

Tax Tips for Forest Landowners for the 2015 Tax Year

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Federal income tax laws can influence a private woodland owner's financial decisions about land management. Yet, special favorable tax provisions on timber that are intended to encourage private forest management and stewardship are commonly unknown. To help woodland owners in filing their 2015 tax returns, this publication explains the federal income tax laws on timber. The information is not legal or accounting advice. It is current as of September 30, 2015.

Timber Property Classifications

For tax purposes, a woodland property may be classified as an investment, business or personal-use property. Tax deductions and losses that are allowed for investment or business properties may be limited or denied for personal-use property. So the classification is important in that the tax treatment on each type of property differs widely. If your primary purpose of owning land is for personal enjoyment (such as fishing and family retreat), your property may be taxed as personal-use property. In contrast, if your primary purpose of land ownership is for making a profit from growing timber, your timber may be taxed as an investment property or a business when such profit-seeking timber activities are more regular, active and continuous than an investment. Which status applies depends on the specifics of each case. The IRS presumes a profit motive if profit is realized in at least 3 of the past 5 years. Such profit, however, includes expectation of future profit from the appreciation of asset.

Example 1: Mr. Smith sold timber for \$20,000 profits in 2015. He replanted the land with loblolly pines. He treats his woodland property as an investment.

Basis and Depletion Deduction

Timber basis. Basis is the cost of the timber to the owner. You may deduct it from timber sales, which reduces the tax due on the sales. To establish the timber basis, find out how the property was acquired. For purchased property, the timber basis is the amount you paid for it. For inherited property, the basis of timber is its fair market value (FMV) on the decedent's date of death. If you receive the timber as a gift, the timber basis is the lower of its FMV or the donor's basis.

Example 2: Mrs. Anderson inherited forest land a year ago but didn't establish the timber basis. A consulting forester provided a retroactive professional appraisal on her timber value on the date of the decedent's death, which established her timber basis.

Depletion. Depletion is a deduction against timber sale.

Example 3: Mrs. Anderson sold 600 cords of pulpwood. She

took depletion deduction of \$6,000 (\$10,000 of total timber basis ÷ 1,000 cords of total volume x 600 cords of timber sold).

Timber Sales

Sale of standing timber. Sales of standing timber held as an investment for more than 1 year qualify for long-term capital gain, which is taxed at advantageous lower tax rates than ordinary income. Sale of inherited timber is considered long-term. Report the sale of standing timber held as an investment on Form 8949 and Schedule D.

Both outright sales and pay-as-cut sales of standing timber by a business qualify for long-term capital gain (Sec. 1231 gain) after the timber has been held for more than 1 year. Report the sale of standing timber held for business use on Form 4797 and Schedule D. If you sell timber outright in a business, you also are required to file Form T unless you only have an occasional timber sale (see "Filing Form T" below).

Example 4: Your consulting forester advised an improvement cutting and estimated that there were 800 cords that should be sold. The highest bid was \$30/cord. You signed the contract for sale of standing timber owned as an investment. You report a capital-gain on Schedule D and Form 8949.

Sale of products cut from timber held for use in a business. 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, the gains are ordinary income unless you elect to use sec. 631(a) on Form T, Part II.

Example 5: You paid a contractor \$2,000 to cut standing timber held for business use for over 1 year into logs and you 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 elect to use sec. 631(a) on Form T, report a \$22,000 long-term capital gain (\$23,000 FMV - \$1,000 basis) on Form 4797 and Schedule D, and \$5,000 of ordinary income (\$30,000 sale price - \$23,000 FMV - \$2,000 contractor fee) on Schedule C. If you fail to make the election, all \$27,000 profit is ordinary income.

Net Investment Income Tax

For taxpayers meeting income threshold, investment timber sales and passive business timber sales are subject to a 3.8 percent net investment income tax, effective January 1, 2013. This 3.8 percent tax, enacted as part of the 2010 healthcare reform law, applies *only* to single taxpayers with adjusted gross income ("AGI") over \$200,000 or couples with over \$250,000 AGI. "Material participants" in timber business are not subject to this tax.



Example 6: Husband and wife's adjusted gross income is \$260,000, including a \$50,000 capital gain from their investment timber sale. The timber gains of \$10,000 (the lesser of the excess of their adjusted income of \$260,000 over the \$250,000 threshold or the capital gains of \$50,000) are subject to the 3.8 percent tax (\$380 tax), in addition to the capital gain tax on the sale.

Installment Sales

An installment sale involves receiving one or more payments after the year of sale, allowing you to defer tax by spreading your gain over 2 or more years. Interest is charged on deferred payments.

Example 7: You sold timber for \$10,000 (\$8,000 after deducting timber depletion and sale expenses) in 2015. Your *gross profit percentage* is 80 percent ($\$8,000 \div \$10,000$). The buyer paid you \$5,000 in 2015 and will pay the remaining \$5,000, plus interest, in 2016. Report a \$4,000 gain ($\$5,000 \times 80\%$) for 2015, using Form 6252.

Timber Management Expenses

Timber management expenses may include fees to a consulting forester; cost for competition control; the expense for insects, disease and fire control; pre-commercial thinning or firebreak maintenance. Investment timber owners may deduct expenses on Schedule A, but they are subject to a 2 percent of adjusted gross income reduction. Business timber owners who are "materially participants" deduct them in full on Schedule C. Property taxes are deductible.

Reforestation Costs

Taxpayers (except trusts) may deduct up to \$10,000 (\$5,000 for married couples filing separately) per year of reforestation costs per *qualified timber property* (QTP). Any amount over \$10,000 per year per QTP may be deducted over 84 months (*amortized*). Trusts are eligible for amortization deduction. Qualifying costs include the direct costs to plant or replant a stand including natural regeneration.

Example 8: You spent \$17,000 to reforest after a harvest. Deduct \$10,000, plus 1/14th of the remaining \$7,000 (\$500) on your 2015 tax return. Deduct 1/7th of the \$7,000 (\$1,000) on your returns for 2016–2021 and the last 1/14th (\$500) on your 2022 return. If you qualify as an investor, take the \$10,000 deduction as an adjustment to gross income on the front of Form 1040; if you hold your forest land for business use, take it on Schedule C. Elect to amortize and take amortization deductions on Form 4562, Part VI.

Depreciation and Sec. 179 Expensing

Depreciation is a tax deduction that is based on the cost (basis) of assets used, such as those for machinery, computers, cars, vans, logging equipment, bridges, culverts, fences, temporary roads or the surfaces of permanent roads. For example, light-duty truck and logging equipment are depreciated over 5 years.

Also, business taxpayers may deduct up to \$25,000 in the first year in qualifying property in 2015, subject to a \$200,000 phase-out and business taxable income limitation (sec. 179 expensing). Land is not depreciable.

Cost-share Payments

If you receive a cost-share payment from a qualified government program, you may exclude part or all of the payment from your income if the cost share is used in capital expenditure. Otherwise, it is ordinary income. Qualified federal programs include the Forest Health Protection Program (for southern pine beetle and mountain pine beetle), Conservation Reserve Program, Environmental Quality Incentives Program, Wildlife Habitat Incentives Program, and Wetlands Reserve Program (discontinued Feb. 7, 2014). Several state programs also qualify for exclusion. The excludable amount is the *present value* of the greater of \$2.50 per acre or 10 percent of the average annual income from the affected acres over the last 3 years.

Example 9: You received a \$3,900 cost-share payment from the Conservation Reserve Program and used it as capital expenditure for your 100-acre woodland. If you had no income from the property in the last 3 years, you could exclude up to \$4,798 ($(\$2.50 \times 100 \text{ acres}) \div 5.21\%$). The interest rate is from the Farm Credit System Bank. If you had \$6,600 of income from the property, you could exclude the entire payment: $(10\% \times (\$6,600 \div 3)) \div 5.21\% = \$4,222 > \$3,900$. Attach a statement to your tax return describing the program and your calculations.

Timber Casualty and Theft Losses

Loss of timber from a casualty—a sudden, unexpected and unusual event such as a fire or severe storm—may be deductible from your taxes. The deduction is the *lesser* of the decrease in FMV caused by the casualty or your basis in the timber block (the area you use to keep track of your basis). 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.

Filing Form T (Timber)

You must file Form T (Timber), *Forest Activities Schedule*, if you claim a timber depletion deduction, sell cut products in a business (under sec. 631(a)), or sell outright timber held for business use. However, there is an exception for owners who only have an occasional timber sale, defined as one or two sales every 3 or 4 years.

Conservation Easement

You may take a deduction on qualified donation of conservation easement in 2015. *Absent of new legislation extending the enhanced incentives*, the deduction is up to 30 percent (vs. 50 percent or 100 percent if qualified by the enhanced provision from 2006 to 2014) of the taxpayer's AGI in a year. Any excess donation over the 30 percent limit may be carried forward to the next 5 years.