



## Tax Tips for Forest Landowners for the 2010 Tax Year

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This bulletin provides tax tips for woodland owners and their tax advisors in the preparation of the 2010 individual tax return. It is current as of September 15, 2010, and supersedes Management Bulletin R8-MB 134. Please be aware that the information presented here is not legal or accounting advice. Consult your legal and tax advisors for more complete information.

### Timber as Personal, Investment or Business Property

The tax rules vary depending on whether your woodland is personal, income-producing (investment), or business property. You must make this determination for your holding each tax year. If you do not have a profit motive, your timber may be personal property, which provides limited opportunities for deductions. If you have a clear profit motive, your property may be an investment property, or it may be business property if your management activity is more regular, frequent, and intensive than required for an investment. A written management plan is one of the best places to document a profit motive. For a timber held as a business, you also must determine whether you materially participate in its operation, in order to establish whether you face restrictions (called *passive loss restrictions*) on the deduction of business losses. The tests for material participation are based on factors including the number of hours of your participation.

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

**Example 2:** You manage your timber as the sole proprietor of a business. You keep business records, including the number of hours of your participation in the business to establish that you materially participate in its operation. Your woodland is business property for tax purposes.

### Timber Sales

The net sale amount, not the gross proceeds from a sale, is taxed. You may deduct depletion (see below) and expenses from the sale. Report the sale of timber held as an investment on Schedule D, as a long-term capital gain if you owned the timber more than 1 year or a short-term capital gain if not. Report the sale of timber held as a business on Form 4797 and Schedule D, whether you sold it outright (lump-sum) or pay-as-cut (sec. 631(b)).

**Example 3:** You sold for \$8,000 standing timber held as investment more than 1 year and incurred \$800 in sales expenses. Assuming your basis in the timber (see below) is zero your net taxable amount from the sale is \$7,200 (\$8,000 - \$800), which you

report on Schedule D. If you held the timber as a business, you would report the sale on Form 4797 and Schedule D.

Income from sale of *cut* (vs. *standing*) timber is taxed in two parts. The difference between the fair market value (FMV) of the standing timber on the first day of your tax year and your basis in it is taxed as a capital gain (to qualify as a long-term capital gain you must have held the timber more than 1 year before cutting it for use in your business). The difference between the proceeds from the sale of the cut products and the sum of the FMV of the standing timber and the cost of converting it into products for sale is taxed as ordinary income (sec. 631(a)).

**Example 4:** You paid a contractor \$2,000 to cut standing timber you had held more than 1 year into logs, then sold the 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. Make a sec. 631(a) election on Form T, Part II. Then report a \$22,000 long-term capital gain (\$23,000 - \$1,000) on Form 4797, and \$5,000 in ordinary income (\$30,000 - 23,000 - \$2,000) on Schedule C.

For 2010, the maximum rate for long-term capital gains is 15%, or 0% for amounts that fit under the ceiling for the 15% tax bracket if added to your ordinary income (\$34,000 for single taxpayers, \$68,000 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 5:** You sold timber for \$10,000 (\$8,000 after deducting depletion and sales expenses) in 2010. The buyer paid you \$5,000 in 2010 and \$5,000 plus interest in 2011. Your gross profit percentage is 80% ( $\$8,000 \div \$10,000$ ). Report only a \$4,000 gain for 2010 ( $\$5,000 \times 80\%$ ), using Form 6252.

### Timber Basis and Depletion

Your basis in purchased timber is the total cost of acquisition (e.g., purchase price, survey, legal fees). Your basis in inherited timber is its FMV on the date of death, but your basis in gifted timber is the lesser 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 kept in 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 against the potential tax savings.

**Example 6:** In 2010 you bought a deed to 1,000 MBF of timber for a total cost of \$212,000. Your basis in the timber is \$212,000, even though your forester estimates its FMV is \$220,000.

If you have a timber sale or a casualty loss, you can take a deduction against your timber basis. To calculate your depletion deduction for a sale, divide your basis by the total volume of timber (the *depletion unit*) then multiply by the number of units sold.

**Example 7:** Continuing with example 6, you immediately sold 200 MBF of timber for \$220/MBF. Your depletion unit is \$212/MBF ( $\$212,000 \div 1,000 \text{ MBF}$ ) and your depletion is \$42,400 ( $\$212 \times 200 \text{ MBF}$ ).

### Timber Management Expenses

If you have a profit motive for your woodland, you can deduct ordinary and necessary timber management expenses, such as costs incurred to protect the woodland from insects, disease or fire, control brush, or do a precommercial thinning or mid-rotation fertilization. Management expenses for property held as an investment are subject to a 2% of adjusted gross income (AGI) reduction on Schedule A. In contrast, expenses for business property may be deducted in full on Schedule C. You may add to your timber basis expenses subject to the 2% AGI reduction and recover them when you sell the timber.

### Reforestation Costs

Sec. 194 allows tax deductions for the cost of reforesting your woodland following a harvest or afforesting open land. 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 (*amortized*) over 84 months. Costs for both artificial and natural regeneration qualify.

**Example 8:** You spend \$7,000 to reforest your woodland following a harvest. If you hold the woodland as an investment, deduct the full amount as an adjustment to gross income on the front of Form 1040; if you hold it as business property, deduct it on Form 1040, Schedule C or F (if you qualify as a farmer; see below).

**Example 9:** You spent \$17,000 to reforest your property. Deduct \$10,000 plus 1/14th of the remaining \$7,000 (\$500) in 2010. Deduct 1/7th of the \$7,000 (\$1,000) in years 2011 through 2016, and the last 1/14th (\$500) in 2017. Report the amortization deductions on Form 4562, Part VI.

### Depreciation, Bonus Depreciation, and First-Year Expensing

Capital expenditures such as those for logging equipment, bridges, culverts, fences, temporary roads, or the surfaces of permanent roads may be deducted (*depreciated*) over the property's useful life. For example light-duty trucks and logging equipment are depreciated over 5 years. You also may take bonus depreciation equal to 50% of the cost of property purchased and placed in service in 2010. If you purchased qualifying property (generally tangible personal property, but not improvements to land, buildings, or components of buildings) for your forest business in 2010, you can elect to expense up to \$250,000, subject to phase-out and business taxable income limitations (*first-year expensing*).

### Cost-share Payments

Sec. 126 allows recipients of payments from approved public cost-share programs to exclude all or part of the payments from their income. Approved federal programs include the Forest Health Protection Program (e.g., the southern pine beetle and mountain

pine beetle cost-shares), the Conservation Reserve Program, Environmental Quality Incentives Program, Wildlife Habitat Incentives Program, and Wetlands Reserve Program. Approved state programs also qualify. The excludable amount is the present value of the greater of \$2.50 per acre or 10% of the average annual income from the property over the last 3 years. You generally cannot claim an exclusion if the cost may be expensed. You also may not claim a deduction for an expenditure reimbursed with the cost share and at the same time exclude the cost share from your income.

**Example 10:** You received a \$4,000 cost-share from the Conservation Reserve Program for your 100-acre woodland. Assuming no income from the property in the last 3 years, you can 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 income from the property, you could exclude the entire cost-share:  $(10\% \times (\$9,600 \div 3)) \div 7.63\% = \$4,194 > \$4,000$ . Attach a statement to your tax return describing the cost-share program and your calculations.

### Casualty and Theft Losses

The loss of timber from a casualty—a sudden, unexpected, and unusual event such as a fire or 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 timber that was damaged). 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 11:** 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 12:** Continuing with example 11, you sold 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 depletion deduction, sell cut products under sec. 631(a), or have a lump-sum sale of timber held as business property (sec. 631(b)).

### Schedules C and F

Taxpayers in the trade or business of farming (e.g., crops, dairy, or livestock) file Schedule F. Woodland business owners also file Schedule F if their timber ownership is incidental to a farming operation; otherwise, they should use Schedule C.

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