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Federal Income Tax on Timber

A Key to Your Most Frequently Asked Questions

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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 IRS 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.

INTRODUCTION
2011 Edition

This publication provides a quick reference on timber tax laws that are important to woodland owners. It presents a concise and easy-to-understand explanation of the most commonly asked tax questions.

The intended audience includes consulting foresters, woodland owners and loggers who need a basic understanding of federal income tax rules on the management of woodland property. It is also a valuable resource for tax practitioners: CPAs, 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 have been added to encourage management and stewardship of private woodland that are commonly unknown by tax professionals. This publication is prepared to help woodland taxpayers and their professional advisors to learn and utilize these tax laws.

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

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1. Personal Property

Type of Activity

Your woodland property may be taxed under one of three tax classifications:

- personal property,
- investment (income-producing) property, or
- business property.

The tax rules vary considerably with each classification. You must determine your property's tax classification for each tax year.

How to Qualify for Best Tax Treatments

The determining factors for your woodland property's tax classification depend on why you own the property, your use of it, and your activities on it.

Woodland property not used to produce income may be classified 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.

There are tax disadvantages for personal property: losses on the sale of personal property are generally *not* deductible except as casualty loss as a result of fire or storm damages or theft. Gains from sale of personal property are taxed as capital gains (*IRS Publication 544*).

Reporting and Tax Forms

Use ***Form 1040 Schedule D*** and the new ***Form 8949*** to report capital gains from 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 11 through 13 for a discussion of "basis").

The amount of capital gains from sales of personal property is determined by subtracting the property's adjusted basis and selling expenses from the gross sale proceeds.

I. Your Woodland Tax Classification

2. Investment (Income-Producing) Property

Types of Activity

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

Sales of standing timber held as an investment are taxed as *capital gains*. 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 short-term; if you owned your timber for longer than 1 year, the capital gains from your timber sale are long-term.

Expenses for woodland held as an investment are deductible, but such deductions (together with other miscellaneous itemized deductions) are subject to 2% of your adjusted gross income floor (see page 17). Only the excess amount over the 2% floor is deductible. (This limitation is a disadvantage when compared to deductions allowed under the business classification—see next page—in which all expenses are deductible, though other restrictions also apply.)

How to Qualify for 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 business property. The distinction between an investment and business is based on specific circumstances. If your acreage is relatively "small" with infrequent sales transactions, you may prefer to claim the investment status for simplicity of filing.

Reporting and Tax Forms

Use ***Form 1040 Schedule D*** and the new ***Form 8949*** to report gains from sales of standing timber held as an investment. It's prudent to file ***Form T (Timber), Forest Activities Schedule,*** if you claim a deduction for depletion of timber (see page 15).

Timber management expenses for woodland held as investment are reported on ***Form 1040 Schedule A*** (see page 17).

I. Your Woodland Tax Classification

3. Business Property

1) Business or Hobby

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.

How to Qualify for Best Tax Treatment

Business or Hobby. The IRS lists a set of factors to determine "profit" 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 there are losses, are they due to circumstances beyond your control or the start-up phase of the business?
- 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 made a profit in similar activities in the past?
- Does the activity make 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 you show a profit in at least 3 of the last 5 years. Such "profit" 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 6). For 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 7). The woodland management expenses are deductible on ***Form 1040 Schedule C*** (see page 18).

Hobby. Income from a hobby activity is taxable as "other income" on ***Form 1040***. Hobby expenses, deductible up to hobby income, are reported on ***Form 1040 Schedule A***. Hobby losses are generally not deductible.

I. Your Woodland Tax Classification

3. Business Property

2) Passive Activity

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 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 non-passive activity (such as retirement income, salary, or self-employment income). You can carry the unused losses over into future years.

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

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

How to Qualify for 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; or
- All facts and circumstances indicate material participation (a minimum of 100 hours is required).

Reporting and Tax Forms

Passive business losses are computed on ***Form 8582***.

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

Material participation must be established on an annual basis.

II. TIMBER SALES

1. IF YOUR WOODLAND PROPERTY IS AN INVESTMENT

Types of Forest Activity

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

Long-term capital gains are advantageous:

- They are taxed at *lower rates* than ordinary income. (In 2011, the maximum rate for long-term capital gain is 15% while the maximum rate for ordinary income is 35%.)
- They are not subject to self-employment tax (as ordinary business income is) except for gains from sale of property by passive business (which will be subject to a 3.8-percent Medicare tax starting in 2013 if the taxpayer's individual adjusted gross income is over $200,000 or $250,000 for a married filing jointly).
- They do not adversely affect your social security payments at retirement.

Capital losses can offset capital gains in full as well as $3,000 ordinary income each tax year.

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

How to Qualify for Best Tax Treatments

For sales to qualify for long-term capital gains, you must hold the investment timber* for longer than 1 year prior to the sale.

If you receive the property as a gift and your basis is the donor's basis (see page 13), both the donor's and your holding periods may be counted together as your holding period (*IRS Publication 544*). If the recipient's basis is the fair market value of the property, the recipient's holding period starts after the date of gift (*IRS Publication 17*).

If you inherit the property, your timber is considered long-term.

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

Reporting and Tax Forms

Capital gains from sales of standing timber held as investment are reported on ***Form 1040 Schedule D*** and the new ***Form 8949***. It's prudent to file ***Form T (Timber), Forest Activities Schedule***, if you claim a deduction for depletion of timber (see page 15). The amount of capital gains is determined by subtracting the timber's adjusted basis (pages 11 to 13) (through depletion) (see page 15) and selling expenses from the gross sale proceeds.

EXAMPLE

You sold 100 thousand board feet (Doyle scale) of southern loblolly pine sawtimber for $30,000 in 2011. 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***. Since you claim a $15,000 (depletion) deduction, it's prudent to complete and attach ***Form T (Part II and Part III)*** to your return.

II. Timber Sales

2. If Your Woodland Property Is a Business

1) Sale of *Standing* Timber (Section 631(b))

Type of Forest Activity

Qualified sales of standing timber* by a woodland business may be taxed as long-term capital gains (Section 1231 gains). This includes 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 upon 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 on page 5.

How to Qualify for 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 *longer than 1 year* in a trade or business.

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

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

Reporting and Tax Forms

The gain or loss of the standing timber sale in a business is the difference between the sale proceeds and the timber's adjusted basis (see pages 11 to 13) (through depletion) (see page 15) and sales expenses.

Use ***Form 4797*** and ***Form 1040 Schedule D*** to report the standing timber sale in a business. Also it's prudent to file ***Parts II and III of Form T (Timber), Forest Activities Schedule*** (see "Form T" on page 24) when you claim a deduction for depletion of timber (see page 15) or make 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. Since the timber is a property in your timber business for more than one 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's prudent to file ***Form T (Parts II and III)***.

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

II. Timber Sales

2. If Your Woodland Property is a Business

2) Sale of *Cut* Timber (Section 631(a))

Type of Forest Activity

Instead of selling standing timber, timber business owners can cut the standing timber themselves or have their standing timber cut for them and then sell the cut timber products or use the timber in their businesses.

This type of sale differs from standing timber sale in that it has two parts for tax purposes: *standing* timber "disposal," if elected, and *cut* timber sale. All gains are ordinary income unless an election is made 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 5.

MAKING SEC. 631(a) ELECTION

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

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

☐ Yes ☐ No

How to Qualify for 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 longer 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. And you must make a (Section 631(a)) election on ***Form T (Timber), Forest Activities Schedules*** (see page 24).

The capital gains from *standing* timber cutting is the difference between its fair market value (FMV) on the first day of the tax year in which it is cut and its adjusted basis (see "basis" on pages 11 to 13 and "depletion" on page 15).

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.

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

Reporting and Tax Forms

For qualified timber, make the election for 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 is 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.

II. Timber Sales

3. Farming and Timber

Type 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.

Generally growing timber is not treated as part of the business of "farming" for many income tax provisions, such as expensing of water and soil conservation costs and endangered species recovery costs (total deduction of such expenses are limited to 25% 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 5 to 7) while sales of farm crops are generally ordinary business income.

How to Qualify for Best Tax Treatments

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" as well as "plantations, ranches, ranges, and orchards" (*IRS Publication 225*). This definition typically does not include timber.

The tax rules for timber sales (see pages 5 to 7) apply to farmers who also own timber.

Qualified reforestation costs may be deducted and amortized by a woodland owner and a farmer (see page 14).

A farmer may expense tree planting costs under the Conservation Reserve Program along with water and soil conservation expenses up to 25% of gross farming income. This excludes 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.

Use ***Form 1040 Schedule D*** and ***Form 8949*** to report sale of standing timber owned as capital asset (see page 1 and 5) by a woodland owner or a farmer who also owns timber. Report investment timber expenses on ***Form 1040 Schedule A*** (see page 17).

Use ***Form 4797*** and ***Form 1040 Schedule D*** to report qualified capital gains for timber business (see pages 6 and 7). Report timber business expenses on ***Form 1040 Schedule C*** (see page 18).

II. TIMBER SALES

4. EXPENSES OF SALE

Type of Forest Activity

Timber sale expenses are the costs incurred directly from the sale of timber, such as:

- the costs of advertising;
- timber cruising (to determine timber volume);
- overnight travel (excluding commuting expenses);
- marking for harvesting;
- scaling (measurement of products);
- legal fees; and
- fees paid to consulting foresters

How to Qualify for Best Tax Treatments

Timber sale expenses are fully deductible from the sale proceeds.

To support your timber sale expenses, adequate records must be maintained. This 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.

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 24).

Reporting and Tax Forms

If your timber holding is an investment, timber sale expenses are reported on the new ***Form 8949*** and ***Form 1040 Schedule D*** (see page 5).

If your timber is a business, standing timber sales and the sales expenses are reported on ***Form 4797*** and ***Form 1040 Schedule D*** (see page 6).

For business owners who elect to treat timber cutting as sale under Section 631(a), the timber sale and sale expenses are reported on ***Form 4797*** and ***Form 1040 Schedule D*** and ***Schedule C*** (see page 7).

II. TIMBER SALE

5. INSTALLMENT SALE

Type 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.

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 receive 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.

How to Qualify for 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 must generally 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 24). Interest payments you receive on the installments are reported as ordinary income. You can elect out of installment sale by including the entire gains on ***Form 1040 Schedule D*** or ***Form 4797***.

EXAMPLE

In 2011, you sold timber for $10,000 that you bought in 2000 for $4,000. 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% ($5,000 profit / $10,000 contract price).

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

The interest payments are separately reported as ordinary income.

III. Capital Asset and Cost Recovery

1. Timber Basis

1) Basis of Purchased Timber

Type of Forest Activity

Basis of purchased timber is its purchase cost.

Documenting the timber basis is beneficial because: 1) it reduces timber sale proceeds and thus reduces your taxes on timber sale; 2) allows you to claim loss deduction if your timber is lost, damaged, or destroyed by casualty, theft, condemnation; and 3) it 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 fair market value.

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.

How to Qualify for 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 pre-merchantable timber and merchantable timber categories (such as sawtimber, pulpwood, etc.). Include both timber volume and value in the basis.

The original basis of timber may change over time by adjustments, such as 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 in ***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 24). 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 $2,000 discount because you paid in full by cash. You spent $200 in title search and $800 for consulting forester's fees. So your total cost was 39,000 ($38,000 + $200 + $800), which should be allocated between land and pulpwood timber in proportion to their fair market value.

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).

III. Capital Asset and Cost Recovery

1. Timber Basis

2) Basis of Inherited Timber

Type of Forest Activity

The basis of inherited timber is the fair market value 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).

There is another option for 2010 decedents. An election allows a limited stepped-up basis, but the estate tax is eliminated entirely, regardless of the size of the estate. Such limit is $3 million if passed to spouse, plus an additional $1.3 million 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 11 for retroactive determination of timber basis and the advantage of establishing basis.

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

How to Qualify for 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 24). 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 elect 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 2011, you had a timber sale. Your tax preparer asked your timber's adjusted basis to file your tax return.

You didn't 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 fair market value 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.

III. Capital Asset and Cost Recovery

1. Timber Basis

3) Basis of Gifted Timber

Type of Forest Activity

If the fair market value (FMV) of the timber at the time of the gift is equal 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 it; 2) the FMV on the date of 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 more than the donor's adjusted basis.

See the benefits of establishing basis on page 11. Also see the explanation of retroactive determination of timber basis on page 11.

How to Qualify for 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 gift taxes paid, if there were 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.

EXAMPLE

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

Since 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.

Reporting and Tax Forms

Document and report the original basis of timber in ***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 24).

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

III. Capital Asset and Cost Recovery

2. Reforestation Costs

Type 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 over the $10,000 may be deducted ("amortized") over an 84-month period: in the year of reforestation, you can deduct 1/14th of the excess costs. In the 2nd-7th years, 1/7th of the excess costs are deducted, and in the 8th year, the final 1/14th is deducted.

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% investment tax credit (applicable for reforestation prior to October 23, 2004) was no longer available after October 22, 2004.

How to Qualify for Best Tax Treatments

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

"Qualified timber property" means 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 only eligible for the amortization provision.

Reforestation must be kept separately from other timber account that is allowed for depletion or casualty loss.

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 last $143. After you have recovered your entire reforestation costs, your timber basis will become zero.

Reporting and Tax Forms

You make amortization election and report the amount on ***Form 4562 Part VI***. Amortization election may only be made on a timely filed return (including extension) (Section 1.194-4(a)). However, for a timely filed return without making the election, the IRS allows the taxpayer to still make such election by filing 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 giving 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 in 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 24).

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

III. Capital Asset and Cost Recovery

3. Timber Depletion Deduction

Type 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 in computing the taxable gain or loss.

How to Qualify for 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.

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's prudent to file ***Form T Parts II and III*** when a depletion deduction is claimed.

Reporting and Tax Forms

The depletion deduction is reported in the year the timber is sold. It's prudent to file ***Form T (Timber), Forest Activities Schedule***, with your tax return to claim the depletion deduction (see page 24). You 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.

III. Capital Asset and Cost Recovery

4. Depreciation, Section 179 Expensing, and Special (Bonus) Depreciation

Type 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, land improvements, such as bridges, culverts, and temporary roads, can also be depreciated. However, the land cannot be depreciated.

For timber business, a one-time first-year write-off of the purchase cost of the equipment, up to a set limit, is available if qualified (Section 179 expensing). In 2011, the maximum Section 179 expensing is $500,000, subject to $2 million phase-out and business taxable income limitations.

A special temporary additional ("bonus") depreciation deduction may also be taken. In 2011, you may take bonus depreciation equal to 100% of the cost of qualified property placed in service in 2011.

How to Qualify for 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 longer than 1 year; and 3) wear out, decay, or get used up.

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

To qualify for Section 179 expensing, the property must be acquired by purchase. Your deduction is limited to the taxable income from your active business in the year, including wages; any excess over the limit may be carried to next year. If the total purchase price exceeds $2 million for 2011, your deduction is reduced.

Qualified properties for special ("bonus") depreciation generally 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

Depreciation deduction, including any Section 179 expensing and bonus depreciation, are claimed on ***Form 4562***. You must elect to use the Section 179 deductions on that form. You elect ***not*** to take the special bonus deprecation 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% of the time in your timber business in 2011. You may elect to claim $1,200 (80% 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% of $1,200) in the 1st year and $480 (32% of $1,200) in the 2nd year (using the "200% declining balance" with "half-year" convention). Or, you may elect to use the straight-line method to claim a depreciation deduction of $120 (10% of $1,200) for the 1st year and $240 (20% of $1,200) for the 2nd year.

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

IV. Expenses of Woodland Management and Protection

1. Woodland as an Investment

Type of Forest Activity

Costs incurred to manage and protect your woodland as a business may be currently 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 investment. But, they are only deductible to the extent that such costs exceed 2 percent of your adjusted gross income (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.

How to Qualify for 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 standard deduction in a year, capitalizing the carrying charges may be beneficial. However, you may not capitalize carrying charges incurred in any year that your property is productive (generating income).

Reporting and Tax Forms

Forest management expenses for timber property that is held as an investment is reported on ***Form 1040 Schedule A*** subject to the 2% adjusted gross income 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 property tax for your woodland held as an investment property. Additional expenses were:

$150 for consulting forester's fee
$25 for tools and supply fee
$625 firebreak maintenance cost

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

IV. Expenses of Woodland Management and Protection

2. Woodland as a Business

Type of Forest Activity

The forest management and protection costs (see examples on page 17) 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 4).

Taking these deductions as part of business operations has advantages over deductions on investment property, which are subject to the 2% adjusted gross income floor (see page 17). Deductions by timber business operations are not subject to the 2% 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 4). The deduction from passive activity can only offset income from passive activity.

How to Qualify for Best Tax Treatments

To currently deduct the woodland management and protection costs, you generally must meet the profit requirement and timber operations not be classified as hobby activity (see page 3). Note that profit requirement include 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 4), 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***. Timber operation incidental to farming is reported 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".

V. Cost-Share Payment

1. Tax Treatment in General

Type of Forest Activity

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

The cost-share payments are reported on ***Form 1099-G***, which is also sent to the IRS. You must account for the payments in your tax return.

Generally, cost-share payments are taxable income unless they are from an approved program that qualifies for the income exclusion (allowed under Section 126; see page 20 for exclusion treatment in details).

How to Qualify for Best Tax Treatments

Forestry cost share payments received for purposes other than reforestation or other capital expenditure must always be included in gross income. The expenses may then be deducted, subject to the passive activity rules (see page 4) for business and the 2% gross adjusted income floor rule (see page 17) for investment timber.

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 2011, you received $3,000 cost share payment to improve the timber stands in your woodland held as an investment. Your own out-of-pocket cost for it was $6,200.

Because the cost share was used for tree stand improvement, 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% of your adjusted gross income floor limitation for timber held as investment.

V. Cost-Share Payment

2. Exclusion from Income

Type of Forest Activity

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

Your cost share payment incurred for reforestation project qualifies for reforestation tax deductions (see page 14) if the payment is included in your gross income.

How to Qualify for Best Tax Treatments

To qualify for the income exclusion, the cost share payment must come from approved programs (by both the US Department of Agriculture and the Treasury for the federal programs), such as the Forest Health Protection Program, the 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% of the average annual income from the affected acres in the last 3 years (see the **Example** for calculation steps).

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

Note: what 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 payment qualifies for income exclusion:

If you had no income from the property in the last 3 years, you could exclude $3,876 (($2.50 x 100 acres) / 6.45%). The interest rate (6.45%) 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% of $9,600 / 3), which is greater than $250 ($2.50 x 100 acres) to calculate the exclusion amount: (10% x ($9,600 / 3)) / 6.45% = $4,961. Since $4,000 cost share is less than the excludable amount of $4,961, your entire cost share of $4,000 may be excluded. Attach a statement to your tax return describing the cost-share program and your calculations.

VI. TIMBER LOSSES

1. CASUALTY LOSS

Type of Forest Activity

Loss of timber from casualty event such as fire or storms is deductible. However, the deduction is limited to the lesser of the decrease in fair market value (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. However, you may postpone tax on the gain by acquiring qualified replacement property within the replacement period.

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

How to Qualify for Best Tax Treatments

To qualify, the loss must result from an identifiable event that is sudden, unusual, and unexpected, such as: an earthquake, fire, hurricane, tornado, or 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 “single identifiable property damaged or destroyed”. This may be the property maintained in your timber record / account (or "block" typically by large commercial landowners on Form T).

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 timberland, purchase of standing timber or purchase of stock (at least 80%) of corporations that own timber or timberland. Generally, 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.

Form T (Timber), Forest Activities Schedule, should also be prepared, although you may or may not be required to file it (see page 24).

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. However, for federally declared disaster areas, 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***.

VI. Timber Losses

2. Theft Loss

Type 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 are more than what you expected when you estimated the deductible theft loss, include the excess as ordinary income for year in which you receive 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 21) within a specified replacement period (generally 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.

How to Qualify for Best Tax Treatments

To prove a theft deduction, a landowner must show only that the theft of your property occurred, when you discovered that your property was stolen, and whether a claim for reimbursement exists.

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, ***Form T (Timber), Forest Activities Schedule***, should be prepared, although you may or may not be required to file it (see page 24).

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

To defer the taxable gain, you 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).

VI. Timber Losses

3. Condemnation

Type 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 due to condemnation is determined in the same way as that for a casualty loss: the deductible amount is the lesser of the fair market value (FMV) loss or the property's adjusted basis.

If the condemnation compensation is greater than your basis in the property, a gain is realized. However, you may defer the gains by purchasing replacement property (see page 21).

How to Qualify for 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 prior to 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, you 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***.

VII. Form T

Type of Forest Activity

Form T (Timber), Forest Activity 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.

How to Qualify for Best Tax Treatments

You are required to file Form T only if you:

- claim a timber depletion deduction;
- sell cut timber products in your business (under Section 631(a)); or
- 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)" (*Form T Instructions*). But "you must maintain adequate records." It's a prudent business practice to use Form T.

Reporting and Tax Forms

Use ***Form T (Timber), Forest Activity 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.

MORE INFORMATION

Wang, L., and J.L. Greene. Tax Tips for Forest Landowners for the 2011 Tax Year. USDA Forest Service Southern Region Management Bulletin R8-MB 139. Available at <http://www.fs.fed.us/spf/coop/programs/loa/tax.shtml> and <www.timbertax.org> (free download).

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National Timber Tax website: <www.timbertax.org>.

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IRS Publication 544, Sales and Other Dispositions of Assets. Available at <www.irs.gov/pub/irs-pdf/p544.pdf> (free download).

IRS Publication 551, Basis of Assets. Available at <www.irs.gov/pub/irs-pdf/p551.pdf> (free download).