United States
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# Federal Income Tax on Timber

## A Quick Guide for Woodland Owners

### Fourth Edition
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* Publication based on three editions of the *Federal Income Tax on Timber: A Key to Your Most Frequently Asked Questions* (R8-TP-34, issued in April 2001 and revised in December 2005, and R8-TP-39, issued in November 2011) published by USDA Forest Service Southern Region. Authors of these issues include Harry L. Haney, Jr., Garland Gray Emeritus Professor of Forestery at Virginia Polytechnic Institute and State University; William C. Siegel, Attorney and USDA Forest Service Volunteer in River Ridge, LA; Larry M. Bishop, Former Forest Management and Taxation Specialist for the USDA Forest Service Southern Region; and Linda Wang, National Timber Tax Specialist for the USDA Forest Service.

## Disclaimer

This publication is intended to be used solely for educational purposes. The materials contained herein are not legal or accounting advice and should not be construed as such. Consult your professional legal or tax advisors for your specific tax situation. Pursuant to the Internal Revenue Service Circular 230 rules, any U.S. Federal tax advice contained here is not intended or written to be used for the purpose of avoiding penalties under Federal tax law, or promoting, marketing, or recommending to another party any transaction or matter addressed herein.

# Preface

## 2012 Edition

This publication provides a quick reference on timber tax laws that are important to woodland owners. It presents concise and easy-to-understand explanations of issues related to woodland owners.

The intended audience includes woodland owners, loggers, and consulting foresters who need a basic understanding of Federal income tax rules on the management of woodland property. The publication is also a valuable resource for tax practitioners: certified public accountants, tax managers, enrolled agents, attorneys, and tax return preparers who seek a quick overview of timber tax rules.

Since the first income tax Form 1040 appeared in 1913, many timber tax provisions, which are commonly unknown by tax professionals, have been added to encourage management and stewardship of private woodland. This publication is prepared to help woodland taxpayers and their professional advisors learn and use these tax laws.

This fourth edition is updated with the 2012 tax information. It has a different title from the third edition to make it consistent with the revised content.

Please send any comments about this publication to lwang@fs.fed.us.

**Linda Wang,**
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# Contents

# Introduction

This publication explains how the Federal tax laws apply to woodland property.

The first section describes the three types of woodland ownerships and the differing tax treatments for each. This section is very important because, as a woodland owner, you must determine your tax treatment each year. It also includes a discussion on how you may be taxed differently depending on if you use your land for farming or growing timber.

In the second through fourth sections, the publication shows you how to report income from a timber sale, how to set up the timber basis, and how to deduct the timber management cost. Deducting costs include the operation expenses, as well as the capital costs that are recovered by depreciation and depletion. Special reforestation tax rules are also covered here.

Next, the publication explains the tax treatment of cost-share payments and how to deduct the loss of timber caused by fire or storms, theft, and condemnation.

Lastly, the publication addresses how and when to file the tax form for timber, which is Form T, Forest Activities Schedule.

For updates to this publication, please go to the Forest Service, an agency of the U.S. Department of Agriculture (USDA), Tax Web site at http://www.fs.fed.us/spf/coop/programs/loa/tax.shtml.

# Tax Classifications of Woodland Property

## Personal Property

### Identifying Types of Activity

If you do not use your woodland property to produce income, you may classify it as being held for personal use. For example, your primary purpose for owning the property may be for personal enjoyment, such as for a family retreat or for personal hunting and fishing, rather than for making a profit.

### Qualifying for the Best Tax Treatment

Please note that, as a landowner, you may face tax disadvantages for owning personal property. For example, your losses on the sale of personal property are generally not deductible except as casualty losses as a result of fire, storm damage, or theft. Gains from the sale of personal property are taxed as capital gains (Internal Revenue Service (IRS) Publication 544).

### Reporting and Tax Forms

Use Form 1040 Schedule D and the new Form 8949 to report capital gains from the sale or exchange of personal property.

The adjusted basis of personal property is the original cost or other value of the property as determined under the tax law, adjusted for subsequent changes (see pages 12 through 14 for a discussion of *basis*).

To calculate the amount of capital gains made from the sale of personal property, subtract the property's adjusted basis and selling expenses from the gross sale proceeds.

Your woodland property may be taxed using one of the following three tax classifications:

1. Personal property.
2. Investment (income-producing) property.
3. Business property.

The tax rules vary considerably with each classification. For each tax year, you must determine your woodland property's tax classification based on the following determining factors:

- Why you own the property.
- How you use the property.
- Your activities on the property.

## Investment (Income-Producing) Property

### Identifying Types of Activity

Woodland property held for an income-producing purpose may be considered an investment when the activity does not rise to the level of a trade or business.

The sale of standing timber that is held as an investment is taxed as a capital gain. Capital gains are defined as either long-term or short-term gains.

If you owned your timber for 1 year or less, the capital gains from your timber sale are considered short term; if you owned your timber for more than 1 year, the capital gains from your timber sale are considered long term.

Expenses for woodland held as an investment are deductible, but such deductions (together with other miscellaneous itemized deductions) are subject to 2 percent of your adjusted gross income (AGI) floor (see page 18). Only the excess amount of more than the 2-percent floor is deductible. This limitation is a disadvantage when compared with deductions allowed under the business classification—see next section—in which all expenses are deductible, although other restrictions also apply.

### Qualifying for the Best Tax Treatment

You must have a profit objective to claim an investment status for your woodland. One of the best ways to document a profit objective is by including income production in your woodland management plan.

Timber owned primarily for generating profit may be classified as either an investment or a business property. The distinction between an investment and a business is based on specific circumstances. If your acreage is relatively small, with infrequent sales transactions, you may prefer to claim it as an investment to simplify the filing process.

### Reporting and Tax Forms

Use Form 1040 Schedule D and the new Form 8949 to report gains from the sale of standing timber held as an investment. It is prudent to file a Form T (Timber), Forest Activities Schedule, if you claim a deduction for the depletion of timber (see page 16).

Report timber management expenses for woodland held as investment on Form 1040 Schedule A (see page 18).

# Business Property

## Business or Hobby

### Identifying Types of Activity

A business is an activity you regularly and continuously engage in primarily to make a profit. Although both investment status and business status require clear for-profit objectives, a business carries out timber activities on a more regular, active, and continuous basis than an investment. Which status applies depends on the specifics of each case.

If the profit objective is not met, your activity may be considered a hobby rather than a business. Losses that are deductible for a business are not allowed for a hobby.

### Qualifying for the Best Tax Treatment

The IRS lists a set of factors to determine profit motive from an activity:

- Does the time and effort you put into the activity indicate an intention to make a profit?
- Do you depend on income from the activity?
- If losses are incurred, are they because of circumstances beyond your control or because the business is in the start-up phase?
- Have you changed methods of operation to improve profitability?
- Do you and your advisors have the knowledge needed to carry on the activity as a successful business?
- Have you produced a profit in similar activities in the past?
- Does the activity produce a profit in some years?
- Can you expect to make a profit in the future from the appreciation of assets used in the activity?

The IRS presumes a profit motive if profit is realized in at least 3 of the past 5 years. Such profit, however, includes the appreciation of asset, which is more relevant for the case of timber. You may have to prove a for-profit intent in case of an IRS audit. One of the best ways to document a profit objective is by including income generation in your woodland management plan.

### Reporting and Tax Forms

**Business:** Use Form 4797 and Form 1040 Schedule D for qualified sale of standing timber (Section 631(b)) (see page 8). For the sale of cut timber, if elected, report qualified capital gains portion on Form 4979 and Form 1040 Schedule D, and the ordinary income portion on Form 1040 Schedule C (Section 631(a)) (see page 9). Deduct woodland management expenses on Form 1040 Schedule C (see page 19).

**Hobby:** Use Form 1040 to report income from a hobby activity that is taxable as “Other income.” Report hobby expenses, deductible up to hobby income, on Form 1040 Schedule A. Hobby losses, in general, are not deductible.

# Business Property

## Passive Activity

### Identifying Types of Activity

Your timber activity may be a business if you regularly and continuously engage in it primarily to earn a profit. Your participation in the business may be active or passive.

To be actively engaged in business, you must materially participate in the business activity; otherwise, your participation may be considered a passive activity.

For passive activities, the deduction of a business loss (expenses exceeding income) is restricted: loss from passive activity cannot offset income from nonpassive activity (such as retirement income, salary, or self-employment income). You can, however, carry over the unused losses to future years.

The passive loss rules apply to individuals, partners, members of LLCs, and S corporation interests, estates, and trusts.

Note: In general, woodland held as investment is not subject to the passive loss rules.

### Qualifying for the Best Tax Treatment

Material participation in the business may help avoid passive loss restrictions. To materially participate, your involvement must be regular, continuous, and substantial. If you meet at least one of the following tests, you are considered a material participant in your business.

- You participate in the activity for more than 500 hours during the tax year.
- Your participation constitutes substantially all of the involvement in the activity during the tax year.
- You participate for more than 100 hours in the activity during the tax year and no other individual participates more.
- Your participation in all of your significant participation businesses, including timber, exceeds 500 hours for the tax year (a *significant participation activity* is defined as a trade or business in which you participate for more than 100 hours).
- You materially participated in the activity for at least 5 of the preceding 10 tax years.
- All facts and circumstances indicate material participation (a minimum of 100 hours is required).

### Reporting and Tax Forms

Compute passive business losses on Form 8582.

Keep records on the time spent managing the property to support your participation in the woodland business.

Material participation must be established on an annual basis.

# Business Property

## Farming

### Identifying Types of Forest Activity

Woodland owners may own farmland and engage in farming operations. Farmers may own timber, either as a minor part of their farming business or as a separate timber operation.

In general, growing timber is not treated as part of the business of farming for many income tax provisions, such as expensing water and soil conservation costs and endangered species recovery costs (total deduction of such expenses are limited to 25 percent of gross income from farming) and income averaging for qualified farmers.

Standing timber sales may be capital gains (provided they meet the requirements; see pages 7 through 9), but sales of farm crops, in general, are considered ordinary business income.

### Qualifying for the Best Tax Treatments

According to IRS Publication 225, you are in the business of farming if you cultivate, operate, or manage a farm for profit, including "livestock, dairy, poultry, fish, fruit, and truck farms" and "plantations, ranches, ranges, and orchards." This definition typically does not include timber.

The tax rules for timber sales (see pages 7 through 9) apply to farmers who also own timber.

As a woodland owner and a farmer, you may deduct and amortize qualified reforestation costs (see page 15).

If you are a farmer, you may expense tree-planting costs under the Conservation Reserve Program, along with water and soil conservation expenses up to 25 percent of gross farming income. This deduction rule is not available to woodland owners.

### Reporting and Tax Forms

Use Form 1040 Schedule F to report farming income and expenses, including minor sales of logs, firewood, or pulpwood if timber is a minor part of your farming operation.

If you are a woodland owner or a farmer who also owns timber, use Form 1040 Schedule D and Form 8949 to report the sale of standing timber owned as capital asset (see page 7). Report investment timber expenses on Form 1040 Schedule A (see page 18).

Use Form 4797 and Form 1040 Schedule D to report qualified capital gains for a timber business (see pages 8 and 9). Report timber business expenses on Form 1040 Schedule C (see page 19).

# Timber Sales

## Investment Sales

### Identifying Types of Forest Activity

If your woodland is categorized as an investment, your standing timber sales are considered capital gains rather than ordinary income.

Long-term capital gains are advantageous in the following ways.

- Capital gains are taxed at lower rates than ordinary income. (In 2012, the maximum rate for long-term capital gain was 15 percent, and the maximum rate for ordinary income was 35 percent.)
- Capital gains are not subject to a self-employment tax (as ordinary business income is) except for gains from the sale of a property by a passive business (which will be subject to a 3.8-percent Medicare tax starting in 2013 if the taxpayer's individual AGI is more than $200,000 or $250,000 for a married person filing jointly).
- Capital gains do not adversely affect your social security payments at retirement.
- Capital losses can offset capital gains in full as well as the $3,000 ordinary income each tax year.

Short-term capital gains are taxed at ordinary income tax rates.

### Qualifying for the Best Tax Treatments

For a timber sale to qualify as a long-term capital gain, you must hold the investment timber* for more than 1 year before the sale.

If you receive the property as a gift and your basis is the donor's basis (see page 14), both the donor's and your holding periods may be counted together as your holding period (IRS Publication 544). If, as the recipient, your basis is the fair market value (FMV) of the property, your holding period starts after the date of gift (IRS Publication 17).

If you inherit the property, your timber profit realized upon selling, is considered to be a long-term gain.

* The term "timber" includes evergreen trees that are more than 6 years old when they are severed from their roots and sold for ornamental purposes, such as Christmas trees.

### Reporting and Tax Forms

Report capital gains from the sale of standing timber that is held as an investment on Form 1040 Schedule D and the new Form 8949. It is prudent to file Form T (Timber), Forest Activities Schedule, if you claim a deduction for depletion of timber (see page 16). Determine the amount of capital gains by subtracting the timber's adjusted basis (pages 12 to 14) (through depletion) (see page 16) and selling expenses from the gross sale proceeds.

**EXAMPLE**

You sold 100,000 board feet (Doyle scale) of southern loblolly pine sawtimber for $30,000 in 2012. The selling expenses totaled $4,500. You bought the timber in 2002 for $15,000 as an investment. Your taxable capital gains are $10,500 ($30,000 - $4,500 - $15,000). Since you owned the property for more than 1 year, the $10,500 capital gains are long term. Report the sale on **Form 1040 Schedule D** and the new **Form 8949**. Because you claim a $15,000 (depletion) deduction, it is prudent to complete and attach **Form T (Parts II and III)** to your return.

# Sales From Business Property

## Sale of Standing Timber (Section 631(b))

### Identifying Types of Forest Activity

Qualified sales of standing timber by a woodland business may be taxed as long-term capital gains (Section 1231 gains). These sales include both lump-sum and pay-as-cut standing timber sales.

A lump-sum sale is an outright sale of standing timber for a fixed total amount agreed on in advance.

Under a pay-as-cut contract, the timber purchaser pays the seller at a specified rate per unit of timber actually cut. The seller bears the risk of loss until the timber is cut.

The advantages of long-term capital gains are listed on page 7.

### Qualifying for the Best Tax Treatments

To be eligible for long-term capital gains (Section 1231 gains), you must be the owner of standing timber (including a sublessor of timber or the holder of a contract to cut the timber) for more than 1 year in a trade or business.

Effective after December 31, 2004, outright sales of standing timber and pay-as-cut sales by a timber business qualify for long-term capital gains after the timber has been held for more than 1 year (as amended by the American Jobs Creation Act of 2004).

Historic note: Before 2005, timber business owners had to sell the standing timber by a pay-as-cut contract (retained economic interests) to qualify for capital gains treatment.

* The term “timber” includes evergreen trees that are more than 6 years old when they are severed from their roots and sold for ornamental purposes, such as Christmas trees.

### Reporting and Tax Forms

The gain or loss of the standing timber sale in a business is equal to the sale proceeds minus the timber’s adjusted basis (see pages 12 to 14) (through depletion) (see page 16) and sales expenses.

Use Form 4797 and Form 1040 Schedule D to report the standing timber sale in a business. It is prudent to file Parts II and III of Form T (Timber), Forest Activities Schedule (see Form T on page 25), when claiming a deduction for depletion of timber (see page 16) or making an outright sale of timber in a trade or business.

**EXAMPLE**

You run a timber-growing business. The highest bid for your standing timber by a logger was $40,000, and you accepted this offer. The adjusted basis of the timber was $5,000 and your selling expenses were $6,000. Because the timber is a property in your timber business for more than 1 year, the standing timber sale qualifies for long-term capital gains (Section 631(b)).

Your taxable capital gains of $29,000 ($40,000 - $6,000 - $5,000) are reported on **Form 4797** and **Form 1040 Schedule D**. It is prudent to file **Form T (Parts II and III)**.

# Sales From Business Property

## Sale of Cut Timber (Section 631(a))

### Identifying Types of Forest Activity

Instead of selling standing timber, you can cut the standing timber and then sell the cut timber products or use the timber in your business.

This type of sale differs from a standing timber sale because it has two parts for tax purposes: standing timber disposal, if elected, and cut timber sale. All gains are considered ordinary income unless you elect to treat standing timber cutting as a sale to qualify for capital gains (known as Section 631(a) election).

See the advantages of long-term capital gains on page 7.

MAKING SEC. 631(a) ELECTION

On IRS Form T, Part II (Timber Depletion), Line 18, Section 631(a):

A. Are you electing, or have you made an election in a previous tax year that is, in effect, to report gains or losses from the cutting of timber under section 631(a)? (See instructions.)

☐ Yes ☐ No

### Qualifying for the Best Tax Treatments

To qualify for capital gains (Section 1231 gains) for the cutting of standing timber, you must own or hold the contractual right to cut timber for more than 1 year before it is cut. The timber must be cut for sale or for use in your business. Timber held for less than 1 year is not eligible. In addition, you must make an (Section 631(a)) election on Form T (Timber), Forest Activities Schedule (see page 25).

The capital gains from standing timber cutting is the difference between its FMV on the first day of the tax year in which it is cut and its adjusted basis (see "basis" on pages 12 to 14 and "depletion" on page 16).

The ordinary income from sale of cut timber is the difference between sale price and the FMV of standing timber on the first day of the tax year in which it is cut minus cut-n-haul expenses.

### Reporting and Tax Forms

For qualified timber, make Section 631(a) election in the year the timber cutting takes place on Line 18, Part II of Form T. No election is allowed on an amended return (Section 1.631-1(c)). Report the capital gains portion on Form 4797 and Form 1040 Schedule D. Report ordinary income on the sales of cut timber on Form 1040 Schedule C. File Form T when you make a Section 631(a) sale.

**EXAMPLE**

You hired a logger who cut standing timber held longer than 1 year in your woodland business and hauled it to a local paper mill and sold it at $103/cord. It had an adjusted basis of $10/cord. The FMV of the standing timber on January 1 was $26/cord. The cut-n-haul cost was $67.5/cord.

Without a Section 631(a) election, the entire gains of $25.5/cord are ordinary income ($103 - $67.5 - $10). Under Section 631(a) election, gains of $16/cord ($26 - $10) from standing timber cutting are capital gains. The rest of $9.5/cord gains ($103 - $67.5 - $26) from sale of cut timber is ordinary business income.

* The term "timber" includes evergreen trees that are more than 6 years old when they are severed from their roots and sold for ornamental purposes, such as Christmas trees.

# Timber Sale Expenses

## Identifying Types of Forest Activity

Timber sale expenses are the costs incurred directly from the sale of timber and include the following costs:

- Advertising
- Timber cruising (to determine timber volume)
- Overnight travel
- Marking for harvesting
- Scaling (measurement of products)
- Legal fees
- Fees paid to consulting foresters

## Qualifying for the Best Tax Treatments

Timber sale expenses are fully deductible from the sale proceeds.

To support your timber sale expense deduction, maintain adequate records. These records include receipts, bank statements, canceled checks, financial statements, invoices, mill-scale slips, closing statements, 1099-S forms (reporting gross sale proceeds paid to you for the sale of your timber), sales contracts, and forest management plans to support the deduction.

## Reporting and Tax Forms

If your timber holding is an investment, report timber sale expenses on the new Form 8949 and Form 1040 Schedule D (see page 7).

If your timber is a business, report standing timber sales and the sales expenses on Form 4797 and Form 1040 Schedule D (see page 8).

Business owners who elect to treat timber cutting as sale under Section 631(a) should report the timber sale and sale expenses on Form 4797 and Form 1040 Schedule D and Schedule C (see page 9).

**EXAMPLE**

You sold hardwood sawtimber for $8,000. Its adjusted basis was $1,000. You paid $800 to a consulting forester handling the sales. Your timber is an investment.

| | |
|---|---|
| Sale price | $8,000 |
| - Selling expenses | $800 |
| - Adjusted basis (depletion) | $1,000 |
| Gains | $6,200 |

You report the sale expenses on the new **Form 8949** and **Form 1040 Schedule D**. It is prudent to file **Form T** (see page 25).

# Installment Sales

## Identifying Types of Forest Activity

An *installment sale* is a sale in which you receive one or more payments in a tax year after the year of timber sale rather than in full in the year of sale.

An installment sale may allow you to defer tax and spread the gain over the installment payment periods; otherwise, you must pay taxes on the entire gains in the year of timber sale.

## Qualifying for the Best Tax Treatments

If you receive sale proceeds after the year of sale, you must use the installment sale reporting. You may, however, elect not to use the installment sales by reporting the entire profit in the year of sale, even though you will not be paid for all of the sale proceeds until later.

Interest is generally charged on deferred payments. If interest is not charged, a portion of the payment generally must be calculated as (imputed) interest.

Installment sales generally do not apply to pay-as-cut contracts (even with a retained economic interest) by the IRS regulation.

## Reporting and Tax Forms

For each year that you receive installment payments, report the gain on Form 6252. The gain is then transferred to Form 1040 Schedule D for investment timber and Form 4797 for business timber. Form T (Timber), Forest Activities Schedule, may also be required (see page 25). Report interest payments you receive on the installments as ordinary income. You can elect out of installment sales by including the entire gains on Form 1040 Schedule D or Form 4797.

**EXAMPLE**

In 2011, you sold $20,000 of timber, realizing a profit of $18,000. You took a note payable in March 2012. The sale is considered an installment sale because you received one payment in the tax year after the year of sale. So, you report the gain in 2012 on **Form 6252**.

You may elect not to use the installment method on your timber sale if you want to report the $18,000 gain in 2011, the year of timber sale.

**EXAMPLE**

In 2011, you sold timber, which you bought in 2000 for $4,000, for $10,000. Selling expenses were $1,000. You are to receive installment payments of $2,000 in 2011 and 2012 and $6,000 in 2013, plus interest. Your gross profit is $5,000 ($10,000 - $4,000 - $1,000). Your gross profit percentage is 50 percent ($5,000 profit/$10,000 contract price).

You file **Form 6252** to report the gains of $1,000 (50 percent x $2,000 installment) in 2011 and 2012 and $3,000 (50 percent x $6,000) for 2013.

The interest payments are reported separately as ordinary income.

# Capital Asset and Cost Recovery

## Timber Basis

### Basis of Purchased Timber

#### Identifying Types of Forest Activity

The basis of purchased timber is its purchase cost.

Documenting the timber basis is beneficial because it (1) reduces timber sale proceeds and, thus, reduces your taxes on timber sale; (2) enables you to claim loss deduction if your timber is lost, damaged, or destroyed by casualty, theft, or condemnation; and (3) allows you to recover the costs of reforestation that you may incur.

The cost of woodland purchase should be allocated among the capital assets acquired, such as land, timber, and other property, based on its relative share of their FMV.

The best time to establish the original basis of your timber is at the time of acquisition because the timber volume and value may be readily available then. Retroactively determining timber basis may be acceptable, but the cost of doing so should be weighed against any potential tax savings.

#### Qualifying for the Best Tax Treatments

The basis of purchased timber includes the purchase price of the timber and other acquisition costs, such as legal fees, accounting fees, title search, and consulting forester's fees.

Document your timber basis in premerchantable timber and merchantable timber categories (such as sawtimber, pulpwood). Include both timber volume and value in the basis.

The original basis of timber may change over time through adjustments, such as a new purchase, timber growth, timber loss, or sale. The adjusted basis of timber is used to determine the gains or losses of timber sale, casualty, theft loss of timber, or condemnation.

#### Reporting and Tax Forms

Document and report the original basis of timber on Form T (Timber), Forest Activities Schedule, Part I. If you are not required to file Form T, you should keep it as part of your records (see page 25). Subsequent adjustments to timber basis, such as timber growth and recovery of basis from timber sale, are made in Part II of Form T.

**EXAMPLE**

The tract of woodland next to your property was appraised at $40,000 ($10,000 for the land itself and $30,000 for 3,000 cords of pulpwood timber on it). You purchased it for a total of $38,000. The seller gave you a $2,000 discount because you paid in full by cash. You spent $200 for a title search and $800 for a consulting forester's fees. Your total cost was 39,000 ($38,000 + $200 + $800), which should be allocated between land and pulpwood timber in proportion to their FMV.

The land's basis is $9,750 ($39,000 x $10,000/$40,000) and the pulpwood's basis is $29,250 ($39,000 x $30,000/$40,000).

# Timber Basis

## Basis of Inherited Timber

### Identifying Types of Forest Activity

The basis of inherited timber is the FMV of the timber on the date of the decedent's death (stepped-up basis) or the value on the alternate valuation date (6 months after the date of death).

As another option for 2010 decedents, an election enables a limited stepped-up basis, but the estate tax is eliminated entirely, regardless of the size of the estate. Such a limit is $3 million if passed to a spouse, plus an additional $1.3 million if passed to any other heirs.

The basis of an inherited property under the special use valuation (of Section 2032A) is the value under such method.

Your basis of land, timber, and other capital assets must be separately established.

See page 12 for retroactive determination of timber basis and the advantage of establishing basis.

### Qualifying for the Best Tax Treatments

Establishing timber basis requires a determination of the timber volume and value on the date of the decedent's death.

The basis is set up by timber account (or block, typically by large commercial landowners): for example, an area within geographic boundaries, political boundaries, or management units. Keep track of timber volume as part of the timber basis.

Retain records to verify your timber basis computations.

### Reporting and Tax Forms

Document the original basis of timber on Form T (Timber), Forest Activities Schedule, Part I. If you are not required to file Form T, prepare and keep it as part of your records (see page 25). Subsequent adjustments to timber basis, such as timber growth and recovery of basis from timber sale, are made on Form T, Part II.

For 2010 decedents, the estate must have elected on Form 8939 by January 17, 2012, to use the limited stepped-up basis (this option avoids the estate tax entirely).

**EXAMPLE**

On June 2, 1998, you inherited the woodland that has been kept in the family for generations. In 2012, you had a timber sale. Your tax preparer asked for your timber's adjusted basis to file your tax return.

You did not establish the timber basis at the time of inheritance. But, your forester was able to provide a professional report that established the timber volume and FMV on the date of the decedent's death: 800 cords of pulpwood at $15 per cord. So your timber basis is $12,000 ($15 x 800 cords). Properly setting up timber basis saves taxes from the timber sales.

See IRS Publication 4895, Tax Treatment of Property Acquired From a Decedent Dying in 2010.

# Timber Basis

## Basis of Timber Received as a Gift

### Identifying Types of Forest Activity

If the FMV of the timber at the time of the gift is equal to or more than the donor's adjusted basis, your timber basis is the donor's adjusted basis. Gift taxes paid by the donor may increase your basis by all or a portion of it, depending on the date of the gift.

If the timber's FMV at the time of the gift is less than the donor's adjusted basis, your basis is (1) the donor's adjusted basis for figuring gain when you later dispose of it or (2) the FMV on the date of the gift for figuring loss from the sale. You may have neither a gain nor loss from sale of gifted timber if you sell for more than the FMV but not for more than the donor's adjusted basis.

See the benefits of establishing basis on page 12. Also see the explanation of retroactive determination of timber basis on page 12.

### Qualifying for the Best Tax Treatments

To determine the basis of gifted timber, you need to know the donor's basis, the FMV at the time of the gift, and the amount of gift taxes paid, if any.

Establishing the original basis of timber at the time of gift saves time and money because timber value and volume information may be readily available.

### Reporting and Tax Forms

Document and report the original basis of timber on Form T (Timber), Forest Activities Schedule, Part I. If you are not required to file Form T, you should keep it as part of your records (see page 25).

Subsequent adjustments to timber basis, such as timber growth and recovery of basis from timber sale, are made on Form T, Part II.

**EXAMPLE**

In 1999, your father transferred title to you, as a gift, of a 49.5-acre woodland that had timber with an FMV of $16,000. His timber basis was $2,000.

Because the FMV of timber of $16,000 is more than your father's adjusted basis of $2,000, your original basis for the timber was $2,000, the donor's basis.

## Reforestation Costs

### Identifying Types of Forest Activity

Reforestation costs include site preparation, seedlings, labors, tools, consulting forester's fee, and depreciation on equipment used in planting and seeding. It also includes post-establishment brush control to ensure the survival of the stands.

To recover the reforestation costs incurred after October 22, 2004, up to $10,000 per year ($5,000 if married filing separately) may be expensed in the year of reforestation per qualified timber property. Any excess amount of more than the $10,000 may be deducted (amortized) over an 84-month period; in the year of reforestation, you can deduct one-fourteenth of the excess costs. In the second through seventh years, you can deduct one-seventh of the excess costs, and in the eighth year, you can deduct the final one-fourteenth.

The $10,000 expensing was increased to be $20,000 per eligible property in the Gulf Opportunity Zone for timber owners with no more than 500 acres, effective August 27, 2005, through the end of 2007. Trusts, publicly traded C-corporations, and real estate investment trusts do not qualify.

Historic note: The 10-percent investment tax credit (applicable for reforestation before October 23, 2004) was no longer available after October 22, 2004.

### Qualifying for the Best Tax Treatments

*Qualified expenditure* is direct costs incurred to establish commercial timber stands.

*Qualified timber property* is a woodlot located in the United States that will contain trees in significant commercial quantities—both natural and artificial regeneration qualify.

Individuals, estates, partnerships, and corporations are eligible for both the $10,000 reforestation expensing and the amortization provisions. Trusts are eligible only for the amortization provision.

Reforestation accounts must be kept separately from other timber accounts that allow for depletion or casualty loss.

### Reporting and Tax Forms

You may elect amortization and report the amount on Form 4562 Part VI. Amortization election may be made only on a timely filed return (including extension) (Section 1.194-4(a)). For a timely filed return without making the election, however, the IRS allows the taxpayer to still make such election by filing an amended return within 6 months of the due date of the return (excluding extension). Write "Filed pursuant to Section 301.9100-2" on Form 4562. Attach a statement to your tax return, providing the purpose, nature, and amount of the expenditures and the date, location, and type of timber being grown (see the instructions for Form T (Timber), Forest Activities Schedule).

For timber held as investment property, report the reforestation deduction on the front page of Form 1040 by writing "reforestation" and the amount in the Adjusted Gross Income section. For timber held as business property, report the reforestation amount under Other Expenses on Form 1040 Schedule C. Form T (Timber), Forest Activities Schedule, Part IV should be filled out as part of the record if not required to file (see page 25).

Note: Reforestation expensing and amortization can be deducted even if you do not take itemized deductions.

**EXAMPLE**

Reforesting your timber tract cost you $12,000 in 2011. You can deduct $10,000 outright in 2011. Of the remainder, you can elect to deduct (amortize) $143 in 2011 (($12,000 - $10,000) x 1/14). In 2012 through 2017, you can deduct $286 (($12,000 - $10,000) x 1/7), and in 2018, you can write off the remaining $143. After you have recovered your entire reforestation costs, your timber basis will become zero.

# Timber Depletion Deduction

## Identifying Types of Forest Activity

*Depletion* refers to the cutting of standing timber.

Depletion Unit = Adjusted Basis/Total Timber Volume.

The depletion unit is usually measured in dollars per unit of timber, such as tons, thousand board feet, or cords (or per individual tree for Christmas trees).

Depletion Deduction = Depletion Unit x Timber Volume Harvested.

Depletion allows owners to recover timber basis at the time of timber sale. The amount of depletion is subtracted from the timber sale proceeds to compute the taxable gain or loss.

## Qualifying for the Best Tax Treatments

Depletion deductions are allowed to the owner of an economic interest in standing timber (Section 1.611-1(b)). The timber owners look for the return of capital invested.

## Reporting and Tax Forms

Report the depletion deduction in the year the timber is sold. It is prudent to file Form T (Timber), Forest Activities Schedule, with your tax return to claim the depletion deduction (see page 25). Calculate the depletion deduction using Part II of Form T.

You must retain adequate records to substantiate your timber basis and the timber depletion deduction.

**EXAMPLE**

You had a timber sale in 2011 in which 1,000 cords of pulpwood was sold at a lump sum of $15,000 ($15/cord). The total amount of timber on your property was 3,000 cords, with an adjusted basis of $6,000. Your selling expense was $1,000 for a consulting forester.

Your timber depletion unit is $2/cord ($6,000/3,000 cords). Your depletion deduction for the sale was $2,000 ($2 x 1,000 cords sold). The taxable gain was thus $12,000 ($15,000 - $2,000 depletion - $1,000 expense). It is prudent to file **Form T Parts II and III** when a depletion deduction is claimed.

# Depreciation, Section 179 Expensing, and Special (Bonus) Depreciation

## Identifying Types of Forest Activity

You may take a depreciation deduction on machinery and equipment over its useful life, for example, tractors, trucks, harvesting equipment, and computers. Also, you can depreciate land improvements, such as bridges, culverts, and temporary roads. The land, however, cannot be depreciated.

For timber business, a one-time, first-year writeoff of the purchase cost of the equipment, up to a set limit, is available if the expenditure is qualified (Section 179 expensing). In 2011, the maximum Section 179 expensing was $500,000, subject to a $2 million phaseout and business taxable income limitations. In 2012, Section 179 expensing is limited to $139,000 and the phaseout limit is $560,000.

You may also take a special temporary additional (bonus) depreciation deduction. In 2011, you could take bonus depreciation equal to 100 percent of the cost of qualified property placed in service in 2011. The bonus depreciation rate is 50 percent for qualified property in 2012 (the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010).

## Qualifying for the Best Tax Treatments

To qualify for the depreciation deduction, the property must (1) be used in a business or held for the production of income; (2) have a determinable useful life that is longer than 1 year; and (3) wear out, decay, or get used up.

In most cases, you may use accelerated depreciation methods (such as a 200-percent or 150-percent declining balance with half-year convention) or elect to use a straight-line method. You can also use a units-of-production method for land improvement, such as logging roads.

To qualify for Section 179 expensing, you must acquire the property by purchase. Your deduction is limited to the taxable income from your active business in the year, including wages; any excess of more than the limit may be carried to the next year. If the total purchase price exceeds $2 million for 2011 ($560,000 for 2012), your deduction is reduced.

Qualified properties for special (bonus) depreciation, in general, are tangible properties with a recovery period of 20 years or less. The original use of the property must begin with you. It must be new property.

## Reporting and Tax Forms

Claim depreciation deduction, including any Section 179 expensing and bonus depreciation, on Form 4562. You must elect to use the Section 179 deductions on that form. Bonus depreciation is automatically assumed (even if you did not claim it) unless you make an election not to use it by attaching a statement to your return.

**EXAMPLE**

You spent $1,500 to purchase equipment with a 5-year useful life and used it 80 percent of the time in your timber business in 2012. You may elect to claim $1,200 (80 percent of $1,500) as a Section 179 deduction (subject to the business taxable income limit).

Alternatively, you may use accelerated depreciation to deduct the $1,200 over 5 years. You may deduct $240 (20 percent of $1,200) in the first year and $480 (32 percent of $1,200) in the second year (using the 200 percent declining balance with half-year convention). Or, you may elect to use the straight-line method to claim a depreciation deduction of $120 (10 percent of $1,200) for the first year and $240 (20 percent of $1,200) for the second year.

If it is a new property, you may use the bonus depreciation to deduct it.

# Expenses of Woodland Management and Protection

## Investment Property

### Identifying Types of Forest Activity

Costs incurred to manage and protect your woodland as a business may currently be deducted. These costs may include fees paid to consulting foresters; overnight travel expenses; the cost of tools with a useful life of less than 1 year; hired labor costs; road and firebreak maintenance costs; timber stand management expenses; and fire, insect, and disease control costs.

Other deductible costs incurred by woodland owners include property taxes and interest on bank loans (carrying charges).

The costs of timber management and protection are deductible for woodland held as an investment, but they are deductible only to the extent that such costs exceed 2 percent of your AGI (as part of total miscellaneous itemized deductions). Property taxes are fully deductible. Interest on loans is deductible up to the net investment income (investment income minus investment expenses) in a year, with excess carried forward indefinitely. Alternatively, you may elect to capitalize the carrying charges and recover them from timber sales or casualty losses.

### Qualifying for the Best Tax Treatments

To permit the deduction of timber expenses, your timber must be held with the intention to make a profit. Deductible expenses must be ordinary and necessary forest management expenses.

If you take a standard deduction in a year, capitalizing the carrying charges may be beneficial. You may not capitalize carrying charges incurred in any year that your property is productive (generating income), however.

### Reporting and Tax Forms

Forest management expenses for timber property that is held as an investment is reported on Form 1040 Schedule A and are subject to the 2-percent AGI floor. Alternatively, you may elect to capitalize the carrying charges by filing a statement indicating your election on a timely filed return.

**EXAMPLE**

This year you paid $200 in property tax for your woodland held as an investment property. Additional expenses included the following:

- $150 for consulting forester’s fee.
- $25 for tools and supply fee.
- $625 firebreak maintenance cost.

Your AGI was $38,000. The $800 timber management expenses ($150 + $25 + $625) are deductible on **Form 1040 Schedule A, Itemized Deductions**. The deduction is subject to the 2-percent AGI floor, however. Thus, the actual deduction was only $40 ($800 - $760). The $200 property tax may be deducted in full on **Schedule A**.

## Business Property

### Identifying Types of Forest Activity

The forest management and protection costs (see examples on page 18) in your timber-growing business are fully deductible against income from any source when you materially participate in the business (see material participation on page 5).

Taking these deductions as part of business operations has advantages over deductions on investment property, which are subject to the 2-percent AGI floor (see page 18). Deductions by timber business operations are not subject to the 2-percent floor limitation.

The deduction for timber management and protection costs incurred in a business is limited if you do not materially participate in the activity (see page 5). The deduction from passive activity can offset income only from passive activity.

### Qualifying for the Best Tax Treatments

To currently deduct the woodland management and protection costs, you generally must meet the profit requirement, and timber operations must not be classified as hobby activity (see page 4). Note that profit requirement includes the expectation of a future profit from asset appreciation. The expenses must be ordinary and necessary in carrying on your business during the tax year. Also, if your woodland business is a passive activity (see page 5) and your business has a loss, passive loss cannot be deducted in the current year.

### Reporting and Tax Forms

Report your deductible business expenses on Form 1040 Schedule C. Report timber operation incidental to farming on Form 1040 Schedule F.

Specific lines are listed for taxes, interest, and travel and meals expenses; most timber management expenses that are not separately listed may be reported under Other Expenses.

# Cost-Share Payment

## General Rule for Reporting Cost-Share Payments

### Identifying Types of Forest Activity

You may receive financial assistance (cost-share or other payments) when you undertake forest management or conservation practices recommended by Federal and State forestry agencies, farm agencies, or natural resource conservation agencies on your woodland property.

The payment issuing agency is required to report the cost-share payment and send copies to you and the IRS on **Form 1099-G**. You must account for the payments in your tax return.

In general, cost-share payments are considered taxable income unless they are from an approved program that qualifies for the income exclusion (allowed under Section 126; see page 21 for exclusion treatment in details).

### Qualifying for the Best Tax Treatments

Forestry cost-share payments that are received for purposes other than reforestation or other capital expenditures must always be included in gross income. The expenses may then be deducted, subject to the passive activity rules (see page 5) for business and the 2-percent AGI floor rule (see page 18) for investment timber.

The annual rental payment or the one-time incentive payment under the Conservation Reserve Program must be reported as income (Rev. Rul. 2003-59). These payments may not be excluded from gross income under Section 126.

### Reporting and Tax Forms

For a timber business, report the cost-share payment that must be included in your income on Form 1040 Schedule C. For timber investment property, report the cost-share payment that must be treated as income under "Other Income" on the front page of Form 1040.

**EXAMPLE**

In 2012, you received a $3,000 cost-share payment to improve the timber stands in your woodland held as an investment. Your own out-of-pocket cost for the project was $6,200.

Because you used the cost-share payment for tree stand improvement, which is a deductible expense rather than a capital expenditure, you report $3,000 under "Other Income" on the front page of **Form 1040**. You deduct the $9,200 as part of the forest management expenses on **Form 1040 Schedule A**, subject to 2 percent of your AGI floor limitation for timber held as investment.

## General Rule for Excluding a Cost-Share Payment From Income

### Identifying Types of Forest Activity

Qualified cost-share payments may be partially or entirely excluded from your gross income to the extent allowed under Section 126 (Section 126 and Temporary IRS Regulation 16A.126-1 and 16A.126-2).

If your cost-share payment was incurred for a reforestation project, the payment qualifies for reforestation tax deductions (see page 15) if it is included in your gross income.

### Qualifying for the Best Tax Treatments

To qualify for the income exclusion, the cost-share payment must come from approved programs (by both the U.S. Departments of Agriculture and the Treasury for the Federal programs), such as the Forest Health Protection Program, Conservation Reserve Program, Conservation Security Program, Environmental Quality Incentives Program, Wildlife Habitat Incentives Program, and Wetlands Reserve Program. Several State programs also qualify.

Second, the cost-share payment must be used for capital expenditure. You cannot exclude a payment for an expense you can deduct in the year you incur it.

The excludable amount is the present value of the greater of $2.50 per acre or 10 percent of the average annual income from the affected acres in the past 3 years (see the example for calculation steps on this page).

You may not deduct an expense reimbursed with a cost-share payment and, at the same time, exclude the cost-share payment from your income.

Note: The interest rate to use is not specifically defined. One source is to use Farm Credit System Bank rates (for estate valuation under Section 2032A).

### Reporting and Tax Forms

Attach a statement to your return that specifically describes the qualified cost-share program and the calculation of the excludable portion.

**EXAMPLE**

In 2011, you received a $4,000 cost-share payment for capital expenditure in your woodland from a qualified Federal program. Such cost-share payments qualify for income exclusion.

If you had no income from the property in the past 3 years, you could exclude $3,876 (($2.50 x 100 acres)/6.45 percent). The interest rate (6.45 percent) was from the Farm Credit System Bank (see Rev. Rul. 2011-17 for interest rates).

If you had $9,600 in income from the timber property, use $320 (10 percent of $9,600/3), which is greater than $250 ($2.50 x 100 acres) to calculate the exclusion amount: (10 percent x ($9,600/3))/6.45 percent = $4,961). Because a $4,000 cost-share payment is less than the excludable amount of $4,961, your entire cost-share payment of $4,000 may be excluded. Attach a statement to your tax return describing the cost-share program and your calculations.

Note that the tax regulations use "the value of improvement" in calculating the taxable amount. Here, we assume that "the value of improvement" is the same as the cost (especially for reforestation) to simply the calculation.

# Timber Losses

## Casualty Loss

### Identifying Types of Forest Activity

Loss of timber from a casualty event, such as a fire or storm, is deductible. The deduction, however, is limited to the lesser of the decrease in FMV caused by the casualty or your basis in the timber held as investment or business property. If you have not set up your timber basis, you may determine it retroactively.

If the timber is salvageable and your salvage sale exceeds the adjusted basis of your timber, you have a taxable gain. You may postpone tax on the gain, however, by acquiring qualified replacement property within the replacement period.

The appraisal fees are not part of the casualty loss. They are deductible expenses (miscellaneous itemized deductions).

### Qualifying for the Best Tax Treatments

To qualify, the loss must result from an identifiable event that is sudden, unusual, and unexpected, such as an earthquake, a fire, a hurricane, a tornado, or a flood.

To establish the timber basis or appraise the FMV loss of your timber from the casualty, you may need to consult a professional forester in determining the timber quantity and its FMV.

Casualty loss and the FMV loss appraisal are determined on the basis of single identifiable property damaged or destroyed. This property may be the one that is maintained in your timber record/account (or block, typically by large commercial landowners) on Form T (Timber).

It is important to keep records to support your FMV loss appraisal and timber basis for casualty loss deduction.

Replacement property may take the form of reforestation, purchase of new timber land, purchase of standing timber or purchase of stock (at least 80 percent) of corporations that own timber or timber land. In general, the replacement period ends 2 years after the close of the first tax year in which you realize the gains.

### Reporting and Tax Forms

Report casualty loss on Form 4684. Then, for timber investment property, use Form 1040 Schedule A or use Form 4797 for timber held as business property.

Also, prepare Form T (Timber), Forest Activities Schedule, although you may or may not be required to file it (see page 25).

To defer the gain from salvage sales, file an attachment to the tax return, making the election.

Deduct the loss in the year it occurred. For federally declared disaster areas, however, the loss may be deducted in the preceding year upon election.

**EXAMPLE**

A fire caused an $8,000 loss of your timber ($9,000 before-fire FMV - $1,000 after-fire FMV). Your timber basis in the affected property is $3,000. Your casualty loss deduction is $3,000.

Report the loss on **Form 4684** and adjust your timber basis (reducing it to zero) on **Form T, Part II**.

# Theft

## Identifying Types of Forest Activity

Loss of timber due to theft is deductible. For timber property that is held as an investment or as a business, the deductible amount due to theft is the adjusted basis of timber less any insurance or other reimbursement you receive or expect to receive.

If you receive reimbursement in a later year that was more than what you expected when you estimated the deductible theft loss, include the excess as ordinary income for the year in which you received it.

A theft may result in a taxable gain when you receive reimbursement that is more than your adjusted basis in the stolen timber. You may defer the tax on the gain if you purchase replacement property (see page 22) within a specified replacement period (in general, 2 years). If you do not spend all of your reimbursement on qualifying replacement property, you must report the difference as income. The basis in replacement property is its cost less any gain that you defer.

## Qualifying for the Best Tax Treatments

To prove a theft deduction, a landowner must show only that the theft of the property occurred, when he or she discovered that the property was stolen, and whether he or she filed a claim for reimbursement.

## Reporting and Tax Forms

Theft losses are reported on Form 4684. Use Section B of this form for calculation of theft losses for business and investment property. Report your theft loss on business property on Form 4797. Report your theft loss from timber held as an investment property on Form 1040 Schedule A. Also, prepare Form T (Timber), Forest Activities Schedule, although you may or may not be required to file it (see page 25).

You can deduct the theft losses in the year of discovery.

To defer the taxable gain, file an attachment to your return indicating the details of the theft, the reimbursement you received, the calculation of the gain, and the replacement property (or your election to purchase replacement property).

## Condemnation of Timber Property

### Identifying Types of Forest Activity

Condemnation is the lawful taking of private property for public use without the landowner's consent but with compensation to the owners.

Property sale under a threat of condemnation is treated the same as a condemnation if you can provide reasonable grounds to establish that your property will be condemned.

The loss because of condemnation is determined in the same way as that for a casualty loss: the deductible amount is the lesser of the FMV loss or the property's adjusted basis.

If the condemnation compensation is greater than your basis in the property, a gain is realized. You may defer the gains, however, by purchasing replacement property (see page 22).

### Qualifying for the Best Tax Treatments

To qualify, your property must have been condemned or have been threatened with condemnation.

If timber is cut or sold by the landowner before condemnation, only the land is included in the loss calculation.

The replacement period for a condemnation property, such as standing timber, ends 3 years after the close of the first tax year in which any portion of the gain from the condemnation is realized.

### Reporting and Tax Forms

Report timber loss due to condemnation on Form 4684. For business or investment property held for more than 1 year, report on Form 4797. Report any gain or loss of timber you held for investment for 1 year or less on Form 1040 Schedule D.

# Form T (Timber)

## Identifying Types of Forest Activity

Form T (Timber), Forest Activities Schedule, is a form on timber transactions. It can be a part of your timber tax records even if you are not required to file it.

Timber acquisition, sale, reforestation, and stand management activities are all recorded on Form T.

## Qualifying for the Best Tax Treatments

You are required to file Form T only if you do one of the following:

- Claim a timber depletion deduction.
- Sell cut timber products in your business (under Section 631(a)).
- Make an outright sale of standing timber in your business (under Section 631(b)).

Exceptions: You are not required to file Form T “if you only make occasional timber sales (one or two sales every 3 or 4 years),” but “you must maintain adequate records” (Form T Instructions). It is a prudent business practice to use Form T.

## Reporting and Tax Forms

Use Form T (Timber), Forest Activities Schedule, Part I to report acquisition, Part II for timber depletion, Part III for timber and land sales, Part IV for reforestation and timber stand activities, and Part V for land ownership.

If you are required to file Form T, complete all the parts of the form that apply.

# For More Information

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