Taxes and the Family Forest Owner

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Owning forestland vests certain responsibilities with the landowner. One of these responsibilities is paying federal, state, and local taxes.

All private forest landowners in the United States are subject to income tax regulations. For the most part, taxation for forest landowners is the same as for any other hobby, business, or investment. However, several provisions within the tax code are specific to forestry. Forest landowners also pay property taxes on their forestland according to state and local tax regulations. Some states assess taxes on harvested timber in the form of yield or severance taxes.

Unfortunately, many forest landowners are not familiar with either the general tax laws or those specific to forestry. Also, many accountants and tax professionals are unfamiliar with the application of regulations that apply to forestry, because they have few clients fortunate enough to own forestland. As a forest landowner, you should take the time and make an effort to learn the basics of timber taxation—both to comply with the law and to recover your investment expenses in timber.

The subject of taxation is intimidating for many people. Establishing a basic knowledge of taxation principles, as applied to forestry, will allow landowners to determine what applies to their situation and where more intense knowledge is needed. It will also enable you to make sure your tax professional is up to date with federal taxation as applied to forestland ownership and management. Some basic principles are discussed in this chapter to help you get started.

Selection of Ownership Structure

Forest landowners may structure their forestland in several ways to satisfy the Internal Revenue Code. These general structures are based on profit motive, level of activity, and some level of self-determination. The four basic ownership structures are personal use or hobby, investment, and business including the spiral farm category. Ownership practices and structure determine if deductions are allowed for ordinary operating expenses, how deductions are claimed, and the amount of recordkeeping required.

Hobby or Personal Use

Landowners who use their land for hobby or personal use are motivated to grow timber for reasons other than profit. Typical goals for these landowners include recreation, hunting, conservation, private home sites, and the sentiment of keeping land in one's family. Hobby owners cannot deduct expenses except in years when they have offsetting hobby income. Expenses in other years are not deductible. Timber sales generally qualify for capital gains treatment.

Investor

Investors manage timber for a long-term profit. Investors tend to be less active in their ownership than business owners. They may have only one or two timber sales during their lifetime or may have a sale every few years. Reasonable investment expenses are deducted as miscellaneous itemized deductions. If the standard deduction is used, expenses may be capitalized (added to the timber basis) if the proper steps are taken. Investors must keep adequate records to justify deductions and to claim timber depletion. Timber sales may qualify as long-term capital gain or loss. Casualty losses of timber are deductible if there is a timber basis.

Business

Many forest landowners operate their forests as a business. There is no requirement to be incorporated or to use any specific business structure. The business owner is expected to operate in a business-like manner, which includes reasonable accounting records. Other good business practices to consider include creating a name for the forestry business; maintaining a separate bank account to avoid co-mingling personal and business funds; and selection of an appropriate business structure, such as a partnership, corporation, s-corporation or other. Business owners treat their forest- management expenses as business expenses. The sale of standing timber may be treated as a capital gain or loss. A portion of the income from the sale of products, such as cut firewood, pulpwood bolts, or harvested sawtimber is treated as ordinary income. Casualty and noncasualty business losses are deductible if the timber has a basis.

Farmers

Farmers are in a special type of business category. Owning and managing a forest is not normally considered a farming activity. However, many farmers have a forest which is part of their farm. For these owners, it is possible to treat the forest activities as part of the farm. Farmers may treat their forest-management expenses as farm expenses. The sale of standing timber may be treated as a capital gain or loss. A portion of the income from the sale of products, such as cut firewood, pulpwood bolts, or harvested sawtimber is treated as ordinary income. Casualty and noncasualty business losses are deductible if the timber has a basis.

Selection of an Operating Structure

Selection of the correct structure for owning and managing forestland is important. The IRS identifies the structure by how deductions are taken and income is reported. The Timber Tax Website at *www.timbertax.org* has detailed information on the various structures available.

Recordkeeping

Recordkeeping is required for all owners. One reason so many forest landowners are not able to take full advantage of available deductions is that they do not keep adequate records. At a minimum, forest landowners should establish a tree farm journal. This is a dated activity log with columns to post financial events. For landowners with many expenses, a more detailed bookkeeping system would be helpful. The use of commercially available computer software makes this a relatively simple process. The IRS does not prescribe the type of recordkeeping, but if audited, you must have records to back up your tax returns.

Another good reason for family forest landowners to keep records is to provide guidance and information to future owners. A well-kept detailed tree farm journal can provide insight, especially if the landowner has not involved his or her heirs with the forest and land management. One way to help future owners is to include a section within the journal containing the names and addresses of firms and individuals associated with the forest, such as neighboring landowners, vendors, timber buyers, loggers, consulting foresters, public service foresters, or hunting lease holders.

While the IRS has no specific recordkeeping format requirements, IRS Form T: Forest Activities Schedule and its associated instructions provide guidance for details required for timber sales, basis records, reforestation expense, and capitalization. One of the most important financial records to keep is that of the basis, or investment value, of the timber and land ownership.

Basis of Land and Timber

Basis is the investment value of an asset. When an asset is acquired, it has an initial basis, which varies according to how property was acquired. For landowners with limited holdings, the basis is only adjusted when necessary—before and after timber is sold, when a loss is claimed, or when undeducted expenses are capitalized into the basis.

Basis is adjusted when expenses are added to the current basis rather than being deducted—a process known as capitalization.

Basis is recovered by a process called depletion or by applying the basis against sales proceeds. When timber is sold, the taxpayer is not taxed on the gross proceeds, but on the gross proceeds less the sales expenses and the timber depletion (amount of timber basis in the sold timber). Casualty or noncasualty business losses also require basis depletion.

The following example explains the use of basis:

Martin Nester owns 100 acres of timberland. His basis in his timber is $100,000. Martin spends $5,000 on pruning his timber to encourage sawlog production. Since pruning is a capital investment, it must be capitalized or added to the basis rather than deducted. Using IRS Form T: Part IV: Reforestation and Timber Stand Activities, Martin notifies the IRS that he is capitalizing the $5,000 into his timber basis account. His adjusted basis is now $105,000. Ten years later, Martin sells the timber for $250,000. He pays a consulting forester 7 percent commission on sale of the timber, a total of $17,500. The taxable gain on the timber sale is $250,000 less adjusted basis of $105,000 and less sales expenses of $17,500. His net taxable gain is $127,500. Since Martin sells all his timber, the entire basis is depleted. If he had made a partial sale, such as a thinning, improvement cut, or partial harvest, only a portion of the basis would be depleted.

Initial Basis Determination

Timber can be acquired in four ways: through purchase, inheritance, gift, or reforestation investment.

- When the timber is first acquired, it has an initial basis. The amount of the basis depends on how the property was acquired.

- For purchased property, the initial basis is the proportion of the total acquisition cost allocated to the asset.

- For inherited property, the initial basis is "stepped up" to fair market value at the time of the decedent's death or alternative evaluation date.

- For gifted property, the initial basis is the basis of the giver and is called a "carryover" or "transfer" basis. If gift tax is paid on the gift, that affects the gifted asset's basis.

The following examples illustrate the initial basis determination methods and how they affect the net gain on timber sales:

Purchased Timberland. Initial basis for a new landowner is the total acquisition cost. This is the purchase price plus the associated costs such as lawyer's fees, filing fees, timber cruising fees, and realtor's fee. The total acquisition cost must be divided between the various assets that make up the total asset. This division is based on the proportion that each asset contributes to fair market value.

For example:

Rufus Maple purchases 40 acres of forestland for $40,000. He spends $10,000 on legal fees, consulting forester fees for a timber cruise, title search, recording fees, and title insurance. His total acquisition cost is $50,000. Based on current values of land and standing timber, his timber is 60 percent of the total value of the timberland, while the land is 40 percent. His timber basis is $30,000 (60% of $50,000), and his land basis is $20,000 (40% of $50,000).

Inherited Timberland. Determining the basis of inherited timber requires a different rule. This requires an appraisal of the asset after the original owner's death. The land and timber should be appraised separately. A consulting forester can appraise timber.

Let us consider the following example:

Ivy Birch inherited 100 acres of timberland from her father. Ivy realized that she needed to have her timber basis account established. She hired Forester Fred to set up her timber basis. Fred determined that the volume of timber was 100 MBF of pine sawtimber, valued at $40,000, and 200 cords of pine pulpwood valued at $4,000. Ivy's initial timber basis was $44,000.

Gifted Timberland. Often family forests are gifted or deeded to someone rather than allowing the ownership of the forest to transfer at death. Gifted property has a transfer or "carryover" basis. The donor's basis generally becomes the recipient's basis. All or part of any gift tax paid may be added into the basis, depending on the date of the gift. More complete information on basis of gifted property may be found in IRS Publication 551: The Basis of Assets.

For Example:

Fern Frond purchased 100 acres of pastureland. Her total acquisition cost was $5,000. She abandoned the pasture and allowed a natural forest to develop on the property. Twenty years later, Fern deeded the 100 acres to her grandson, Felix. She did not pay gift tax on this transfer of ownership. Fern's basis in the property carries over to Felix. Felix will have a $50/acre basis in land. He will have no basis in timber as Fern did not purchase timber and had not invested money in growing timber.

Retroactive Basis Determination

Many individuals do not have proper accounting records for supporting their timber basis. If the timber has not been harvested and there are adequate records, a consulting forester may be able to establish a basis retroactively. The IRS Timber Casualty Loss Audit Techniques Guide contains instructions on retroactive basis establishment. This guide is available from the *www.irs.gov* website.

Timber Sales and Capital Gains

Proceeds from the sale of standing timber is usually treated as a capital gain or loss. If the timber has been owned for the required holding period (a year and a day) then it will qualify as a long-term capital gain, subject to the lower capital gains tax rate. In addition, it will not be subject to self-employment tax.

Inherited property has no required holding period to qualify for as a long term capital gain. For gifted property, the required holding period can be met by adding the ownership time of the donor and the recipient.

IRS Form T: Forest Activities Schedule can be used to determine the profit from the sale of timber. This form helps calculate basis depletion, which allows landowners to recover their investment in the timber and reduce the tax paid on the timber sale. If all of the timber is sold at one time, the entire timber basis is applied against the timber sale. If the sale is for part of the timber, such as for a thinning, improvement cut, or partial harvest, the basis must be allocated between the timber harvested and the remaining timber, based on per unit values called the depletion unit. A consulting forester may help allocate basis for a partial sale. Form T supplements the other tax forms used to report a capital gain such as Schedule D (Form 1040) Capital Gains and Losses and Form 4797 Sales of Business Property.

Reforestation and Site-Preparation Costs

Site preparation and reforestation expenses are investments in the capital asset of timber. The IRS has specific provisions to deal with their cost recovery. These rules apply whether costs are for artificial or natural regeneration following a timber sale or for establishing a new forest on bare ground. Trusts must capitalize costs into the timber basis account and recover them when timber is sold or a loss is claimed.

The American Jobs Creation Act of 2004 created our current method of recovering reforestation costs. Under these rules, forest landowners can deduct outright the first $10,000 of qualified reforestation expenses during each tax year for each qualified timber property. In addition, landowners can amortize and deduct all reforestation expenses in excess of $10,000 over an 84-month period using a specified formula. Trusts are not eligible for the initial deduction and the IRS currently not allowing amortization.

As an example, assume a forest owner spent $14,000 to reforest a cutover tract. The owner can claim a $10,000 reforestation deduction. The remaining $4,000 is the amortizable basis, which is the amount over the initial $10,000 deduction. This amount may be amortized and deducted over the next 8 years (2006-2013) using this formula:

Year 1:	**1/14 of amortizable basis**
Years 2-7:	**1/7 of amortizable basis**
Year 8:	**1/14 of amortizable basis**

This means that on the owner's first tax return, one-fourteenth of $4,000 or $288 is deducted along with the initial $10,000 deduction. For the next 6 years, the landowner can deduct one-seventh of $4,000 or $571, with the remaining $288 deducted in the 8th year.

Operating Expenses

The ordinary and necessary expenses of forest management may be deducted for forest landowners with a profit motive. This includes investor, business, and farm categories. Such expenses include consulting fees for forest-management plans, boundary line maintenance, herbicide application not associated with reforestation, hazard-reduction burning, tools and supplies, equipment operating costs, office expenses, forestry educational materials, and many other similar expenses. Investors deduct such expenses as miscellaneous itemized deductions. Business owners deduct them as business expenses. Farmers deduct them as farm expenses.

Operating expenses must be reasonable, necessary, and have a profit-related motive in order to be deducted. Judging such expenses by industry standards can help the taxpayer determine if an expense is justifiable. If the expense is standard for industrial forest owners, then it is a reasonable expense. For example, industrial forestland is often treated with prescribed burning to reduce the hazard of wildfire. The nonindustrial private forest landowner may follow suit and claim a tax deduction on this activity. Hobby owners may not deduct operating expenses except in the years in which they have income from the hobby activity.

Casualty and Other Losses

Recently planted forests, young stands, and mature timber stands all contain an element of risk from losses due to natural and unnatural events. Normal losses, such as the death of seedlings from poor planting practices are not deductible. Casualty and noncasualty business losses may be deductible if the forest landowner has basis in the timber. Deductible losses are limited to the loss in fair market value of the asset or the adjusted basis, whichever is less. Insurance or other compensation for losses must also be considered in determining if there is a deductible loss. Deduction of losses is quite complicated and requires the help of a forester to determine the loss in fair market value. The IRS has a Timber Casualty Loss Audit Techniques Guide, available at *www.irs.gov*, which clearly illustrates the determination of the casualty loss deduction.

Timber and Taxation

As this chapter indicates, timber taxation can be quite complicated. The materials presented here have been simplified in order to present general principles. It is important for forest landowners to understand some basic timber taxation principles to maximize overall profits from forestland. Wise landowners will educate themselves about forest taxation or seek assistance from qualified professionals on forest tax issues. The best source of information on timber taxation is the Timber Taxation website, *www.timbertax.org*. The IRS website has many publications on topics of interest to forest landowners at *www.irs.gov*. Additional information is available from state forestry extension offices.

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