to the adjusted basis). Capitalized expenses for temporary forest roads would logically be added to the timber account, but road expenses for permanent roads should be entered into the land account or permanent capital improvement account.

Selling timber

Before entering into an agreement to sell standing timber, you should evaluate the tax consequences of the sale. Not only is it important to determine the amount of gain or loss on the sale, but also it is equally important to determine whether the proceeds will be taxed as long-term capital gain or as ordinary income. There are several reasons why you may wish to report timber income as long-term capital gain:

1. The capital-gain rate of taxation is lower than ordinary tax rates.
2. Capital gains may be used without limit to offset capital losses in a single tax year. This is especially important to landowners with large capital losses. Generally, only $3,000 of ordinary income may be offset by capital losses each year, while the remainder must be carried over for deduction in future years. But with timber income reported as long-term capital gains, those deductions for losses may be taken immediately.
3. In cases where timber holdings constitute a trade or business in which the landowner is the sole proprietor or a partner, timber sale proceeds classified as ordinary income may obligate the landowner to pay self-employment taxes on that income. However, capital gains are exempt from self-employment taxes.

Two criteria will determine whether, for federal income tax purposes, income from the sale of standing timber can qualify as a long-term capital gain. They are (a) the period of time the timber is held and (b) the purposes for which it is held.

Timber must be held for more than one year before cutting to qualify as a long-term capital gain. To determine the holding period, begin counting from the day of purchase or acquisition. Normally, the purchase date is the day the title is transferred.

For most farmers and small timber owners, standing timber qualifies as a capital asset. Therefore, any gain from the sale of standing timber held for more than a year represents a long-term capital gain. There are exceptions, however, such as repeated sales over a short period and the use of timber in a trade or business. These exceptions may cause the Internal Revenue Service to define timber sales as transactions that occur in the ordinary course of a trade or business. If this determination is made, all gain will be taxed as ordinary income—unless the timber is sold under either Section 631(a) or Section 631(b) of the IRC.

To qualify for capital gains treatment, timber owners may sell or dispose of standing timber in three ways:

1. Sell the timber for a lump sum.
2. Cut standing timber and elect to treat it as a sale or exchange. Section 631(a) applies.
3. Dispose of timber while retaining an economic interest (sell-as-cut). Section 631(b) applies.

Sale of standing timber for a lump sum

In a lump-sum sale, the owner sells standing timber for a price agreed upon in advance. Generally, the value is determined by estimating the volume of usable wood products from standing timber. The sale may cover a given acreage, a certain species, or certain diameter classes. The timber (not the land) is deeded to the buyer at the time of purchase.

Because this method of selling timber is relatively simple, it is the one most commonly used by farmers and small timber owners. For those landowners who hold timber only as an investment and make infrequent sales, any gains from a lump-sum sale of timber should qualify as capital gain.

Example: Frank makes a lump-sum sale of timber for $37,500. Sale costs are $2,250. The timber is located on land purchased 20 years ago for $30,000. At the time of the purchase, $20,000 was allocated to the cost basis of land and $10,000 to the cost basis of the merchantable timber. Gain or loss is computed as follows:

	Gross receipts of sale	$37,500
Minus:	Cost of sale	2,250
Minus:	Basis of timber	10,000
	Gain	$25,250

The timber has been held the appropriate time (20 years, 19 more than the 1-year minimum), so Frank's gain of $25,250 qualifies as a long-term capital gain. Sales receipts, costs, and gain are reported on Schedule D, Form 1040, for federal income taxes. The federal tax liability for this sale, assuming a marginal tax rate on long-term capital gain of 20 percent for federal taxes, is as follows:

Taxable gain	$25,250
Taxes due (20 % marginal rate)	$5,050

Selling timber under a lump-sum contract is a good choice for taxpayers who hold timber only as an investment and who make infrequent sales. If a timber owner makes frequent sales or holds timber in the ordinary course of his business, a lump-sum sale may not qualify for capital gains treatment. Unfortunately, the IRC definition outlining the difference between timber held as an investment and that held for use in a trade or business is not clear. Factors considered in determining this difference are:[2]

1. The purpose for which the timber was acquired, whether for sale or investment.
2. The number, continuity, and frequency of sales.
3. The promotional activity of the seller in the sales process.
4. The extent or substantiality of the transaction.

Frequent sales, high income sales, or timber business sales require use of IRC Section 631(a) or (b) to qualify for status as long-term capital gain. Disposing of timber under a sell-as-cut contract or personally cutting the timber may allow the taxpayer to treat the proceeds as capital gains. In these cases, timber falls within a special tax category of business property subject to capital gains treatment. The owner declares that he or she is in the timber business, and the question of whether timber is held for sale to customers never arises—as it does in lump-sum sales.

Disposal of timber with economic interest retained (631[b])

This method of disposal is commonly referred to as a sell-as-cut contract. It requires payment at a specified rate for each unit of timber cut, and the seller retains title (economic interest) in the standing timber. Once the timber is cut, title is transferred to the buyer. The characteristics of this sales method are:

1. The purchaser has the right to cut and use the timber to the exclusion of all others.
2. The price per unit is agreed upon in advance, in units such as dollars per **thousand board feet (mbf)**, per cord, or per ton.
3. Receipts are based on volume harvested. Volume can be measured at the timber site or at the sawmill.
4. The date of disposal is the date on which the timber is cut. This date is defined as that time when, in the ordinary course of business, the quantity felled is first definitely determined.
5. A seller may elect to treat the date of payment as the date of disposal if payment is received before cutting.
6. The gain realized is reported as capital gain income. This is true even if timber is held for sale or if the seller is a dealer or speculator in timber.

Example: Twenty years ago, Kristen purchased a farm for $30,000 that included an estimated 250,000 board feet of timber. She allocated $7,500 of the

[2] *A Guide to Federal Income Tax for Timber Owners*. Agriculture Handbook No. 681, U.S. Department of Agriculture, 1989.

purchase price to timber and $22,500 to the land and improvements. The timber basis was $30/mbf ($7,500 divided by 250 mbf).

In the current tax year, Kristen sells timber for $120/mbf. The buyer cuts 300,000 board feet. Gross sales are $36,000 ($120/mbf multiplied by 300 mbf).

When the trees are cut, the total volume of timber on the farm is found to have increased from 250,000 to 500,000 board feet. Therefore, the basis depletion unit at the time of sale is $15/mbf ($7,500 divided by 500 mbf). Kristen's gain is computed as follows:

	Gross sales (300 mbf at $120/mbf)	$36,000
Minus:	Basis (300 mbf at $15/mbf)	4,500
	Capital gain	$31,500

The gross sales price, basis, and gain are entered in Part 1, Form 4797, of the federal tax return.

Cutting of timber with an election to treat as a sale (631[a])

Under this disposal method, standing timber must be cut by the owner or by a person who has a contract right to cut. The cutter then disposes of logs and other wood products.

1. Definition of ownership: An owner is anyone who has owned or has held a contract right to cut the timber for more than one year. The one-year holding period must include the first day of the tax year in which the timber is cut. A contract right means a person has an unrestricted right to sell timber cut under a contract or to use the timber in a trade or business.
2. Gain is reported in two parts:
   a. Find the difference between the adjusted basis and the timber's fair market value (FMV) as of the first day of the tax year in which it is cut. (For calendar-year taxpayers, FMV is determined on January 1.)
   b. The FMV on the first day of the tax year becomes the new basis. Proceeds of sales minus this basis are ordinary income.
3. An election under IRC Section 631(a) is binding with respect to all eligible timber cut in the year of election and subsequent years. Permission to change must be obtained from the U.S. Commissioner of Revenue.

__Example:__ Ted cuts and sells 300,000 board feet of lumber in the current tax year for $120/mbf. Total receipts are $36,000, with sales and harvesting costs amounting to $2,000.

*The FMV on January 1 is estimated at $33,000 (275 mbf times $120/mbf). The volume estimate is provided by a professional forester who has **cruised** the standing timber. The price of $120/mbf is the prevailing price for like timber in the immediate area. Ted's basis in this tract of timber is $4,500.*

Gain is computed as follows:

	FMV January 1	$33,000
Minus:	Basis	4,500
	Capital gain	$28,500

In October, Ted cuts the timber and sells logs or wood products for $36,000.

	Gross receipts	$36,000
Minus:	Basis (January 1 FMV)	33,000
Minus:	Additional costs	2,000
	Gain (ordinary income)	$1,000

Capital gain transactions are recorded on Part 1, Form 4797, of the federal tax return. Ordinary income is recorded on Part II, Form 4797.

Casualty losses

Timber losses caused by natural or other external forces acting in a sudden, unexpected, or unusual manner may entitle a timber owner to a casualty loss deduction. To qualify as a casualty loss, the damage must cause the existing timber to become unfit for use, for example, trees that are blown down, those that have their tops severed or trunks split, or those that suffer other growth-arresting damage. Injury that merely reduces the rate of growth or the quality of future timber is not a casualty loss.

Casualty loss deductions may be claimed only during the year in which the casualty loss occurs. Casualty losses are reported using Form 4684 of the federal income tax return. The taxpayer should have documentation noting the date of the casualty, the location of the damaged property, appraisals of the property, and photographs taken before and after the disaster. In a declared federal disaster area, taxpayers may file an amended return for the previous year to hasten benefits.

Normally, casualty losses are associated with:

1. Fire.
2. Hurricanes.
3. Windstorms.
4. Ice, sleet, or hail.

5. Earthquakes.
6. Volcanic eruptions.
7. Damage from automobiles or plane crashes or similar events.
8. Combinations of any of the above.

Casualty loss deductions are limited to the lesser amount of the adjusted basis or decrease in fair market value in the timber. Compute the gain or loss from a casualty as follows:

Gross sales receipts from the sale of damaged timber (salvage)	
Plus:	*Insurance recovery*
Minus:	*Cost or other basis in timber*
Minus:	*Expenses of sale*
Result:	*Net gain or loss*

Salvage sales may result in a net gain. A landowner who does not have an established basis before the casualty may not claim a casualty loss deduction.

Casualty loss in premerchantable stands

If **plantations** or young-growth **natural stands** (those not yet of merchantable size or age) are destroyed by casualty, a landowner may claim a loss if separate accounts are maintained for these young tracts. The loss value is derived by dividing the cost or other amount allocated in the account by the total number of acres in plantation or young growth. This value per acre, multiplied by the number of acres of timber destroyed, gives the allowable basis that may be claimed as a casualty loss deduction.

Example: Joseph owns a 25-acre loblolly pine plantation reforested three years ago at a cost of $2,500. In the current tax year, fire destroys 10 of the acres. The loss is calculated as follows:

Cost basis per acre:
$2,500 divided by 25 = $100

Allowable loss:
$100 multiplied by 10 acres destroyed = $1,000

Casualty loss in merchantable stands

The amount of the adjusted basis minus insurance recovery is the maximum casualty loss that can be claimed if a stand is totally destroyed with no opportunity for salvage. However, timber often may be salvaged if the trees are damaged but not rendered **unmerchantable**. In the case of a salvage sale, the gain or loss from the casualty is figured much the same as for any timber sale. First, determine the depletion unit by dividing the adjusted basis by the total number of merchantable units of timber. Then multiply the depletion unit by the number of units destroyed or damaged to find the allowable basis that may be claimed as a casualty loss deduction.

Example 1: Wind damages 10 acres of pine sawtimber, which Amanda salvages for $8,000. The adjusted basis in the timber is $500. A consulting forester charges $800 to administer the salvage sale. Gain or loss is computed as follows:

	Salvage sale receipts	*$8,000*
Minus:	*Costs of sale*	*800*
Minus:	*Cost basis*	*500*
	Gain	*$6,700*

Example 2: Darryl sustains the complete loss of 5 acres of timber in a 50-acre stand. The stand originally contained 200,000 board feet of merchantable timber, of which 20,000 board feet were destroyed. The adjusted basis in the timber is $3,000 with a depletion unit of $15/mbf ($3,000 divided by 200 mbf). Since no salvage is possible and the timber is not insured, the allowable casualty loss is $300 (20 mbf multiplied by $15/mbf).

Tax deferral on gain

If a casualty and subsequent salvage sale result in a net gain, you may defer income taxes levied on the gain by reinvesting the gain in certain “like” properties (Revenue Ruling 80-175). Like properties include other standing timber, replacement timber sites, seeds, seedlings, and currently owned or replacement timber sites in which planting expenses are invested. The ruling specifically refers to such casualties as high winds, earthquakes, or volcanic eruptions but logically includes other types of casualties as well. The taxpayer must alert the IRS of his or her intent to defer by attaching a statement to that year’s return, and then he or she has two tax years to make the reinvestment.

Theft

Loss by timber theft (also termed “timber trespass”) is calculated the same as a casualty loss and is reported on Form 4684 of the federal income tax return. Loss is limited to the adjusted basis minus insurance or other recovered amounts (expected or actual). Theft losses are reported in the year when the theft is discovered. The depletion unit to determine the amount of the loss is based on the quantity of standing timber before the theft.

In North Carolina and many other states, timber trespass victims are often awarded double damages (two times the value of the stolen timber). One-half of the amount represents actual loss recovery; the remainder is income that should be reported as ordinary gain from an involuntary conversion.

Drought loss

Revenue Ruling 90-61 permits a deductible loss resulting from greater-than-normal seedling loss caused by abnormal drought. The amount of the loss is limited to the adjusted basis in the property. Typically, reforestation includes site preparation costs, seedling costs, and planting costs, the sum of which constitutes the basis. If site preparation costs are not needed to replant the timber stand, that amount must be excluded from the loss. Likewise, if the taxpayer has recovered the reforestation costs through amortization (see page 13), the basis must be reduced by the amount of the amortization deductions previously claimed.

Seedling losses due to drought qualify as a noncasualty involuntary conversion (IRC Section 1231). Noncasualty Section 1231 losses are reported on Form 4797 of the federal income tax return.

Pine beetle loss

Revenue Ruling 87-59 establishes that loss of timber over a nine-month period following an unexpected and unusual insect attack gives rise to an allowable noncasualty business loss deduction that must be netted with other noncasualty Section 1231 gains and losses. The loss is limited to the adjusted basis. In the event of a salvage sale of beetle-killed trees, a capital gain or capital loss will usually result; if no salvage is possible, the loss will be defined as ordinary. In the latter case, investors are required to report the loss as a miscellaneous deduction, while businesses must report it as a business loss subject to the passive-loss rules (see page 6).

Cost-sharing payments

Landowners who reforest or adopt timber stand improvement practices may receive cost-sharing payments from federal or state agencies. The Forestry Incentives Program (FIP), for example, offers cost-sharing payments of up to 50 percent of the costs incurred. The N.C. Forest Development Program (NCFDP) offers reimbursement of up to 40 percent. The Conservation Reserve Program provides partial reimbursement. The percentage that each reimburses is subject to change, however, depending on the availability of funds. Also, a landowner may not receive cost-sharing payments from more than one program on a given timber tract for the same practice in the same year.

FIP is a federal program administered through the county Natural Resources Conservation Service (NRCS) offices. NCFDP is a state program administered through the North Carolina Division of Forest Resources.

> ***Example:*** *A landowner, Thomas, receives approval for reforestation cost-sharing under FIP. The total cost incurred by Thomas for site preparation and tree planting is $110 per acre. FIP will reimburse Thomas $55 per acre (50 percent multiplied by $110), contingent upon approval of the practice by the North Carolina Division of Forest Resources.*

Cost-sharing payments for reforestation may be partially or totally excluded from gross income. This exclusion provision is allowable under IRC Section 126. On the other hand, reimbursements received for timber stand improvements under a cost-sharing program are not subject to exclusion. Payments must be reported as income in the year received, although the total cost of these activities, including the cost-sharing portion, may be deducted or capitalized in the tax year incurred.

Exclusion of cost-sharing payment from income

As noted above, a taxpayer may elect to exclude from gross income those payments received from cost-sharing programs for reforestation. The entire amount of the payment may not qualify for the exclusion, however. The excludable portion is the amount of the cost-sharing payment that did not substantially increase the annual income from the property (Regulation 16A.126-1). An increase in annual income is considered substantial if it exceeds the greater of the present value of either:

1. Ten percent of the average income derived from the property before the improvement; or
2. An amount equal to $2.50 times the number of affected acres.

To determine if part or all of a cost-sharing payment may be excluded from income, compute the prior average annual income and the present fair market value of the right to receive income from the affected acreage.

1. "Prior average annual income" means the average of gross receipts received from the affected acres during the three tax years preceding reforestation. For example, if a taxpayer sells timber for $1,000 per acre within three years before reforestation, the prior average annual income per acre is $333 ($1,000 divided by 3). If an owner reforests bare land or land from which unmerchantable trees are removed, the prior average annual income is zero.
2. "Present fair market value" is the prior average annual income capitalized at some percentage rate. Multiply the average annual income by a prescribed 10 percent and divide by a capitalization rate.[3]

Example 1: *Sally sells timber for $1,000 per acre within three years preceding reforestation. Reforestation expenses are $150 per acre, with Sally receiving reimbursement of $75 per acre (50 percent multiplied by $150). She elects to exclude the allowable portion of the $75-per-acre cost-share payment and figures the excludable portion as follows:*

1. *Average annual income equals $333.33 ($1,000 divided by 3 years).*
2. *The excludable portion is equal to 10 percent of the average annual income divided by the capitalization rate ($333.33 multiplied by 0.10 divided by 0.028). The excludable portion equals $1,190.46.*
3. *The cost-sharing payment of $75 minus the excludable portion of $1,190.46 is less than zero. Therefore, the entire $75 may be excluded from income.*
4. *The basis of $150 per acre must be reduced by the $75-per-acre cost-sharing payment excluded from income. The adjusted basis is $75 ($150 minus $75).*

Example 2: *Andrew reforests land at a cost of $150 per acre and receives $75 per acre as a cost-sharing payment. Because the reforestation comes after unmerchantable trees are cleared, there is no income history. Without income history, the present fair market value of the right to receive $2.50 per acre is used to compute excludable income. The excludable portion of the $75 per acre received is computed as follows:*

1. *The excludable portion equals $89 per acre ($2.50 divided by 0.028).*
2. *Since the excludable portion ($89) is greater than the $75 payment received, the entire $75 may be excluded from income.*

How to report the exclusion

Attach a statement to your tax return (or amended return) for the tax year in which you receive the last government payment for the reforestation. The statement must include the following:

1. The dollar amount of the cost funded by the government payment.
2. The value of the reforestation.
3. The amount you are excluding.

If you file a Schedule F, report the total cost-sharing payments you receive on Line 6a, and the taxable amount on Line 6b.

Excluded payments may be subject to recapture by the IRS as ordinary income if the improved property is sold (IRC Section 1255). If the property changes hands within 10 years, excluded payments are recaptured in full. The proportion subject to recapture declines by 10 percent annually for each year the property is held past 10 years. After 20 years, no portion is subject to recapture as ordinary income.

Including cost-sharing payments as income

Taxpayers may elect to include reforestation cost-sharing payments as income in the year received. This way, the entire cost of reforestation may be capitalized and thus qualifies to be amortized over an 84-month period (see pages 14–16, "Reforestation tax credit and amortized deductions"). In addition, cost-sharing payments reported as income can qualify for investment tax credit (see pages 14–16) for the tax year in which they are received.

[3]In the following examples, we have used a capitalization rate of 2.8 percent. This value is an approximation of the real interest rate prevailing in the United States during the past four decades.

Example: *Peter reforests 50 acres at a cost of $5,000. He receives $2,500 as cost-sharing payments and reports the entire amount as income in the year received. Therefore, the entire reforestation cost of $5,000 qualifies for investment tax credit and amortization.*

Many taxpayers will gain maximum tax advantage by reporting reforestation cost-sharing payments as income. The value of the investment credit and amortized deduction often provides a greater tax savings than excluding reforestation payments from current taxable income. The following section further analyzes the tax benefits of including payments as income.

Reforestation tax credit and amortized deductions

Taxpayers who reforest may claim investment tax credit (ITC) on the reforestation costs and recover 95 percent of these costs as deductions over the 84-month amortization period. Amortized deductions are reported as adjustments to gross income, which allows taxpayers to claim the deductions even if they do not itemize their other deductions. The law applies to the first $10,000 of qualified reforestation expenses each year ($5,000 for a married person filing a separate return). Reforestation expenses include the costs of site preparation, seedlings, hired labor, small tools with a life of less than one year, and depreciation on equipment used in establishing a timber stand.

To qualify, timber property must be 1 acre or larger and held for the commercial production of timber. The property need not be owned by the taxpayer, so reforestation expenditures incurred on leased property are eligible. Individuals, corporations, partnerships, and estates qualify, but trusts do not.

Only the first $10,000 of annual reforestation expenditures are eligible for ITC and amortization. This $10,000 may include cost-sharing payments if they are reported as income. Expenditures exceeding the $10,000 annual limit must be placed in a timber capital account. In this way, as timber from the reforested stand is sold, these expenses may be recovered through depletion.

An ITC of 10 percent is claimed in the tax year during which qualifying reforestation expenditures are paid. If the ITC is claimed, the basis (cost of reforestation) must be reduced by one half of the ITC claimed. If a credit is taken, it must be the full credit, and the basis must then be reduced by half the credit (that is, 95 percent of the allowable basis is amortized).

The credit is limited to a maximum of $1,000 annually (10 percent of $10,000). If there is no sale or disposal of the timber within seven years, the credit is not subject to recapture. Recapture rules are the same as for other assets that qualify for investment tax. The credit is claimed by filing Form 3468.

Amortization of expenses begins during the tax year in which a reforestation investment is made. The law requires amortization to begin on the first day of the second half of the tax year in which the expenditures are incurred (July 1 for a calendar-year taxpayer). In other words, amortized deductions are limited to the last six months for the first year. Thereafter, deductions are allowed every month of the following six years and during the first six months of the eighth, and final, tax year (for a total of 84 months). Amortization is claimed using Form 4562, or as an adjustment to income on Form 1040.

If the timber is sold within 10 years, amortized deductions are subject to full recapture as ordinary income. If the timber is held more than 10 years, there is no recapture. Recapture does not apply to the transfer of timber by gift, inheritance, a like-kind exchange, involuntary conversion, or certain tax-free exchanges, such as transferral of personal property to a corporation.

Each year, a taxpayer may claim amortized deductions for reforestation expenditures incurred on each individual timber tract. To claim these deductions, the taxpayer must attach a statement of the date, amount, and description of the expenditure to the tax return. The investment tax credit may be claimed even if the taxpayer elects not to claim amortized deductions. Amortized deductions may be claimed using Form 4562 or one of the following forms:

1. Form 1040: The deduction is taken as an adjustment to gross income by entering the word "Reforestation" and including the amortized deduction amount in the total

adjustments to gross income. This is for taxpayers who do not file Schedule C or Schedule F.

2. Schedule C: The deduction is entered on Line 13.
3. Schedule F: The deduction is entered on Line 16.

The following examples illustrate the use of the tax credit and amortized deduction in several situations.

Example 1: Charles reforests 50 acres at a cost of $7,000 during the current tax year. Cost-sharing gives back $3,500, which he elects to exclude from gross income. This leaves qualifying expenditures of $3,500 ($7,000 minus $3,500).

Charles elects to take the investment tax credit of $350 (10 percent of $3,500). The basis (qualifying expenditures) then is reduced by half of the allowable ITC of $350 and becomes $3,325 ($3,500 minus $175). Amortized deductions are based on $3,325 divided by 84 months, which comes to $39.58 per month.

Year		Amount
1	10% tax credit	$350
	Deduction (6 months)	237
2	Deduction (12 months)	475
3	Deduction (12 months)	475
4	Deduction (12 months)	475
5	Deduction (12 months)	475
6	Deduction (12 months)	475
7	Deduction (12 months)	475
8	Deduction (6 months)	237

Example 2: Faithanne reforests 50 acres at a cost of $7,000. Cost-sharing reimburses $3,500 (50 percent of $7,000), which Faithanne elects to include as ordinary income. The full ITC of $700 (10 percent of $7,000) is claimed, and the basis is reduced by half of the amount of ITC allowed. The adjusted basis is $6,650 ($7,000 minus $350). Amortized deductions are $79 ($6,650 divided by 84) per month. Allowable ITC and amortized deductions for the 84-month period are:

Year		Amount
1	10% tax credit	$700
	Deduction (6 months)	475
2	Deduction (12 months)	950
3	Deduction (12 months)	950
4	Deduction (12 months)	950
5	Deduction (12 months)	950
6	Deduction (12 months)	950
7	Deduction (12 months)	950
8	Deduction (6 months)	475

Example 3: Ruth reforests 150 acres at a cost of $12,000 during the current tax year. No cost-sharing is available. Because only $10,000 of nonreimbursed reforestation expenditures qualify in any tax year, the remaining $2,000 ($12,000 minus $10,000) remain in the timber account to be recovered through depletion as timber is sold. If an ITC of 10 percent is claimed, amortized deductions must be computed on an adjusted basis of $9,500 ($10,000 minus $500).

Year		Amount
1	10% tax credit	$1,000
	Deduction (6 months)	679
2	Deduction (12 months)	1357
3	Deduction (12 months)	1357
4	Deduction (12 months)	1357
5	Deduction (12 months)	1357
6	Deduction (12 months)	1357
7	Deduction (12 months)	1357
8	Deduction (6 months)	679

Remember: Tax credits are dollar-for-dollar reductions in the amount of income taxes owed. The tax advantage gained by amortized deductions will vary, depending on the individual's tax bracket.

Excluding and including payments as income

Taxpayers must analyze the short- and long-term tax consequences of excluding reforestation cost-sharing payments from income. Initially, excluding payments from income appears attractive because it lowers taxable income for the tax year during which payments are received. But exclusion of cost-sharing payments reduces the amount of reforestation expenses eligible for the investment tax credit and the 84-month amortized deduction. This loss may increase the after-tax cost of reforestation, an increase that partly depends upon the taxpayer's marginal tax rate.

By including cost-sharing payments as income, all qualifying reforestation expenses up to $10,000 per year qualify for investment credit and amortization. The additional credit and deductions may offset the taxes due on payments reported as income. In fact, it can result in lower after-tax reforestation costs when compared with those incurred when payments are excluded from taxable income.

To compare the tax savings and after-tax cost of reforestation, assume a taxpayer spends $7,000 to reforest 100 acres. The taxpayer receives a cost-sharing payment of $3,500 (50 percent of $7,000). If the payment is excluded from income, only $3,500 ($7,000 minus $3,500) of the reforestation expenses are eligible for investment credit, amortization, or both. If the payment of $3,500 is reported as income, the entire $7,000 qualifies.

If the taxpayer excludes cost-share payments from income and claims ITC, the adjusted basis for reforestation expense becomes $3,325 ($3,500 minus $175). If the payments are included as income, the adjusted basis is $6,650 ($7,000 minus $350). Amortized deductions and investment credit for excluding and including payments are as follows:

Amortized deductions and investment credit for reforestation costs, excluding and including cost-sharing payments as income

Year		Cost-Sharing Payments: Excluded	Cost-Sharing Payments: Included
1	Deduction (6 months)	$ 238	$ 475
2	Deduction (12 months)	475	950
3	Deduction (12 months)	475	950
4	Deduction (12 months)	475	950
5	Deduction (12 months)	475	950
6	Deduction (12 months)	475	950
7	Deduction (12 months)	475	950
8	Deduction (6 months)	237	475
	Total Deductions	$3,325	$6,650
	Investment credit (Year 1)	$350	$700

Now compute the tax effect on excluding or including cost-sharing payments as income, assuming the taxpayer pays taxes at a 28 percent marginal tax rate. In this analysis, assume that the 28 percent marginal tax rate applies to reported income from reforestation payments as well as to the tax savings from amortized deductions. In other words, amortized deductions equal a 28 percent tax savings, and cost-sharing payments reported as income are taxed at 28 percent.

The tax benefit of including cost-sharing payments as income comes to $1,582, which is $301 greater than the tax benefit of excluding payments ($1,281) because of the larger investment credit and amortizable basis.

Annual tax savings when cost-sharing payments are excluded and included as income

Year		Cost-Sharing Payments: Excluded	Cost-Sharing Payments: Included
1	Tax liability[a]	$0	-$980
	Investment credit	350	700
	Deduction (6 months)	67	133
2	Deduction (12 months)	133	266
3	Deduction (12 months)	133	266
4	Deduction (12 months)	133	266
5	Deduction (12 months)	133	266
6	Deduction (12 months)	133	266
7	Deduction (12 months)	133	266
8	Deduction (6 months)	66	133
	Total Savings	$1,281	$1,582

[a]Tax liability equals 28 percent of the cost-sharing payment of $3,500 included as income.

Since the tax benefits occur over eight years, a more valid economic comparison will be possible when the savings are discounted to their present value. Landowners should discount their future savings because dollars received (saved) in the future are not as valuable as current dollars. Discounting simply reduces the value of future savings to their present value. This example uses an after-tax discount rate of 9 percent.

Now the discounted value of tax savings calculated by including cost-sharing payments as income exceeds by $70 the tax savings calculated by excluding payments ($1,119 versus $1,049).

Present value of tax savings

Year		Cost-Sharing Payments: Excluded	Cost-Sharing Payments: Included
1	Tax liability[a]	$0	-$980
	Investment credit	350	700
	Deduction (6 months)	67	133
2	Deduction (12 months)	122	244
3	Deduction (12 months)	112	224
4	Deduction (12 months)	103	205
5	Deduction (12 months)	94	188
6	Deduction (12 months)	86	173
7	Deduction (12 months)	79	159
8	Deduction (6 months)	36	73
	Total Present Value of Savings	$1,049	$1,119

[a] Not discounted for the first year since liability or benefits do not occur until a tax return is filed.

This means that the present value of the after-tax cost of the reforestation expense is $5,881 ($7,000 minus $1,119) when payments are included as income and $5,951 ($7,000 minus $1,049) when payments are excluded. Whether to exclude or include depends on the tax bracket of the taxpayer. Each taxpayer should calculate the after-tax consequences when choosing to include or exclude payments.

Installment sales

Timber may be sold to tax advantage through what is referred to as an installment sales contract. That is, timber is sold in one year, and the proceeds of the sale are received over a period of years. Timber owners may want to use such a sales arrangement to reduce the tax consequences of the timber sale over several years. The contract must be binding so that the seller cannot receive monies from the sale of timber any faster than stated in the contract. This avoids "constructive receipt" of funds, which causes tax to become due immediately on the total amount of the sale. Installment sales are reported on IRS Form 6252, and the taxable amount flows to Schedule D of Form 1040 (for individual taxpayers). Timber owners who find themselves in the 15 percent income tax bracket except for the gain on the sale of timber will benefit from this arrangement because the capital gain tax rate for the 15 percent tax bracket is 10 percent (or 8 percent if property is held for more than five years for sale after December 31, 2000). The installment sale method of reporting may reduce total capital gain tax paid by keeping the taxpayer in the lowest tax bracket. *Caution: Deal only with reputable timber buyers to be sure that the contract will be honored and all money will be received.* (IRC Section 453.)

Example: *David and Dot own timber that is mature and ready for harvest. In estimating possible tax outcomes from the sale of timber, David and Dot discover that if they take the proceeds over three years in equal payments, the tax liability of the sale will be greatly reduced when added to their other income.*

Wages	$18,000
Farm income	10,400
Rental	2,400
Interest	1,200
Total income	$32,000
Taxable income (using standard deduction and personal exemptions, both 63 years of age)	$19,050
Timber sale	$90,000 gain

By using an installment sale over three years, David and Dot "save" nearly $5,000 in capital gain taxes. Nearly all of the gain from the timber sale is taxed at the 10 percent capital gain tax rate because the three equal payments of $30,000 are within the 15 percent income tax bracket (the upper limit for year 2000 is $43,850). If David and Dot receive the proceeds from the timber sale in one year, $65,200 of the gain would be taxed at 20 percent, resulting in an increased tax liability.

Alternative minimum tax

Timber owners should be aware of Alternative Minimum Tax (AMT) issues when they sell timber. AMT is a method imposed by Congress to make sure that taxpayers using tax shelters and large losses to offset income pay their "fair share." AMT is calculated using IRS Form 6251. Timber owners should consult their tax preparer or accountant about any AMT issues that may result from a sale of timber (IRC Section 55).

Standard deduction and personal exemption for 2000

In 2000, the standard deduction for married couples filing a joint return is $7,350; for single taxpayers, $4,400; for a head-of-household, $6,450; for a qualifying widow(er), $7,350. If a married couple file separate returns, the standard deduction is $3,675 per individual. The additional deduction for being either blind or over 65 years of age is $1,050 for single individuals or

Tax Tables for 2000

If taxable income is:	The tax is:
MARRIEDS	
Not more than $43,850	15% of taxable income.
Over $43,850 but not more than $105,950	$6,577.50 + 29% of excess over $43,850.
Over $105,950 but not more than $161,450	$23,965.50 + 31% of excess over $105,950.
Over $161,450 but not more than $288,350	$41,170.50 + 36% of excess over $161,450.
Over $288,350	$86,854.50 + 39.6% of excess over $288,350.
SINGLES	
Not more than $26,250	15% of taxable income.
Over $26,250 but not more than $63,550	$3,937.50 + 28% of excess over $26,250.
Over $63,550 but not more than $132,600	$14,381.50 + 31% of excess over $63,550.
Over $132,600 but not more than $288,350	$35,787.00 + 36% of excess over $132,600.
Over $288,350	$91,857.00 + 39.6% of excess over $288,350.
HEADS OF HOUSEHOLD	
Not more than $35,150	15% of taxable income.
Over $35,150 but not more than $90,800	$5,272.50 + 28% of excess over $35,150.
Over $90,800 but not more than $147,050	$20,854.50 + 31% of excess over $90,800.
Over $147,050 but not more than $288,350	$38,292.00 + 36% of excess over $147,050.
Over $288,350	$89,160.00 + 39.6% of excess over $288,350.

heads-of-household and $850 for married persons (filing either a separate or joint return) and qualifying widow(er)s.

The personal exemption allowance is $2,800. This allowance will be phased out, depending on filing status and adjusted gross income. Sellers of timber should seek professional help to determine if the phase-out affects them.

Tax rate brackets, standard deductions, and personal exemptions are adjusted annually for inflation.

Estimated income tax payments

When selling timber, owners must be aware of the requirement to make estimated income tax payments for the year of the timber sale and receipt of income. Generally, two rules apply:

1. The required annual payment for most taxpayers is the lower of 90 percent of the tax shown on the current year's tax return or 100 percent of the tax shown on the prior year's return.
2. If the taxpayer's AGI is greater than $150,000, the estimated tax payments must be either 90 percent of the current year's liability or 105 percent of the prior year's tax.

Taxpayers must use Form 1040ES for making the estimated tax payments (IRC Section 6654). *(Note: The required percentage of the prior year's tax goes up to 106 percent for 2000 and 2001, to 112 percent for 2002, and to 110 percent for 2003 and later years.)*

Rule 2 applies if the taxpayer's AGI for the current year exceeds the prior year's by more than $40,000, even though the total AGI is less than $150,000.

If the taxpayer is a farmer, he or she may elect to pay all of the tax and not be subject to a penalty—but the tax return must be filed by March 1 and the tax must be paid at that time. Remember, to qualify as a farmer, two thirds of the taxpayer's gross income must come from farming activities, and the proceeds from the sale of timber are not farm income. The taxpayer should consult his or her accountant or tax preparer for advice about the need to make estimated tax payments.

Sale of the principal residence

With changes made in the Taxpayer Relief Act of 1997 relative to the sale of a principal residence, taxpayers may be able to exclude the gain of standing timber if the land adjoins the property of the principal residence. The taxpayer must live in the house as a principal residence for two of the last five years. He or she also must prove that the timberland was not held for business property and was used for personal pleasure and/or investment (IRC Section 121).

Example: *Steve and Claire own 100 acres. They have lived in their house for more than two years, and it has been their principal residence. Adjoining the homestead are 20 acres of timber. The remaining 80 acres have been used in Steve's farming business. Steve and Claire have not used the 20 acres of timberland for any business purpose, only for personal pleasure. Steve and Claire sell the 100 acres. Since the house and adjoining timberland were dedicated to personal use, Steve and Claire may exclude any and all gain on the two items (up to $500,000 for a married couple filing a joint return, or $250,000 for a single person). The gain on the remaining acreage, which was used for farming, is subject to taxation at capital-gain rates.*

Again, consult a qualified tax preparer or accountant for help in determining if you qualify for this provision.

Income averaging for farmers

The Taxpayer Relief Act of 1997 also brought back income averaging for persons engaged in farming. Originally, this law allowed income averaging for tax years 1998, 1999, and 2000; however, legislation passed in 1998 has made this provision permanent (IRC Section 1301).

Income averaging is allowed only for farm income, that is, income generated in the course of a farming business and the gain from the sale of property (not including land) that was regularly used in the farming business for a substantial period of time. Therefore, any gain from the sale of breeding livestock and machinery used in the farming business that is reported on Form 4797 qualifies as farm income and is eligible for income averaging.

However, income from timber is **not eligible** for income averaging because timber sales are not farm income as defined in IRC Section 1301(b)(3) by reference to IRC Section 263A. Similarly, Christmas trees that are more than six years old when cut from their roots are treated as timber (and are not allowed in income averaging). If the Christmas trees are six years old or less when cut, the income from their sale may be averaged using Schedule J of Form 1040, as this income may be treated as farm income instead of capital gains from the sale of timber.

Glossary

Amortization—the periodic subtraction of an allowed annual amount to recover reforestation costs over a specified period of time.

Back cruising—a procedure used to determine the previous volume of a tract of timber. Current growth rate measurements are calculated and subtracted from the current volume of timber to estimate the volume during a given year in the past.

Basis—the capital invested in timber property.

Capital account—an account used to record the quantity of timber and related capital expenditures.

Capital expenditure—an amount paid for a stand of timber or the amount spent to reforest a tract or improve an existing stand. The anticipated benefit extends beyond a tax year.

Capital gain—the gain realized on the sale or exchange of capital assets, including timber. If timber is held more than one year before cutting or sale, any gain is a long-term capital gain for federal income taxes.

Carrying charges—annual or periodic expenses associated with maintaining an investment.

Cruising—the process of estimating the volume of standing wood products in a timber stand.

Depletion—a method used to recover an owner's basis in timber. Depletion is usually expressed in dollars per thousand board feet, per cord, or per other unit of measure of merchantable timber. It is computed by dividing the adjusted basis of timber by the total quantity of timber.

Growing costs—expenses associated with maintaining a timber stand.

Merchantable timber—stands that contain timber usable for lumber, pulpwood, veneer, poles, crossties, piling, or other wood products.

MBF—one thousand board feet.

Natural stand—a stand originating either from seed dispersed by standing trees or from sprouts arising from stumps or roots left after harvest.

Ordinary expense—necessary expenses connected with a taxpayer's trade, business, or profession and paid or incurred during the taxable year in which the deduction is claimed.

Ordinary income—gain from the sale of timber held less than one year or used in a trade or business. In North Carolina, all income, regardless of source, is treated as ordinary income.

Plantation—a timber stand established by planting or by direct seeding.

Qualifying reforestation expenses—expenses associated with reforestation that qualify for investment tax credit and amortization.

Reforestation costs—expenses incurred in site preparation and establishment of a timber stand.

Salvage—the harvest and sale of timber destroyed by a casualty.

Selling costs—all expenses associated with a timber sale, such as commissions, surveys, temporary roads, and tree marking.

Stumpage—the wood in standing trees that is to be recovered when the trees are cut and processed.

Thinning—intermittent cuts aimed at controlling stand density in order to maintain or increase tree vigor and growth rate. It usually returns an income through the sale of any timber removed.

Timber stand—a contiguous group of trees sufficiently uniform in species composition, age classes, and condition to be managed as a unit.

Timber stand improvement—the removal or killing of trees of undesirable species or quality that are competing with potential crop trees in a timber stand. It normally involves an investment.

Unmerchantable stands—stands that do not contain trees usable for lumber, pulpwood, veneer, poles, crossties, pilings, or other wood products.

Young growth—the stage in forest life between the time a timber stand is established and the time it reaches merchantable size or age.

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