REFORESTATION EXPENSE AND TAXES

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Standing Timber is a Capital Asset

- Investment must be capitalized
- Recovered when asset is sold or claimed as a loss
- Or recovered through special tax rules
Capitalization

- Expenses recorded in reforestation account
- Which is a Subaccount for the Timber account
- Transferred to Merchantable timber account before timber sale with volume info added
- Adjustments made to basis account as needed
- Appropriate amount of basis is subtracted from sales proceeds, along with sales expenses, to determine net taxable gain (profit)
Reforestation Expenses

- Direct costs incurred for reforestation by planting or artificial or natural seeding.
- Does not include owner’s labor unless they pay themselves a salary and report and tax as income, including SE tax.
- Depreciation of equipment rules apply.
Section 194

- Only applies to commercial timber production!
- No orchards
- No Christmas trees
- No wildlife plantings
- No conservation plantings
Capitalization Example

- In 2008, Mike and Linda pay for herbicide application for 100 acres at a cost of $95/acre. After browning, the tract is burned at a cost of $25/acre.
- Total costs in 2008: $12,000
- The property is planted in 2009 at a cost of $75/acre including the cost of seedlings.
- Total costs in 2009: $7,500
## Reforestation Subaccount in the Timber Account

<table>
<thead>
<tr>
<th>Date</th>
<th>Activity</th>
<th>Acres</th>
<th>Cost</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>7/5/08</td>
<td>Herbicide application</td>
<td>100</td>
<td>$9,500</td>
<td>$9,500</td>
</tr>
<tr>
<td></td>
<td>A-1 Forestry Service</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>8/31/08</td>
<td>Site Preparation Burning</td>
<td>100</td>
<td>$2,500</td>
<td>$12,000</td>
</tr>
<tr>
<td></td>
<td>A-1 Forestry Service</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1/9/09</td>
<td>Plant improved loblolly</td>
<td>100</td>
<td>$7,500</td>
<td>$19,500</td>
</tr>
<tr>
<td></td>
<td>A-1 Forestry Service</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Basis Upkeep

- Prior to thinning or timber sale—reforestation account renamed as merchantable timber account
- Volumes typically estimated by timber cruise
- Any undeducted expenses should be added into the basis account in the year of occurrence
- When basis is updated to reflect volumes or added costs or depletion of basis, it is called an adjusted basis
Internal Revenue Code Section 194-Recovery of Reforestation Expenses

- Applies for costs incurred after October 22, 2004
- Deduction of first $10,000 in expenses for each Qualified Timber Property
- Amortization of remainder
- Must elect special treatment
The term “qualified timber property” means a woodlot or other site located in the United States which will contain trees in significant commercial quantities and which is held by the taxpayer for the planting, cultivating, caring for, and cutting of trees for sale or use in the commercial production of timber products.
What is a Qualified Timber Property?

- Determined by how basis records are kept
- Tract
- Stand
- Multiple tracts
Election Options

- Form T: Reforestation and Timber Stand Activities

  or

- Attached statement
## Part IV: Reforestation and Timber Stand Activities (see instructions)

<table>
<thead>
<tr>
<th>Account, block, tract, area, or stand ID for each Qualified Timber Property (QTP)</th>
<th>Kind of activity (burning, chopping, spraying, planting, seeding, thinning, pruning, fertilizing, etc.)</th>
<th>Number of acres treated</th>
<th>Total expenditures</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Total</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Total reforestation expenses</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4a</td>
<td>Amount to be expensed under section 194(b). (See instructions for limitations)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>b</td>
<td>Amount to be amortized under IRC 194(a), including remaining reforestation expenditures not expensed under section 194(b)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Eligibility for Initial Deduction

- Individuals, partnerships, corporations eligible for initial deduction
- Trusts are ineligible for initial deduction
  - (This means irrevocable trusts, not revocable trusts where the trust grantor still has control, e.g. pass through trusts)
Section 194-Joint Ownership

- Limits to deduction are applied at the partnership level and then at the individual level.
- e.g., Jointly owned property gets only one $10,000 initial deduction on the same qualified timber property.
Initial Deduction for Investors

- Adjustment to income on front of Form 1040
- Write in RFST and amount
- Do not take as miscellaneous itemized deduction
- Elect on Form T: Part IV or attach statement
Initial Deduction for Business

- Schedule C (or appropriate form for business structure)
- Other Expenses—write in RFST
- Form T: Part IV Reforestation and Timber Stand Activities
After the Initial Deduction

- If reforestation costs over $10,000 for the year, amortize the remainder over 84 months
Year-by-Year amortization

- 1st year--1/14th of basis
- 2nd year--1/7th of basis
- 3rd year--1/7th of basis
- 4th year--1/7th of basis
- 5th year--1/7th of basis
- 6th year--1/7th of basis
- 7th year--1/7th of basis
- 8th year--1/14th of basis
Eligibility for Amortization

- Individuals, partnerships, corporations, and estates are eligible for amortization.
- Trusts are eligible for amortization, but not for the initial deduction.
- Option to just amortize and not use initial deduction.
Form for Amortization

- Form 4562, Part VI: Amortization
- Include on Form T: Part IV
- Add to the initial deduction and report on 1040, etc. as indicated in previous charts
Example-Initial Deduction

- Red Birch site prepared 120 acres of land for a cost of $19,500 in 2007.
- She takes an initial deduction of $10,000 as an adjustment to income on the front of the 1040.
Example: Red Birch, Part II

- The remaining $9,500 is amortized and deducted over 84 months.
- This deduction is also taken on the front of the 1040 as an adjustment to gross income, since Red is an investor.
Year-by-Year amortization

- 1st year--1/14th of basis $ 679
- 2nd year--1/7th of basis 1,357
- 3rd year--1/7th of basis 1,357
- 4th year--1/7th of basis 1,357
- 5th year--1/7th of basis 1,357
- 6th year--1/7th of basis 1,357
- 7th year--1/7th of basis 1,357
- 8th year--1/14th of basis 679
Information required for election

- Account, block, tract, area, or stand identification number for each qualified timber property (QTP)
- The kind of activity (burning, chopping, spraying, planting, seeding, thinning, pruning, fertilizing, etc.);
- The number of acres treated;
- The total expenditures
I elect to expense and amortize qualified reforestation expenses of $29,500 incurred in 2007 as allowed under Section 194 of the Internal Revenue Code for site preparation of 120 acres (QTP known as Brown Home Place) in Hoover County, MS on August 4-10, 2007. Red Birch
Reforestation Amortization

- Taxpayer must elect to amortize in year expense incurred
- Cannot elect to amortize on an amended return unless made within 6 months of a timely return
Where to File Amortization

- First, enter on Form 4562, Depreciation and Amortization
- Attach Form T: Part IV, Reforestation and Timber Stand Activities
- Investors may use a statement to elect to amortize
- Then use the chart as guideline
(d) Life tenant and remainderman In the case of property held by one person for life with remainder to another person, the deduction under this section shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant.
Cost Share Payments
Approved Cost-Share Programs

- Conservation Reserve Program (CRP)
- Environmental Quality Incentives Program (EQIP)
- Wetland Reserve Program (WRP)
- Wildlife Habitat Incentive Program (WHIP)
- Forest Health Protection Cost Share
- Conservation Security Program
What Changes with Cost-Share?

- You must report cost-share as income
- You receive a 1099
- You must pay tax on cost-share unless you ELECT to exclude it
Cost-Share & Deduction & Amortization

- Pay tax on cost-share—take initial deduction & amortization on full costs
- Exclude cost-share--only take initial deduction & amortization on out-of-pocket costs
Why Exclude?

- Expenses over $10,000 per qualified timber property
- For property held in trust, which cannot take the initial $10,000 deduction
Why Not Exclude?

- If you can deduct total expense as above the line deduction, the net result is the same as exclusion and is less effort.
- You CANNOT exclude cost share for any practice which is not a capital expense.
Cost-Share Test for Exclusion

- You cannot exclude cost-share payments for practices that would normally be deducted annually. This includes hazard reduction burning, timber stand improvement.
How Can I Elect to Exclude?

- With an election statement proving what you can exclude
- Based on one of two formulas
- Made in the year of payment
Figuring Exclusion Amount

- Formulas used to figure exclusion
- Alternative rate of return from investment
- Average income from the property for the past three years—timber sales, hay, crop, hunting lease, etc.
Cost-Share Income Exclusion

- IRS regulations limit the amount of cost-share payment that may be excluded to the greater of
  - The present value (PV) of the right to receive $2.50 per acre; or
Cost share exclusion

- Only available for reforestation since that is a capital expense
- Not available for any practice deducted as ordinary operating expense
- If exclusion is selected, then only out-of-pocket reforestation expense can be treated under special rules of IRC and deducted with initial deduction and amortization
Cost-Share Income Exclusion

The present value of 10 percent of the previous three year's average income from the reforested area

\[ PV = \frac{0.10(\text{total income from last 3 years divided by 3})}{\text{appropriate interest rate}} \]
Interest Rate

- IRS rules for estate valuation uses Farm Credit Bank Interest Rate
- IRC Section 2032A(e)(7)(A)
- Can use other rates
  - Home mortgage rate
  - Personal savings rate
  - Mutual fund return
$500 per acre was harvested from the reforested acre over the last three years. 5.73 percent is an appropriate interest rate.

Option a): $2.50 = \frac{\text{PV}}{0.0573} = 43.63$

Option b): $0.10 \left(\frac{500}{3}\right) = 290.87/\text{ac}$
Cost-Share Exclusion Form

- Create a 3-P “plain paper form”
- I, taxpayer, received a cost-share payment of $3,000 under the EQIP Program on January 13, 2008. I elect to exclude the entire amount from my income as allowed under Section 126. I determined that I was able to exclude up to $290.87/acre by the following method:
Option b): $PV = \frac{.10 (\$500/3)}{.0573} = 290.87/\text{ac}$

I received $500 per acre from a timber sale in 2007. I used the 5.73% discount rate because that is the Federal Land Bank special use value farm rate for my district for 2007.
Cost Share

- Governmental programs to assume part of the cost of reforestation since tree planting provides social benefits
- This is not the rental payments from CRP or WRP