



Timber Taxation

A General Guide for
Forestland Owners

PENNSSTATE



College of Agricultural Sciences
Cooperative Extension

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While enjoying the benefits of woodland stewardship, Pennsylvania forest owners also bear certain social responsibilities. These include protecting water resources, providing goods and amenities for present and future generations, and paying appropriate forest-related taxes. Forest-related taxes come in three forms: annual property taxes, income taxes, and if the value of a gift or bequest is over a certain threshold, gift and estate taxes. This publication discusses income taxes. Forestry taxation is a complicated and somewhat confusing process. An informed landowner who works closely with competent professionals—forester, accountant, lawyer, or other investment advisers—is in the best position to deal with taxes related to forest income.

Even if a woodland is intended to provide only wildlife habitat or a pleasant woodland setting for weekend retreats, a management plan may eventually call for some form of commercial timber harvest. While the income from this sale is subject to income tax, it may be taxable as a long-term capital gain rather than ordinary income. Also, you may be able to deduct management expenses, even during years when no harvesting income is realized.

The laws and regulations pertaining to forestland management and income are complicated. To meet tax obligations, yet legally minimize the tax burden, taxpayers should be familiar with appropriate elements of the federal tax law. The information given in this circular will not enable most landowners to perform their own tax planning and accounting. But if you are a forestland owner, it will introduce you to the complexity of forest taxation and acquaint you with important facts and processes so that you can communicate effectively with your forester and your accountant. More detailed and specific instructions are given in *Forest Owners' Guide to the Federal Income Tax* (see "Further Reading").



Timber as a Capital Asset

Money spent to acquire real estate or equipment or to make improvements that increase the value of real estate or equipment already owned is classified as a capital expenditure. Examples of capital expenditures are purchases of land, timber, and equipment with a useful life of more than one year, expenditures for road and bridge construction,¹ and expenses for tree planting or seeding. Taxpayers cannot deduct capital expenditures from adjusted gross income the year they are incurred. Instead, such costs must be capitalized. Capitalization is the process of recording expenditures in an account and recovering them over the life of the asset or at the time of disposition.

Land, timber, and equipment are the basic capital accounts usually maintained in forest operations. Assets placed in the land account include the land itself, nondepreciable land improvements, and depreciable land improvements. Because neither the land account nor the equipment account has elements unique to forest ownership, this discussion will focus on the timber account.

Timber has had long-term capital gains treatment under the Internal Revenue Code (IRC) since 1944. The Taxpayer Relief Act of 1997 substantially lowered maximum long-term capital gain rates from 28 percent to 20 percent. Under the Act, the rate is scheduled to drop further, to 18 percent for assets purchased and held five years beyond December 31, 2000. There are several major reasons for forestland owners to ensure that their timber sale proceeds qualify for capital gains status:

1. The maximum tax rate for long-term capital gains is only about half the maximum rate for ordinary income (20% versus 39.6%).

¹ The cost of surfacing a permanent road also is a capital expenditure, but the cost of road maintenance can be deducted.

2. If taxpayers have a large capital loss, they can use it to offset a maximum of \$3,000 of ordinary income. However, a large capital loss can be applied against any amount of capital gains.
3. Capital gains are not subject to the 15.3 percent self-employment tax on income realized from a trade or business (12.4% social security tax on income up to \$72,600 for 1999, plus 2.9% medicare tax on all income). Taxpayers who materially participate in their forest enterprise may fall within this circumstance (see page 7).

Federal Tax Form "T"

Record keeping and certain procedures related to timber-account management are necessary components of the timber taxation process. We will set the stage for a more specific discussion of timber taxation by describing the federal tax form that guides most timber taxation record keeping and procedures. Federal Tax Form "T" (Timber), Forest Activities Schedule, provides a convenient format for forestry record keeping. It is organized into nine sections or "schedules."

Form T (Timber) (Rev. March 1996) Department of the Treasury Internal Revenue Service Name(s) as shown on return	Forest Activities Schedules ▶ Attach to your tax return. For tax year ended	OMB No. 1545-0007 Attachment Sequence No. 89 Identifying number
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General Instructions
Section references are to the Internal Revenue Code unless otherwise noted.
Who must file. Complete and attach Form T to your income tax return if you:

- Claim a deduction for depletion of timber.
- Claim a deduction for depreciation of plant and other improvements relating to timber accounts, or
- Elect under section 631(b) to treat the cutting of timber as a sale or exchange.

Generally, you should file Form T to treat the cutting of timber as a sale of timber or if you are involved in other timber transactions.

Complete Form T in accordance with sections 611, 631, and 1221 and related regulations. Complete only Schedules C and F if you are a small-woodlot owner whose only timber-related activity during the year was an isolated sale of timber.

Overview of form. Form T has nine schedules. Use the following rules to determine which schedules to complete:

Schedule A (optional). If you do not file the Schedule A maps with Form T, you must make them available if your return is examined.

Schedule B. Complete for any year you acquire timber, timber cutting contracts, or forest land. Complete Schedule B whether the acquisition is a purchase, exchange, gift, or inheritance.

Schedule C. Complete for any year you sell or exchange timber, timber cutting contracts, or forest land.

Schedule D. Complete if you claim a loss on your income tax return for timber lost due to fire, wind, theft, or other causes.

Schedule E. Complete only if you pay or incur expenses for reforestation of forest land or for timber stand activities. Examples of reforestation expenses are costs for site preparation and for planting or seeding. Capitalized expenditures, such as precommercial thinning and fertilization, are precommercial thinning and fertilization.

Schedule F. Complete for each timber account that has changed in quantity or dollar amount. A timber account may change in quantity or dollar amount as a result of acquisitions, dispositions, the cutting of timber, corrections, additions for growth, and casualty or theft losses. Complete Schedule F to figure depletion for timber cut or the basis for timber sold or lost during the tax year. Also use Schedule F if you treat the cutting of timber as a sale or exchange under section 631(b).

Schedule G. Complete to show changes in ownership of land during the tax year.

Schedule H (optional). Complete if you incur expenses for the building of logging truck roads. If a timber company builds the road but later charges the landowner for the cost, the landowner should complete Schedule H. If you elect not to complete Schedule H, you must make the information available if your return is examined.

Schedule I (optional). Complete if you incur expenses for building drainage structures, such as ditches. If you elect not to complete Schedule I, you must make the information available if your return is examined.

For more information about federal income tax rules and recordkeeping for forestry activities, see **Agriculture Handbook No. 708**, Forest Owners' Guide to the Federal Income Tax. To order this handbook, call 202-512-1800 (not a toll-free number) or write the Superintendent of Documents, U.S. Government Printing Office, Mail Stop SSOP Washington, DC 20402-9328. The handbook costs \$10.00 (subject to change). Its GPO stock number is 001-000-0462-1-7.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is:

Recordkeeping 37 hr., 4 min.
Learning and sending the form to the IRS 35 min.
Preparing and sending the form to the IRS 1 hr., 14 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. See the instructions for the tax return with which this form is filed.

Schedule A Maps (Optional)

1 This schedule consists of a map (or maps) of your timber properties. Whether you file the maps with your income tax return is your option, but you must make them available if your return is examined. Maps of convenient size are desirable, varying in scale from approximately 4 inches to the mile in small tracts to 1/8 inch to the mile in tracts larger than 200,000 acres. The maps should show your name and the tax year. Give standard map symbols in enough detail to show clearly the location of: (a) timber cutting contracts; (b) forest lands acquired separately from the land; (c) forest lands acquired; (d) areas where you cut timber; (e) timber sold or otherwise disposed of under cutting contracts; (f) forest land sold or otherwise disposed of; and (g) forest land sold or otherwise disposed of with the timber cutting rights reserved to you or outstanding in third parties.

Cat. No. 15717G
Form T (Timber) (Rev. 3 98)

Schedule A, Maps

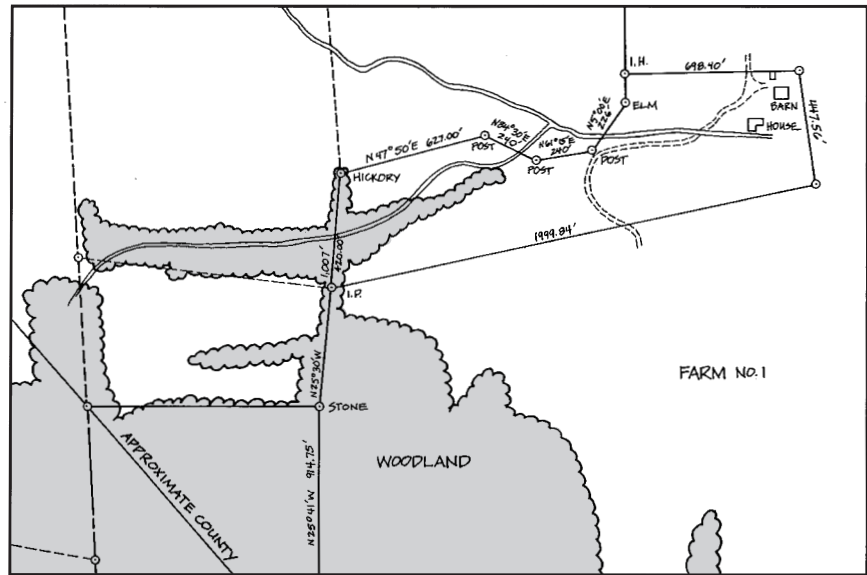
Schedule A consists of a map of the forestland. Although filing the map with the income tax return is optional, the map must be available on examination of the return.

Schedule B, Acquisitions

Purchases of timber, timber-cutting contracts, or forestland should be detailed in Schedule B. This schedule provides a format for recording costs associated with such acquisitions and for allocating total purchase costs to appropriate capital assets. For purchased forest property, the total amount to be allocated is the property's actual cost plus all other acquisition costs. For inherited property, the amount allocated is the fair market value of the asset, usually measured on the decedent's date of death. A gift, however, retains the donor's basis and allocation.

The value allocated to a particular asset category, or account, is the basis, or book value, of that asset. The asset categories included in Schedule B are "forested land," "other unimproved land," "improved land," "merchantable timber," "premerchantable timber," "improvements," and "mineral rights." For purchased or inherited property, amounts are allocated to the respective accounts according to the asset's relative value at the time the property was acquired. A forester or real estate appraiser can be helpful in establishing relative values and determining allocations.

The premerchantable timber account should be maintained as two separate subaccounts: (1) young growth (naturally seeded trees of premerchantable size) and (2) plantation (planted or seeded trees of premerchantable size). The merchantable timber account should contain entries reflecting the timber's volume and value at the time of acquisition. The premerchantable subaccounts should contain entries



reflecting their acreage and your estimate of their contribution to the overall value of the forest property. Keep in a permanent file any supporting documentation, including property maps, timber cruise information, forester's appraisals, and other materials relating to the acquisition and the allocation of basis. Good record keeping simplifies tax reporting and expedites the audit process if the IRS questions a subsequent tax return.

Schedule C, Profit or Loss from Land and Timber Sales

Schedule C is used for recording and reporting all dispositions of timber, timber-cutting contracts, or forestland. The gain or loss from a sale or exchange of timber is equal to the total proceeds reduced by the adjusted basis of the timber sold and by any expenses directly related to the transaction. An example of how a timber sale affects the timber account is presented later.

Schedule D, Losses

If there were losses from fire, insects, wind, or other causes during the tax year and if they were claimed on the income tax return, document the nature and value of the loss in Schedule D.

Schedule E, Reforestation and Timber Stand Activities

Schedule E is used to report expenses for reforestation and timber stand improvement during the tax year. Keep on file the detailed information necessary to support your entries in the schedule and be prepared to make it available upon examination of your return. Report all expenditures that are required to be capitalized and items that you elect to capitalize.

Schedule F, Capital Returnable through Depletion

Use Schedule F to document and calculate adjustments to timber basis due to growth, acquisition, sale, or other changes. The basis of each timber account should be adjusted to reflect growth, harvest, acquisitions, losses claimed, capitalized carrying charges, and new-stand establishment activities. The young growth and plantation subaccounts should be adjusted to reflect capital expenses incurred in connection with preparing a site for natural regeneration or for planting or seeding. Establishment costs include money spent for site preparation, costs of seedlings or seed, costs of mechanical or chemical conditioning of the site, costs of short-life tools (axes, dibbles, etc.), fencing costs, and costs



of labor associated with those treatments. There are significant tax incentives for reforestation, as discussed under “Reforestation Tax Credit and Amortization.” As the trees reflected in the young growth and plantation subaccounts become merchantable, an appropriate amount of basis and timber volume should be transferred to the merchantable timber account. In the absence of additional timberland purchases and regeneration following harvests, the young growth subaccount will eventually be reduced to a zero dollar balance as the trees grow into the merchantable category.

Year-end quantity and basis are calculated in Schedule F, providing you with an adjusted basis and the information needed to calculate the *depletion unit*, or basis per unit of timber volume.

Schedule G, Land Ownership

Changes in the land account due to acquisition or disposal are reported in Schedule G.

Schedule H, Road Construction, and Schedule I, Drainage Structures

Schedules H and I are for reporting activities related to the construction of roads and water-level control devices, respectively.

Annual Deduction of Operating Expenses

Besides understanding Form T requirements, forestland owners should know how tax law affects their treatment of the ordinary and necessary costs of forestland management. These costs may be expensed. Expensing is the recovery of costs by deducting them in full in the year they are paid or incurred. Forest management expenses, property taxes, and interest can be deducted from a landowner’s ordinary income, subject to a system of rules instituted by the 1986 Tax Reform Act. These rules, referred to as *passive loss rules*, were intended to limit taxpayers’ ability to use paper losses from “tax shelters” to offset income from other sources. Passive loss rules apply to individuals, estates, trusts, and some types of corporations. They are confusing and difficult to interpret without the benefit of IRS rulings and case histories. Some background information may clarify the complexities of deducting management expenses.

Categories of Income-Generating Activities

For timber owners subject to passive loss rules, there are three categories of income-generating activities for purposes of deducting expenditures, in-

cluding timber management costs, taxes, and interest (see Table 1):

- *Portfolio* (investment) income is derived from savings accounts, bonds, stocks, and similar investments, including timber held for the production of income but not part of a trade or business. Management expenses associated with portfolio activities are deductible as miscellaneous itemized deductions against income from any source, but only to the extent that they exceed 2 percent of adjusted gross income when combined with all other miscellaneous itemized deductions. Alternatively, taxpayers can capitalize management expenses for recovery when they sell or dispose of the timber (taxpayers cannot capitalize the expenses counted toward the 2 percent floor for miscellaneous itemized deductions; they are lost). Property taxes are fully deductible against income from any source. Interest on indebtedness related to the timber is deductible only to the extent of net investment income.
- *Passive* business income is derived from activities in which the taxpayer does not “materially participate” (defined below) in managing the resources used to produce the income. Examples include income from limited partnerships, some rental properties, and timber that is largely managed by others. Taxes, management expenses, and interest associated with passive activities can only be deducted against passive income.
- *Active* business income is derived from wages, salaries, and other activities in which the taxpayer “materially participates.” Income from timber held as part of a trade or business in which the taxpayer materially participates is active income. Management expenses, taxes, and interest are fully deductible against income from any source.

Table 1. Limitations on deductibility of management expenses, taxes, and interest.

Type of Expense	Method of Holding Property		
	Investment (Portfolio)	Business (Passive)	Business (Active)
Management Expenses	Deductible to the extent they exceed 2% of gross income	Deductible only against passive income	Deductible against income from all sources
Property Tax	Deductible against income from all sources	Deductible only against passive income	Deductible against income from all sources
Interest	Deductible only against interest income	Deductible only against passive income	Deductible against income from all sources

Because only the active income category allows full recovery of all management expenses, a forestland owner usually benefits through material participation in managing the property as a trade or business. Meeting any of several tests of “regular, continuous, and substantial” involvement qualifies a forestland manager as materially participating in managing his or her forestland on a year-to-year basis. The four most applicable tests are:

1. participation in the management and operation of the forestland for more than 500 hours during the year. Most taxpayers will not approach this level of participation.
2. participation in the management and operation of the forestland that constituted substantially all of the participation during the year. In most years, there will be little difficulty meeting this test.
3. participation in the management and operation of the forestland for more than 100 hours during the year, and the participation was greater than that of any other person. Only during particularly active years would most forestland owners meet the 100-hour minimum.
4. material participation in the management and operation of the for-

estland in at least five of the last ten tax years. Under this test, taxpayers can still qualify as materially participating in years they made extensive use of hired contractors or professional foresters.

In each test, participation includes the hours both you and your spouse spent managing and operating the forestland. But participation does not include time spent doing work that is not considered “ordinary and necessary” for timber management in your area. An example might be time spent establishing wildlife food plots (unless the plots contribute toward income earned from a hunting lease). Work done as an investor also is not considered participation—for example, studying and reviewing financial statements, preparing or compiling financial analyses, and monitoring finances or operations in a nonmanagerial capacity.

The greatest uncertainty about the material participation tests is how the IRS will treat participation by forestry contractors and consulting foresters. At least in the early stages of an examination, the IRS may consider that owners who use the services of contractors and consultants do not “materially participate” in the management of their forestland, even if the owners clearly reserve and exercise final authority in making man-

agement decisions. For this reason, it is recommended that you ensure you qualify under the terms of the fourth test described by doing substantially all work required to manage and operate your forestland in years you do not use the services of contractors or consultants.

Expenses Eligible for Deduction

The ordinary and necessary costs of producing a profit (broadly defined to encompass appreciation in tree value) from an “active” timber-growing operation qualify as deductible operating expenses. Examples include salaries and wages, legal fees, business travel, small tools, timber stand maintenance, and consulting fees.

Forms and Record Keeping

Active forestland managers use Schedule C of Form 1040, and farmers list deductions on Schedule F of Form 1040. If you are unable to meet the requirements of active participation, then as an investor you should list expenses as miscellaneous itemized deductions on Schedule A of Form 1040.

It is important to maintain a managerial diary as part of your record keeping. Daily time reports, logs, or similar documents are not required if material participation by “reasonable means” can be established. A managerial diary constitutes a reasonable means if it identifies services performed, records the approximate number of hours you and your spouse spent performing such services, and includes narrative summaries of each service performed. The diary should be supported by receipts, contracts, and maps relevant to the activities. Participating in forest-related organizations such as the Pennsylvania Forestry Association, American Tree Farm System, or Forest Stewardship Program; using a consultant or other professional forester; and having a management plan will also provide evidence of active participation.



Income from Timber Sales

Capital Gains

For most forestland owners, a sale of timber is not a common occurrence. But when a sale does occur, important tax considerations should influence management, record keeping, and reporting. Standing timber held for more than one year is a capital asset, and income generated from its sale is a long-term capital gain. Logs, cordwood, fuel, and other products from felled trees generate ordinary income. As stated earlier, capital gains treatment of your timber sale provides many benefits (see page 4).

Method of Sale

A taxpayer may dispose of timber through one of three sale methods: a lump sum sale, a pay-as-cut sale (Section 631(b) disposal), or treating cutting as sale (Section 631(a) transaction). A lump sum sale transfers title of the standing timber to the purchaser before felling and relieves the seller of any retained economic interest. The income produced by this kind of sale qualifies for capital gains treatment only if the owner is an investor or can demonstrate that he or

she does not hold the timber primarily for sale to customers.

Taxpayers wishing to generate active income must dispose of the timber on a pay-as-cut basis with a retained economic interest, or they must cut the timber themselves and convert it into products for sale to others. In the first method, the timber is sold on a unit basis, and the income qualifies as a long-term capital gain under the provisions of Section 631(b) of the Internal Revenue Code (IRC). Title to the timber transfers at felling. The seller retains an economic interest and bears the risk of loss until the tree is cut. In the second method, timber cut by a landowner qualifies as capital gain under Section 631(a) of the IRC if the owner specifically elects capital gain treatment on an original tax return, timely filed. Selling under either of these provisions allows a landowner to realize capital gains income and to have the income qualify as active business income.

Gain or loss on a sale of timber is determined in the same way as for sale of assets in general. The total proceeds from the sale or exchange are reduced by the basis of the asset and by all expenses directly related to the

sale. Sale expenses may include advertising, timber cruising, marking, and scaling, and the fees of foresters, appraisers, lawyers, or other advisers directly related to the timber sale.

Tables 2 and 3 illustrate the important steps in calculating basis and determining the income from a sale of timber. The values shown in the tables reflect the transactions discussed in the following example:

A taxpayer purchased a 40-acre tract of timberland 11 years ago. The value attributable to the 200 thousand board feet (MBF) of stumpage at \$50 per MBF totaled \$10,000. An additional 10 acres of adjoining forestland with 50 MBF of timber was purchased five years later, with \$3,750 attributable to the timber account. Estimated from forest inventory data collected by a professional forester, timber growth on the properties from date of purchase through last year totaled 50 MBF. Therefore, at the end of last year, the standing timber volume was 300 MBF, the basis in the timber account was \$13,750, and the depletion unit was \$45.83 per MBF (\$13,750 divided by 300 MBF).

For discussion purposes, the timber is grown another year, then harvested on a pay-as-cut basis during the fall (Table 3). As a result of the additional year's growth, the depletion unit rate is reduced to \$44.35 per MBF. The sale, a marked thinning, removes 100 MBF from the 50 acres. The buyer pays the \$200 per MBF he or she had bid for the sale. The sale was conducted by a consulting forester for a 15 percent commission; in addition, the taxpayer incurred another \$500 of direct sale-related expenses. The gross receipts of \$20,000 (100 MBF x \$200/MBF) were reduced by the adjusted basis and the costs of the sale, netting the landowner a \$12,065 return (\$20,000 - [\$44.35/MBF x 100 MBF] - [0.15 x \$20,000] - \$500).

Regardless of how timber is sold, taxpayers can allocate the sale pro-

Table 2. Calculating basis in the timber account.

	<i>Quantity (MBF)</i>	<i>Cost or Other Basis</i>
Timber acquired in year 0	200	\$10,000
Addition for 10 years growth	45	-
Timber acquired in year 5	50	\$3,750
Addition for 5 years growth	5	-
Total available in December of year 10	300	\$13,750
Depletion Unit = (Cost or Other Basis/Quantity)		= \$13,750/300 MBF = \$45.83/MBF

Table 3. Determining gain or loss on a sale of timber (adapted from Form T, Schedule F).

	<i>Quantity (MBF)</i>	<i>Cost or Other Basis</i>
Estimated quantity of timber and amount of capital returnable through depletion at end of the immediately preceding tax year	300	\$13,750
Addition for growth (period covered 1 year)	10	-
Total at end of year, before depletion	310	\$13,750
Unit rate returnable through depletion (\$13,750/310 MBF)	-	\$44.35/MBF
Quantity of timber sold during the year	100	-
Allowable basis of sale (100 MBF x \$44.35/MBF)	-	\$4,435
Total reductions during the year	100	\$4,435
Net quantity and value at the end of the year	210	\$9,315

ceeds and calculate the net return using Form T, Schedule C. Report a long-term capital gain resulting from a lump-sum timber sale on Part II of Form 1040, Schedule D, but report ordinary income on Schedule C or F. Report a long-term capital gain resulting from a Section 631(b) disposal or Section 631(a) transaction on Part I of Form 4797. From there it will be transferred to Form 1040, Schedule D. In a Section 631(a) transaction, report the income that results from converting the standing timber into products on Form 1040, Schedule C.

Miscellaneous Federal Tax Considerations

Reforestation Tax Credit and Amortization

Annually, taxpayers may claim a 10 percent investment tax credit on up to \$10,000 of qualified reforestation expenditures, including costs for site preparation, fencing, herbicides, seeds, seedlings, labor, and tools. The site must be at least one acre, located in the United States, and capable of commercial timber production. On a qualified expenditure of \$10,000,

taxpayers may reduce federal income taxes owed by \$1,000 ($0.10 \times \$10,000$). This is a substantial incentive and should be explored by any forestland owner contemplating harvest and reforestation.

A related tax incentive allows amortization of up to \$10,000 of annual reforestation expenditures over eight tax years. On a qualified expenditure of \$10,000, taxpayers can amortize (deduct from gross income) \$714 ($1/14$) in the year of the expenditure, \$1,429 ($1/7$) in each of the second through the seventh years, and the final \$714 ($1/14$) in the eighth year. This also is a substantial incentive, allowing forestland owners to recover part or all of their reforestation expenditures without having to wait until the timber grows to merchantable size.

If both the investment tax credit and amortization are applied to a single reforestation activity, the amount amortized must be reduced by half of the tax credit taken. On a qualified expenditure of \$10,000, the amount of the tax credit is \$1,000 ($0.10 \times \$10,000$) and the amount amortized is \$9,500 ($\$10,000 - [0.5 \times \$1,000]$). Claim the reforestation tax credit on Form 3468; elect to amortize and claim the deduction on Part VI of Form 4562.

Cost Share Payments and Conservation Reserve Program

The federal government and many state governments offer cost-share programs to pay a part of the cost of managing forestland. Federal cost-share assistance is available for practices to reforest and improve timber stands (under the Forestry Incentive Program), restore lost or degraded wetlands (under the Wetlands Restoration Program), carry out stewardship practices (under the Stewardship Incentives Program), implement environmental conservation practices (under the Environmental Quality Improvement Program), and



develop or improve wildlife habitat (under the Wildlife Habitat Incentive Program).

Under IRC Section 126, a calculated portion of cost-share payments from a qualified program may be excluded from gross income, at the taxpayer's option. The excludable portion does not qualify for the reforestation tax credit and amortization incentives. Only cost-share payments that are included in your gross income and your own out-of-pocket expenses for the practice can be used to calculate these incentives. The decision to exclude payments or to claim the investment tax credit and amortization is influenced by your income and other considerations, and is beyond the scope of this discussion.

Conservation Reserve Program (CRP) payments are not covered by the IRC Section 126 exclusions and must be claimed as ordinary income. At least part of a CRP cost-share payment, however, may be deductible under the provisions of IRC Section 175.

Casualty Loss

To qualify as a recoverable casualty loss, a timber loss must be traceable to a sudden and unexpected event. Examples are fire, high wind, ice, and hail. Insect and drought losses usu-

ally do not result in a casualty, although they may result in a noncasualty business loss deduction. Regulations allow the recovery of losses only up to the basis value of the timber lost, not its fair market value. The amount of loss must be established by a fair and objective procedure; depending on the extent of the loss, the services of a forester may be required to establish this amount. The loss should be claimed as the difference between the basis value and the combined amount you receive or expect to receive from any salvage operation and insurance reimbursement.

Timber Theft

Timber theft is handled in a similar fashion. Regulations allow recovery of up to the basis value. You must report the date the theft was discovered and document that it occurred. Again, a forester can assist in determining the amount and value of theft. Deduct theft losses in the year of discovery and use the adjusted basis value for that year. Report casualty losses and theft on Part B of Form 4684. A loss of personal use property must exceed 10 percent of your adjusted gross income to be deductible; report such losses on Form 1040, Schedule D.

Christmas Tree Production

In general, most Christmas tree producers are subject to the same provisions as timber growers; the sale of rooted trees does not qualify for capital gains treatment. Christmas trees do not qualify for the reforestation tax credit and amortization incentives, but since Christmas tree growing almost always constitutes a business, management expenses, taxes, and interest are fully deductible against income from any source. The sale of Christmas trees is complicated by a 1977 IRS Revenue Ruling. In order to ensure capital gains treatment, producers who sell standing trees to wholesalers should be careful to meet the requirements for a Section 631(b) disposal, while producers who sell cut trees to wholesalers or choose-and-cut trees to individuals should be careful to meet the requirements for a Section 631(a) transaction. Christmas tree production and taxation are different enough from timber management to exclude their further consideration here. Again, however, it is important to recognize that the issues are potentially complex and are likely to warrant the counsel of a tax professional.

Estate Taxation

Another subject beyond the scope of this circular is the federal tax implications of estate planning and management. Forestland owners should develop a comprehensive estate plan that fully considers tax consequences. Your estate-planning team should include your attorney, tax professional, bank trust officer or other fiduciary, and forester.

Summary

The federal tax implications of forestland ownership and management are complex and subject to change. The intent of this circular is not to enable taxpayers to perform their own tax planning, but to increase their awareness of tax considerations so they can be included in forest planning. Potential savings from proper timber and tax management are significant, particularly if commercial timber harvests, management expenses, or reforestation efforts are part of a forest management plan.

Proper tax planning and implementation involve a team effort by you, your forester, and your tax professional. Taxpayers should:

- make certain the forester and the tax professional fully understand the IRS rules applying to timber.
- establish a written forest management plan.
- keep records to the level of detail and for the length of time required.
- enjoy the many benefits accruing from forestland stewardship, and avoid (not evade) paying unnecessary taxes.

Further Reading

Forest Owners' Guide to the Federal Income Tax. 1995. U.S. Department of Agriculture Handbook No. 708. Available from the U.S. Government Bookstore, Atlanta, Georgia. Telephone: (404) 347-1900.

It is also available online at the University of Georgia Extension Web site: www.uga.edu/~soforext/forestmgmt/aghandbook.html (Note: this handbook is in the process of being revised and will be released as *USDA Handbook #718*.)

Timber Tax Management Web Site. www.fnr.purdue.edu/ttax/ This site is maintained cooperatively by the Purdue University Department of Forestry and Natural Resources and the USDA Forest Service.

Estate Planning for Forest Landowners. 1993. USDA Forest Service, Southern Research Station. General Technical Report SO-97. Also available from the U.S. Government Bookstore, Atlanta, Georgia. Telephone: (404) 347-1900.

The following magazines have regular tax-related articles: *Forest Landowner* (published by the Forest Landowner Association, Atlanta, Georgia), *Tree Farmer* (published by the American Forest Foundation, Washington, D.C.), and *National Woodlands* (published by the National Woodland Owners Association, Vienna, Virginia).

 Glossary

Account. A record of all transactions that affect one segment of a business. Examples are a land account, timber account, or equipment account.

Allocation. The process by which the capitalized costs for purchases or improvements are recorded to the appropriate capital account. For instance, if a 20-acre tract of land and timber was purchased for \$20,000, and the land and timber each accounted for \$500 per acre of the purchase, then \$10,000 is allocated to each account.

Amortization. The process by which the basis of certain assets, such as qualifying reforestation expenditures, is recovered through deductions over a specified period of time.

Basis. In general, the amount invested in a capital asset acquired by purchase. The basis of property acquired by other means is determined by the method of acquisition; see page 9 for how to determine the basis of an asset acquired by gift or inheritance.

Capital gain or loss. The net income realized on the sale or exchange of a capital asset, such as land, timber, buildings, or equipment. A capital gain is treated differently for income tax purposes from ordinary income or the profit realized from the operation of a business.

Capitalization. The process of adding the cost of acquiring a capital asset to a capital account. Depending on the nature of the asset, the capitalized amount may be recoverable through depreciation, depletion, amortization, or only through sale or exchange.

Cruise. The process by which the volume, type, and quality of timber within a designated area is determined. A cruise can be made by measuring each tree in the area—referred to as a timber inventory—or only those trees selected in a statistically based sampling system.

Depletion. The using up or wasting away of a natural resource. In the case of timber, depletion is the recovery of the owner's basis in timber and applies when the timber is harvested and the products cut from the timber are sold or used in the owner's business.

Depreciation. The process by which the basis of a capital asset with a determinable useful life is recovered as the asset is used for the production of income. Capital assets associated with forest ownership whose basis is recoverable through depreciation include equipment, buildings, fences, temporary roads, and the surfaces of permanent roads.

Expensing. Also called deducting; the recovery of an expense by subtracting it from taxable income in the year it is paid or incurred.

Fair market value. The price at which property, timber for example, would change hands in a transaction between a willing, informed buyer and a willing, informed seller. In a Section 631(a) transaction the timber or other asset must be valued as it existed on the first day of the owner's tax year, regardless of any changes that subsequently happen to it or to the market.