



## Tax Tips for Forest Landowners for the 2011 Tax Year

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This bulletin summarizes Federal income tax provisions related to woodland property, for use by woodland owners in preparing their 2011 individual tax return. It is current as of Sept. 15, 2011, and supersedes Management Bulletin R8-MB 136. It is for educational use only. Consult your tax advisor for more information.

### Personal Use, Investment or Business Property

The tax rules vary depending on whether your woodland is personal use, investment, or business property. You must make this determination each tax year. If you do not have a clear profit motive, your woodland may be personal use property, which provides limited opportunities for deductions. But profit motive includes the expectation of future profit from appreciation in value due to growth and enhanced quality, as with timber. If you have a profit motive, your woodland may be investment property, or it may be business property if your management activity is more regular and intensive than required for an investment. A written forest management plan is an excellent place to document a profit motive. You must determine whether you *materially participate* in the management of woodland held for business use, in order to establish whether you face restrictions (called the *passive loss rules*) on the deduction of business costs. Investment property is not subject to the passive loss rules.

**Example 1:** You grow timber for profit from appreciation in value but do not conduct it as a business. Your woodland is investment property.

### Timber Basis and Depletion

**Timber basis.** Your basis in purchased property is the total amount you paid for it (purchase price, survey, legal fees, etc.). Your basis in inherited property generally is its fair market value (FMV) on the donor's date of death, but your basis in gifted property is the lower of its FMV or the donor's basis. Your basis in land and timber acquired together should be divided in proportion to their FMV and posted to separate accounts. If you didn't allocate basis when you acquired your woodland, a professional forester can determine it retroactively, but you should weigh the cost of establishing the basis against the potential tax savings.

**Example 2:** You bought forest property for a total cost of \$30,000. The FMV of the bare land is 64% of total FMV and the timber (300 thousand board feet (MBF)) 36%. Your basis in the timber is \$10,800 (36% x \$30,000).

**Timber depletion.** This is a deduction against timber sale proceeds (below). It is calculated by dividing your timber basis by the total volume of timber (the *depletion unit*), then multiplying by the units of timber sold.

**Example 3:** Continuing with example 2, say you sold 200 MBF of the timber. Your depletion unit is \$36/MBF (\$10,800 ÷ 300 MBF) and your depletion deduction is \$7,200 (\$36/MBF x 200 MBF).

### Timber Sales

**Sale of standing timber.** Only the net sale amount, after deducting timber depletion and expenses of the sale, is taxed. You may need to report the sale of timber held as an investment (sec. 1221) on the new Form 8949 as well as Schedule D (final versions and instructions for these forms were not available as of this writing). Use Part II of each form to report a long-term capital gain from timber held over 1 year. Report the sale of timber held for business use (sec. 631(b)) on Form 4797 and Schedule D, whether you sold it outright (lump-sum) or pay-as-cut. Use Part I of Form 4797 to report a long-term capital gain. If you sell timber outright under sec. 631(b) you also must file Form T, Part II.

**Example 4:** You sold standing timber held as investment for over 1 year for \$8,000, incurring \$800 in sale expenses. Assuming your basis in the timber is zero, your net long-term capital gain is \$7,200 (\$8,000 – \$800). You may need to report the sale on Form 8949 and Schedule D. Use Part II of each form.

**Sale of cut timber.** If you cut your own timber or have it cut by a contractor working at your direction, either for sale or for use in your business (sec. 631(a)), the income is taxed in two parts. If you make an election on Form T, Part II, the difference between the FMV of the standing timber on the first day of your tax year and its basis is taxed as a capital gain. The difference between the proceeds from sale of the wood products and the sum of the FMV of the standing timber and the costs of converting it into products for sale (cutting, hauling, etc.) is ordinary income.

**Example 5:** You paid a contractor \$2,000 to cut standing timber held for business use for over 1 year into logs and sold the cut logs to a mill for \$30,000. The FMV of the standing timber was \$23,000 on Jan. 1 and your basis in it was \$1,000. If you make the sec. 631(a) election on Form T, Part II, you may report a long-term capital gain of \$22,000 (\$23,000 – \$1,000) on Form 4797 and Schedule D, and \$5,000 (\$30,000 – \$23,000 – \$2,000) in ordinary income on Schedule C. If you fail to make the sec. 631(a)

election, all \$27,000 is ordinary income.

For 2011, the maximum rate for long-term capital gains is 15% (0% for amounts which, if added to your ordinary income, fit under the ceiling for the 15% tax bracket: \$34,500 for single taxpayers, \$69,000 for married taxpayers filing jointly).

### Installment Sales

An installment sale involves receiving one or more payments after the year of sale. Interest is charged on deferred payments. The advantage of an installment sale is that it allows you to defer tax by spreading your gain over 2 or more years.

**Example 6:** You sold timber for \$10,000 (\$8,000 after deducting timber depletion and sale expenses) in 2011. The buyer paid you \$5,000 in 2011 and \$5,000 plus interest in 2012. Your gross profit percentage is 80% ( $\$8,000 \div \$10,000$ ). Report a \$4,000 gain for 2011 ( $\$5,000 \times 80\%$ ), using Form 6252.

### Timber Management Expenses

If you hold your woodland for profit you can deduct ordinary and necessary timber management expenses, such as the cost to protect the woodland from insects, disease or fire, control brush, do a precommercial thinning or mid-rotation fertilization, maintain firebreaks, etc. Expenses for woodland held as an investment are subject to a 2% of adjusted gross income reduction on Schedule A, but in years the property produces no income, you may elect to add expenses subject to the 2% reduction to your timber basis and recover them when you sell timber. Deduct expenses for woodland held for business use on Schedule C.

### Reforestation Costs

You may take a tax deduction for reforesting after a harvest or afforesting open land (sec. 194). Costs for both artificial and natural regeneration qualify. You may deduct the first \$10,000 (\$5,000 for married couples filing separately) per year of such expenses per qualified timber property. Any additional amount may be deducted over 84 months (*amortized*).

**Example 7:** You spent \$17,000 to reforest after a harvest. Deduct \$10,000, plus 1/14th of the remaining \$7,000 (\$500) on your 2011 tax return. Deduct 1/7th of the \$7,000 (\$1,000) on your returns for 2012–2017 and the last 1/14th (\$500) on your 2018 return. Elect to amortize on Form 4562, Part VI. If you hold your woodland as an investment, take the deduction as an adjustment to gross income on the front of Form 1040; if you hold your woodland as a business, take it on Form 1040, Schedule C (or F if you qualify as a farmer).

### Depreciation, Bonus Depreciation, and Sec. 179 Expensing

Capital expenditures, such as for logging equipment, bridges, culverts, fences, temporary roads, or the surfaces of permanent roads, may be deducted (*depreciated*) over a set number of years. For example light-duty trucks and logging equipment are depreciated over 5 years. You also may take bonus depreciation equal to 100% of the cost of qualified property placed in service in 2011. If you hold your woodland for business use, you can expense up to \$500,000 in qualifying property (generally tangible personal property, but not improvements to land, buildings, or components of buildings) placed in service in 2011, subject to a \$2 million phase-out and business taxable income limitations (*sec. 179 expensing*).

### Cost-share Payments

If you receive a cost-share payment from an approved program, you may exclude all or part of the payment from your income (sec. 126). Approved federal programs include the Forest Health Protection Program (for southern pine beetle and mountain pine beetle), the Conservation Reserve Program, Environmental Quality Incentives Program, Wildlife Habitat Incentives Program, and Wetlands Reserve Program. Several state programs also are approved. 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 over the last 3 years. You generally may not exclude a payment if the cost can be expensed. Neither can you claim a deduction for an expense reimbursed with a cost-share payment and also exclude the payment from your income.

**Example 8:** You received a \$4,000 cost-share payment from the Conservation Reserve Program for your 100-acre woodland. If you had no income from the property in the last 3 years, you could exclude \$3,275 ( $(\$2.50 \times 100 \text{ acres}) \div 7.63\%$ ). The interest rate is from the Farm Credit System Bank. If you had \$9,600 in income, you could exclude the entire payment:  $(10\% \times (\$9,600 \div 3)) \div 7.63\% = \$4,194 > \$4,000$ . Attach a statement to your tax return describing the cost-share program and your calculations.

### Casualty and Theft Losses

Loss of timber from a casualty—a sudden, unexpected, and unusual event such as a fire or severe storm—may result in a tax deduction. The deduction is limited to the lesser of the decrease in FMV caused by the casualty or your basis in the timber block (the area or unit you use to keep track of your basis in the damaged timber). Similarly, a theft loss deduction is limited to the lesser of the decrease in FMV or your basis in the stolen timber. A competent appraisal usually is required.

**Example 9:** A fire caused \$5,000 in damage to your timber (\$9,000 before-fire FMV – \$4,000 after-fire FMV). Your basis in the affected block is \$2,000. Your loss deduction is the lesser amount, or \$2,000. Report the loss on Form 4684, Section B, and adjust your timber basis (reduce it to zero) on Form T, Part II.

**Example 10:** Continuing with example 9, you sell the damaged timber for \$2,000 in a salvage sale. You have a taxable gain of \$2,000 ( $\$2,000 - \$0$  basis), but you can defer tax on the gain by using it to acquire qualified replacement property (e.g., reforestation) within the allowable replacement period (generally 2 years).

### Filing Form T

You must file Form T, Forest Activities Schedule, if you claim a timber depletion deduction, sell cut products under sec. 631(a), or sell timber held for business use lump-sum (sec. 631(b)).

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